



The Michigan Business Law

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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 deadlines for submitting articles are as follows:

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MISSION STATEMENT

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

To fulfill this mission, the Section shall: (1) 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 Christopher P. Yates



The State of Michigan's Business Courts

Michigan's business courts have followed a popular trend in commercial litigation. The business-court experiment in Michigan began with pilot projects in 2011, which were replaced with a statutory scheme enacted in

2012 that mandated specialized business dockets across the state in circuit courts with three or more circuit judges beginning on January 1, 2013. Now, after a decade of experience with business courts in Michigan, we can take stock of the experiment's successes and challenges.

Without question, business courts have enabled judges to focus more effectively on the large commercial cases filed in Michigan's state-court system. The circuits with business-court judges have seen dramatic improvements in the time and expenses required to resolve complex commercial disputes. In addition, those commercial dockets have allowed judges to deal with emergency matters, such as motions for temporary restraining orders and preliminary injunctions, with alacrity.

But business-court judges who also handle dockets that include criminal matters or noncommercial civil litigation have often been forced to put commercial cases on the back burner in order to address higher-priority demands in their noncommercial cases. In addition, judges in business courts initially received substantial training, but the training programs for business-court judges in Michigan have waned in recent years even though new business-court judges recently have been appointed in many circuits.

Business courts exist in a competitive environment, where sophisticated commercial litigators can choose federal courts, arbitration, or other dispute-resolution mechanisms instead of Michigan business courts. Accordingly, our state and our Section have an obligation to make business courts as efficient and effective as possible in order maintain their viability. Thanks in large part to the tireless work of Doug Toering, our Section is developing a comprehensive plan to assist the business courts in their efforts.

The Section's Business Courts Committee is working on proposed amendments to the statutory jurisdiction of the Michigan business courts to ensure that commercial litigation appropriate for business courts winds up in front of business-court judges, while litigation that does not fit the business-court model is kept out of the business courts. Jurisdictional changes were made by our Legislature in 2017 at the behest of our Section, and we are confident that the Legislature will look favorably upon the modest changes that we intend to propose soon.

Beyond that, the Business Courts Committee is working closely with business-court judges to design and present more training programs, eventually hosting quarterly conferences aimed at providing business-court judges with the training that they need to handle their dockets in the most efficient and effective manner. Additionally, at the request of business-court judges, the Business Courts Committee had begun the process of setting up a Listserv for all Michigan business-court judges through the State Bar of Michigan.

Finally, the Business Courts Committee has started discussing how best to ensure that business-court judges can devote the time and attention necessary to handle emergency matters in commercial litigation as quickly as the emergencies require. Although we recognize that each trial court must decide for itself how best to allocate its judicial resources, we hope to convince the trial courts with busy commercial dockets to free up their business-court judges to work on their commercial dockets without undue interference from noncommercial cases.

I am proud to have spent more than a decade piloting and then running the specialized business docket in the Kent County Circuit Court. Now, as a member of the Michigan Court of Appeals, I am simply an observer and a supporter of Michigan's business courts, but I remain committed to the business-court experiment in Michigan. I hope that you will enthusiastically join me and the members of our Section's Business Courts Committee in offering our assistance whenever and wherever possible to Michigan's business courts. The business courts have become a valuable resource for businesses and commercial litigators alike. Let's do all that we can to make sure this experiment succeeds.

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New Corporations Division System Coming Soon

The Corporations, Securities & Commercial Licensing Bureau's Corporations Division is gearing up for an exciting launch in the summer of 2024. This eagerly awaited launch introduces the MiBusiness Registry Portal, a cutting-edge software program and online filing system. The new system is poised to significantly enhance the Corporations Division's filing procedures while introducing a host of online functionalities, all designed to better serve the needs of the business community.

The selection of this system was based on its proven success in other states, making it a great fit that brings a multitude of benefits and broadens the spectrum of services accessible to the public. Developed by Tecuity, this advanced system has recently been successfully implemented in California and Pennsylvania, further underscoring its reliability and effectiveness.

The portal represents a significant advancement for businesses, enabling them to seamlessly submit a broader range of documents and annual filings online, facilitate electronic payment of filing fees, and conveniently order certificates and certified copies through online channels. This expansion in online submission capabilities promises to substantially diminish the volume of paperwork and manual check processing traditionally handled by the Division. Consequently, this streamlining of processes will lead to faster results for both business entities and valued customers.

The new portal introduces enhanced security measures. To access the system for the first time, users are required to create an account when submitting a document or placing an order. Once an account is established and users connect themselves to an entity, subsequent logins grant them access to view and take actions for any of the entities they are affiliated with, which streamlines their interactions within the system.

The upcoming system will introduce a convenient feature that en-

ables users to attach documents to online forms. In the existing system, if you wish to include specific provisions in the Articles of Organization while completing them online, you must type or manually copy and paste the required language into the online form. However, with the forthcoming system, users will have the capability to directly attach a document containing the necessary language, simplifying and streamlining the process.

The new system will usher in a modern era for the Corporations Division, enhancing its core functions and elevating its capabilities, ultimately resulting in improved customer service.



Alexis Lupo is the Corporations Division Director; Michigan Department of Licensing & Regulatory Affairs; Corporations, Securities & Commercial Licensing Bureau. As Corporations Division Director with the State of Michigan, Ms. Lupo oversees the review and filing of business entity documents for the formation, continuation, and growth of corporations, limited liability companies, limited partnerships, limited liability partnerships, and trademarks.

Criminal Tax Offenders See Potential Sentencing Relief and Multi-Year Tax Planning – Who Will Make the Decisions?

For most tax practitioners, the concept of a criminal tax conviction and sentencing is alien. However, we have all likely had the experience where a client, or regrettably a colleague or friend, has run afoul of the criminal justice system and has been convicted by either a guilty plea or jury/judge conviction of a tax or other “white-collar” criminal offense. The initial shock subsides, and then the question turns to incarceration, and of course, for how long?

The IRS Criminal Investigation division and the Department of Justice Criminal Tax Division issue new releases and publish statistics about indictments, convictions, and sentences. It is not uncommon for sentences to span years and sometimes decades. Yes, it is serious business. Yet, the factual underpinning of each case matters greatly, and the eventual sentence can indeed span decades or months of incarceration, home confinement, or supervised release. Most sentences combine incarceration, supervision, financial penalties such as fines and restitution, as well as related civil consequences such as loss of certain rights.

For purposes of this column, I am writing about the first of major changes in the scoring system or sentencing guideline system that is used to compute the sentencing guideline or starting point for the sentencing judge to consider. The sentencing guideline is the nonbinding recommended range of incarceration. It is presumed reasonable. Like golf, the lower the score the better. In tax offenses, the amount of tax loss drives the sentencing guideline. Other factors can aggravate or increase the guideline, and a few can mitigate or lower the guideline.

One of the most important factors in the calculation is the offenders “criminal history.” Offenders with an extensive criminal history will score a higher sentence than a first-time of-

fender. Now, a new change effective November 2023, provides a two-level reduction with “zero points.” In my experience, most tax offenders have zero criminal history points. This change can reduce a typical sentencing guideline from 37-46 months to 30-37 months. A potential change of 16 months. In addition, this change can reduce the applicable “Zone” wherein the sentencing judge has more flexibility (perceived or otherwise) and opts for home confinement instead of a prison facility.

It will take time to see the overall impact of this change on sentence length and composition. The sentencing guideline table is but one factor in fashioning a sentence. However, this change will be a welcome tool in defending white collar offenses.

Multi-Year Tax Planning

Recently, I was a speaker at a Michigan Association of Certified Public Accountants (MICPA) conference. It was a nice event, and the attendees were interactive and responsive. My topic was my humble effort to “demystify” multi-year tax planning. That topic got me thinking about the current tax landscape and who will be making the decisions. First, it is important to recognize that the tax cuts and other important changes, such as the state and local tax cap expire at the end of 2025 because the underlying legislation was enacted under the reconciliation rules—the end-around the filibuster. So, the legislation expires after ten years. Do you remember when there was no estate tax? That was the result of the end of the ten-year enactment of the enabling statute. Thus, strange things can happen.

In 2024, there is a presidential race, 33 U.S. Senate seats and all voting U.S. House seats are up for election. At present, presidency and senate are under Democratic control and the House under Republican control. As

such, we have a divided government. However, three “Independents” caucus with the Democrats in the Senate providing a slim 51-49 majority. The Republicans have only a seven-seat majority in the House and are a divided caucus.

There are presently several lawsuits proceeding regarding the congressional maps. Alabama is chief amongst those cases with the U.S. Supreme Court tossing out Alabama’s proposed congressional maps. Alabama’s second attempt at redrawing the districts has recently been rejected by a three-seat panel. The battle could flip one seat in Alabama.

In the Senate, there are several open seats including Michigan as Senator Stabenow is not seeking reelection. The majority of the 33 seats currently up for election are held by Democrats. The election outcome concerning control of the Senate is uncertain at best.

The presidential race speaks for itself. Will there be a rematch, an incumbent, or perhaps two other candidates?

The reality is that without knowing the decision makers, the current political landscape makes predicting and planning for tax policy beyond 2025 impossible. Pay close attention because, in this situation, doing nothing is doing something.

IRS Goes Public with Their Battleplan

On September 8, IRS Commissioner Werfel announced aggressive examination, collection, and criminal investigation plans of the IRS. The use of artificial intelligence (AI) figures prominently in the IRS strategy. The plans include:

- Auditing the 75 largest partnerships in the United States. Reportedly, each of the partnerships has at least \$10 billion in assets.
- 500 other large partner-

ships received “compliance alerts.”

- Undisclosed foreign bank accounts of the wealthy.
- Aggressive collection action against the wealthy with unpaid tax liabilities.

Stay tuned for more details. Nonetheless, a proactive discussion with some clients seems in order.

The IRS is under political pressure to focus more enforcement resources on the wealthy and taxpayers making over \$400,000 per year. At the same time, it has been well-documented that the IRS lacks resources to audit, investigate, and litigate against the most complex tax planning and wealthiest taxpayers. Strategic investments in AI may be a way to thin the proverbial herd and find the high-value targets. As such, the next audit letter may not be so random.

Employee Retention Credit Program Moratorium

On September 14, 2023, the IRS announced the Employee Retention Credit claims will not be processed through at least the end of 2023 to address concerns about dubious and/or improper claims.

The COVID-era relief program has been the subject of relentless media campaigns, featuring celebrity spokespersons touting a program that can pay up to \$26,000 per employee. Often, large fees are charged to prepare the forms.

The IRS reports a virtual avalanche of claims numbering in the hundreds of thousands for virtual mills. Many times, the taxpayer’s accountant has informed the taxpayer that they don’t qualify for the credit, but the promoter contradicts the accountant and creates a fear of missing out.

The IRS is developing a program wherein a taxpayer can seek to withdraw an ERC claim. Both the civil and criminal divisions are ramping up enforcement of the claims. The IRS Criminal Investigation division recently announced that it had opened over 250 active criminal investigations addressing nearly \$3 billion of

ERC claims. There have already been some convictions and prison sentences imposed.

Anyone concerned about an ERC claim that was filed should consult experienced criminal tax counsel to assess their options. As I have written about in previous columns, going to the IRS before they come to you can be an effective strategy under the right circumstances.



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Privacy Risk Mitigation – Enforcement Beyond the Cyberattack

When someone says data privacy, different images arise. Some immediately jump to the image of a data breach at a hospital and think about the HIPAA implications involved. Others contemplate the information they keep private or the possibility of something shared on social media platforms being hacked.

But it isn't just the hacker's keystrokes that create potential risk. It's the pen of the drafter of policies and the inking of the contracts that has become of great interest to both regulators and class action counsel. Indeed, according to the Pew Research Center, in a 2019 study—28% of people think privacy is about organizations not being able to access individuals' possessions or their private life. It's this area of privacy that has been at the forefront of the media and on consumers' minds in recent months and, therefore, should be on ours.

In the News: California Challenges and Settles with Google

On September 14, 2023, the California Attorney General announced a \$93 million settlement with Google based on allegations that the company violated California consumer privacy laws. In addition to the \$93 million, Google agreed to certain injunctive relief, which, in part, would require the company to provide additional information to consumers. In a notable twist, it wasn't a data breach that triggered this action; it was Google's use of data and the information provided to consumers when the data was collected.

Google, according to the AG's claims, deceived users as it collected, used, and stored location data for profiling and advertising without user consent. In its complaint, the AG focused on the collection of location-based advertising that allows advertisers to precisely target users based on their physical location. This information can then be used to build a be-

havioral profile of each individual to further provide more targeted ads. As an example, the complaint discussed the Google Maps popup that allows a user to "[e]nhance [their] Google Maps experience." By accepting and enabling this feature, a user turns on location history, which allows Google to collect and store location even when not using the Google Maps app. At a high level, the allegations claim that Google failed to provide sufficient information and transparency to allow consumers to make informed decisions on their privacy through their policies and data collection.

In the settlement, Google did not admit to wrongdoing, but it agreed (1) to show additional information to users when enabling location-based settings, (2) to provide more transparency about their location tracking, and (3) to disclose that location data can be used to build ad targeting profiles and personalization. This settlement highlights the need to both understand what data is being used for by companies and the approach to disclosing those uses, as well as any related contracts involved in those transactions.

A Classic Example in the Heart of the Automotive Industry

But it isn't just high-tech companies or the communications industry that are under scrutiny. On September 6, 2023, Mozilla's *Privacy Not Included initiative made its thoughts about the automotive industry's approach to privacy abundantly clear in its article titled, "It's Official: Cars Are the Worst Product Category We Have Ever Reviewed for Privacy."

Mozilla assessed 25 car brands in its study and had several unique findings along with recommendations. In one of the more interesting parts of the study, Mozilla pointed out what they called "not-so-fun facts." One original equipment manufacturer was "dinged" for untrustworthy AI that may have been related to multiple

crashes. Two were directly implicated with collecting information on one's "sex life." Finally, six manufacturers note in their privacy policy that they are allowed to collect your genetic information or characteristics.

After noting these flashy "not-so-fun facts," Mozilla spelled out concerns of collection, use, and inability to control data within the industry. The key findings included:

- *Cars "collect too much personal data."* One key concept in data protection circles is minimization. This principle provides that a company should collect the minimum amount of personal data required to deliver services involved in the transaction. Mozilla discovered that vehicles collected information on how drivers interacted with the car, the connected services used, and locations drivers have been. Automakers then use the information to derive inferences—including driver's abilities and interests.
- *Most car companies sell or share data.* The Mozilla study determined that 84% of car brands share a driver's personal information with either service providers, other businesses, or even data brokers. Seventy-six percent (76%) of brands note that a driver's personal data can be sold.
- *Drivers have "little to no control" over their personal data.* In Mozilla's study, only Dacia and Renault provided drivers the right to have their personal data deleted, leaving 92% of drivers without an ability to manifest one of the traditional measures of control. And control implicates more than just the right to delete data. Several data protection rights relate to having control over one's data, including the right to opt out of data collec-

tion and the right to limit the use of collected data.

More than Cars and Platforms: Enter the FTC

From a regulatory standpoint, the Federal Trade Commission (FTC) has been the principal federal agency working on privacy policy enforcement efforts. Operating in privacy enforcement since 1971, the FTC brings legal actions against organizations that have violated consumers' privacy rights, or misled them by failing to maintain security for sensitive consumer information, or caused substantial consumer injury. Many of these cases are charged under section 5 of the FTC Act, which bars unfair and deceptive acts and practice in or affecting commerce. Recent cases brought by the FTC dealing with privacy policies and downstream contracts include:

- *1Health.io Inc.* The FTC settled a matter where it alleged that 1Health.io deceived consumers about the ability to get data deleted and changed its privacy policy retroactively without notifying and obtaining consent from the consumers who already had provided their data.
- *BetterHelp, Inc.* The FTC issued an order to settle charges that the online counseling service BetterHelp revealed consumer sensitive data to other companies including platforms like Facebook and Snapchat for advertising after it made promises to keep this data private.
- *Facebook, Inc.* The FTC alleged that Facebook violated its privacy promises to consumers in its privacy policy.

It's All About the Contracts

The Google, automotive, and FTC compliance examples all relate to the collection, transfer, and control of data that links directly back to key contractual relationships between a consumer and the company and,

secondarily, between the company and whomever they may sell or share information. These contracts, including terms of use and privacy policies, are facing increased scrutiny from consumer groups and regulatory authorities around the country. Many of the outcomes of these matters not only turn on the drafted documents but also turn on the actual use and tech systems employed by a prospective client. Therefore, when helping clients, it is important to be thorough with these contracts. But these agreements cannot be drafted with a limited knowledge of a client's operation, they require more analysis and assessment of privacy law in multiple jurisdictions based on the actual uses a client intends. At a minimum, these contracts and policies should be drafted based on information obtained by adhering to the following basic process:

1. Create a client data map or data inventory that includes all types of data collected.
2. Assess the client data across the entire lifecycle including collection, use, transfer, retention, and destruction.
3. Identify what client data is the most and least valuable, what subject matter it covers, and other factors regarding its quality and context.
4. Perform a privacy assessment that evaluates a client's organizational education, awareness, incident responses, remediation plans, and audits.
5. Analyze existing contracts to assure that risks to your data are cascaded through your client's supply chain and vendors.
6. Assess data vendors (e.g., storage, collection) for their ability to meet client organizational standards including reviewing reputation, verification of insurance coverage, and assessment of security controls.

Closing Thoughts

Without question, data privacy and cybersecurity are here to stay. They will long influence our practice and how we interface with clients. To successfully provide service, there will be times that we will need to go beyond worrying about the breach and instead strategize with the "data map" in mind. The universe of possible data privacy and cybersecurity incursions is expanding rapidly, so a thorough, ongoing understanding of clients' relationship with data remains increasingly critical.



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SCAO, Trial Courts, and Delaware

For this issue, we interview the Administrator of the State Court Administrative Office ("SCAO") Honorable Thomas P. Boyd, Berrien County Business Court Judge Donna B. Howard, and former Delaware Vice Chancellor Joseph R. Slight III.

SCAO Administrator Honorable Thomas P. Boyd

Background

Before becoming SCAO Administrator, Judge Boyd served as an Assistant Attorney General beginning in 1995. He was appointed to the 55th District Court bench (Ingham County) in July 2005 and was elected to continued service in 2006, 2008, and 2014. Judge Boyd became SCAO's Administrator on March 23, 2020—the day Governor Whitmer issued the pandemic-related stay-in-place order. Judge Boyd served as the chair of the Michigan Trial Court Funding Commission, which was responsible for reviewing and recommending funding methods for Michigan's trial courts. He received the 2019 Judicial Excellence Award from the Michigan District Judges Association, the 2020 State Bar of Michigan Champion of Justice Award, and the 2021 Advocate of the Year honoree by the National Alliance on Mental Illness-Michigan. We submitted a list of written questions, which Judge Boyd graciously answered.

SCAO Generally

The Michigan Constitution, Article 6, section 3, establishes the State Court Administrator position. The relevant portion provides: "The supreme court shall appoint an administrator of the courts and other assistants of the supreme court as may be necessary to aid in the administration of the courts of this state. The administrator shall perform administrative duties assigned by the court."

Asked about his role with business courts at SCAO, Judge Boyd explained that while trial courts op-

erate autonomously under their chief judge, SCAO offers support and resources for the administration of each state court. SCAO's work with trial courts is divided into six regions. Each region has an administrator. These administrators are each trial court's contact (liaison) with SCAO and the Michigan Supreme Court. The Regional Administrator works to support compliance with statutes, court rules, and the Supreme Court's administrative orders. Additionally, the Regional Administrator solves problems for the courts and solicits advice and feedback from judges and court staff for the betterment of the judiciary. Further, Judge Boyd noted, the SCAO Regional Administrator is also responsible for appropriate follow-up on all concerns or complaints. Follow-up on a public concern often includes a conversation with court administration and, when appropriate, the judge and/or chief judge.

SCAO Resources for Business Courts

The SCAO website is a trove of information. This includes a summary of the business court statute, the business court statute itself, and local administrative orders. It also contains published business court opinions,¹ organized by the particular business court and subject matter. The opinions are keyword-searchable and organized by county (individual courts might also post their own opinions on their own websites).²

Beyond this, the Michigan Supreme Court and SCAO have historically facilitated meetings of the business court judges. These meetings included 2-3 hours of substantive training. Although these sessions were suspended during the pandemic, they are expected to return in 2024.

Selection of Business Court Judges and SCAO

The State Court Administrative Office is tasked with assuring an open and fair application process for selecting business court judges. SCAO also

summarizes applicants for business court judges for the Supreme Court's review. SCAO may make a recommendation if more than one judge applies. Ultimately, the Supreme Court discusses and decides which judge will be appointed, of course.

Asked if the Supreme Court or SCAO would like recommendations for business court judges, Judge Boyd said, "selection of a business court judge is not a popularity contest, and it is important to take steps to assure that it does not become one." That being said, the Supreme Court may instruct SCAO to solicit feedback.

If an attorney has a concern about a business court judge, what should that attorney do? Decisions of judges are, of course, subject to appeal. But concerns about the administration of the court or a courtroom may be directed to that court's chief judge. Concerns that are not successfully resolved with the administration of the court may be directed to the Regional Administrator.³

Berrien County Business Court Judge Donna B. Howard

Background

Judge Howard has an interesting background. An undergraduate economics major at the University of Michigan, she was always good at math and science, but not as much at tax or accounting. So, that realization steered her from business school toward law school. She says that today, it's "ironic that I became a business court judge where I now review ledgers." But her approach to business cases comes from that analytical background. In private practice from 1997 to 2010, she handled large property insurance subrogation, insurance defense, municipal law, and other property matters, and later became Berrien County Corporate Counsel until 2014.

Experience on the Bench

Judge Howard was elected to the 5th District Court in 2014 and appointed to the 2nd Circuit Court and the Business Court at the same time in 2018, after the retirement of Judge John Donahue. She has retained her circuit seat by elections in 2020 and 2022. Her current term on the Business Court expires in 2025. Judge Howard spent her first four years on the bench in the Criminal Division. The Berrien County Trial Court is a concurrent jurisdictional court so although Judge Howard was initially a district judge, she has handled both district and circuit matters simultaneously throughout her tenure. For example, in the Civil Division she may cover motions on a complex multi-party circuit case one day, and the next day cover 30 to 40 landlord-tenant proceedings in district court. In addition to being Presiding Judge of the Civil Division and Business Court, she also presides over the Adult Drug Treatment Court and Adult Mental Health Court for Berrien County. Judge Howard spoke at the annual Business Law Institute on October 6, 2023.

Experience with the Business Court

Judge Howard's general approach to business cases is, "time is money. You can say that about every case. But in business cases, it is ideal to get these resolved. It supports the community if business disputes can be resolved." To that end, Judge Howard provides "extra attention to the business court cases. The legislature and the Michigan Supreme Court have intended that business court cases be treated differently."

Early Scheduling Conferences

In business court cases, Judge Howard's court sets an early scheduling conference after the answer is filed. She addresses whether initial disclosures have been exchanged, the status of efforts to resolve the case, and how much discovery is needed to position the case for alternative dispute resolution. The scheduling conference also helps her understand what the dispute really is. For exam-

ple, Judge Howard wants to understand the parties' circumstances, such as whether the case involves a family-owned business. If the parties want to proceed with litigation, "we will focus on getting this resolved as efficiently as possible and discuss the issues needed to accomplish this." In some cases, particularly those involving family businesses, the case may have an emotional component that needs to be considered.

Motions

As is true in many business courts, Judge Howard frequently sees motions for a temporary restraining order and a preliminary injunction. A temporary restraining order, Judge Howard observes, is "extraordinary relief. To those involved in the business, it may seem that the claim needs a TRO. But they may be missing the fact that the claim boils down to money. If you can be made whole through damages and interest, then this is not suitable for a TRO." Indeed, she notes, "I get a lot of TRO motions that boil down to money." For a TRO, the matter "had better be an emergency, such as a factory shutting down." With that, the attorneys need to remember that the reviewing judge is "coming in blind. The attorneys may have had days or weeks of conversations with their clients about this." The reviewing judge has not. So, Judge Howard reminds counsel that in filing for a TRO, remember that this is an ex parte request for relief, the judge is only hearing from one side, and therefore, it is important to present evidence of the four factors⁴ in the motion, especially irreparable harm. Show that irreparable harm is not speculative.

Still, Judge Howard understands the urgency of a TRO and preliminary injunction at the early stages of litigation. Whether the TRO is granted or denied, she schedules an expedited injunction hearing to give the parties an opportunity to flesh out the immediacy of issues.

Another frequent issue is summary disposition motions under MCR 2.116(C)(8). "I don't mind (C)(8) mo-

tions in lieu of an answer." She prefers if the (C)(8) motion is filed early, rather than later with a (C)(10) motion. If a (C)(8) motion is pending, Judge Howard generally does not permit discovery except for initial disclosures. This is especially true because the plaintiff will likely amend the complaint anyway if the (C)(8) motion is successful. Nevertheless, if there is specific discovery that might facilitate resolution in the future, she is open to permitting that.

Discovery Motions

Judge Howard generally handles discovery motions herself. She has not yet had to appoint a discovery mediator. (In some cases, a receiver was appointed who also handled document production.) She is nevertheless open to appointing a discovery mediator, particularly where a discovery mediation could lead to discussions that resolve the entire case.

Early Mediation

At the early scheduling conference, Judge Howard will discuss how much discovery is needed for alternative dispute resolution. She requires the parties to participate in some kind of ADR. She believes mediation helps the parties focus the issues in the litigation. So, Judge Howard encourages early mediation or pre-suit mediation. If the parties do go to a pre-suit mediation, she usually will not order another mediation during the case. Instead, she will set a settlement conference a few weeks before trial. Along those same lines, if the parties go to early mediation but the case does not settle, she will grant additional time for discovery and motions.

Regarding case evaluation, Judge Howard no longer specifically orders case evaluation, and she rarely sees anyone requesting case evaluation now, given that there are no case evaluation sanctions.

Advice for Litigators

Judge Howard provides simple but wise advice: "Make the case make sense. I will 'Nancy Drew' the case." Judge Howard continues: "There

are elements to every claim; the evidence has to support this — regardless of whether this is a (C)(10) motion or a trial. The evidence and caselaw must support what you are saying.” Judge Howard cautions, “sometimes counsel will cite a court rule but not a case that is like their case. Provide an example of how a case supports your case.” Further to that point, Judge Howard observes that “under *Wilson v Taylor*,⁵ it is not up to the court to find the facts or law to support your argument. Do not simply give me documents and expect me to figure this out.”

Summarizing, Judge Howard states: “If you cover all your bases in your brief and make it make sense, then this is a great brief. This makes the court’s job much simpler.” In other words, “make the case make sense to someone who is not familiar with the case and show how the evidence supports what you say it does.” Ask yourself: “Can someone who does not know the case understand the motion?”

Former Delaware Vice Chancellor Joseph R. Slight III

Background

Now a partner with Wilson Sonsini Goodrich & Rosati, Judge Slight formerly served as a judge on the Delaware Superior Court and later as a Vice Chancellor in the Delaware Court of Chancery. Here, Judge Slight explains the roles of the various Delaware courts. Given Delaware’s influence in corporate governance, this is helpful for all business lawyers to know.

Structure of Delaware Courts

The structure of Delaware’s court system is “very unusual.” There are two constitutionally designated trial courts. The Court of Chancery’s jurisdiction was originally only equity. The Superior Court, by contrast, is a court of general jurisdiction. That court hears matters at law, both civil and criminal. The two courts are separate, although the Chancery Court

has concurrent jurisdiction with the Superior Court in certain instances as designated by statute.

The Court of Chancery is nearly 240 years old; it traces its history back to England. Chancery’s jurisdiction has expanded by statute. Chancery may now hear legal claims regarding breach of contract, such as breach of an asset or stock purchase agreement. For many years, Chancery was the only business court in Delaware. Then in the 2000s, the bar and judiciary in Delaware understood that the Superior Court needed to offer a Commercial Division, so the Complex Commercial Litigation Division (CCLD) was created. The judges there have both civil and criminal cases on their dockets. Judge Slight was heavily involved in creating the CCLD.

Today, if a case has both equitable and legal claims, only Chancery may hear the case. Indeed, under the “cleanup doctrine,” if there is a legal claim along with a bona fide claim in equity, then Chancery may hear the entire case. The purpose is, of course, to avoid having to litigate related claims in two separate courts. A simple breach of contract case (with no equitable claims) goes to the Superior Court, except in cases involving transactional contracts, which again, by statute, may be heard in Chancery as well. Although there is a right to a jury trial under the Delaware constitution, there are no jury trials in the Chancery Court.

More on the Complex Commercial Litigation Division; Expedited Cases in the Court of Chancery

At one point, the CCLD began to see more insurance cases such as disputes involving directors’ and officers’ insurance. The litigants viewed the CCLD’s dedication to these cases as providing a forum to litigate disputes that would not be venued in Chancery. So CCLD developed a unique expertise in insurance cases.

In 2022, approximately 37% of Chancery’s cases were expedited. Expedited cases are “highly intense and challenging,” but at times disruptive.⁶

As Judge Slight recalls, “You’re working on writing an opinion, then you get an expedited case (an ‘expedited hand grenade’) with an expedited hearing on an injunction.” In the expedited cases, there are “armies of sophisticated lawyers on each side with businesses that expect and need decisions quickly.” (Despite that, the Chancery Court has only seven judges.) All of which illustrates the motto that Chancery has had for decades: The Court of Chancery “moves at the speed of business.”

Judge Slight illustrates some of the statutory summary proceedings that must be adjudicated on an expedited basis:

1. Stockholder demands for books and records (these have increased dramatically in recent years);
2. Challenge to an election of directors (who are the rightful directors?); and
3. Requests to compel a timely annual meeting, when such a meeting (for whatever reason) was not held.

In addition, the Chancery Court will provide expedited scheduling in cases with a “drop dead date.” In these disputes, if a decision is not rendered by a certain date, the decision won’t matter. In such cases, the parties often need a decision in weeks or months.

Further to this issue, Judge Slight observes that sometimes cases are adjudicated in Chancery in four weeks that would take 18 months in an ordinary case. So, for example, 30 depositions are taken and millions of documents are produced, all in four weeks. The judges and law clerks are available around the clock. Once the discovery is complete, the case is tried, and the judge writes an opinion of, say, 60-100 pages, perhaps within days after the trial concludes.

Derivative Cases in the Court of Chancery

A derivative case essentially takes authority from the board and gives it to the shareholder. Chancery takes this seriously, and Chancery has

developed a body of law to deal with derivative cases.

Derivative cases are increasing. In the last five years or so, the Delaware Supreme Court has given more life to “oversight” or “Caremark” claims—claims against the board or officers for failing to oversee corporate operations. *See, e.g., In Re: Caremark Int’l Inc Derivative Litigation*, 698 A2d 959 (Del Ch 1996) and *Marchand v Barnhill*, 212 A3d 805 (Del. 2019). *See also* Gerard V. Mantese, *Corporate Law Issues from a National Perspective: An Essay on a Director’s Duty of Oversight—Caremark and Marchand*, 43 MI Bus LJ 36 (Fall 2023).

According to Judge Slight, the oversight claims have increased the derivative demands and (not surprisingly) increased shareholder document demands. As to the latter, Judge Slight observes that “if you want to displace the board by a derivative claim, you must use the tools at hand to develop your case before you bring the case.” One of these tools is the stockholder’s right to demand books and records.

Also, according to Judge Slight, other kinds of *Caremark* cases include data breaches and ESG. Regarding the latter, Delaware law is clear that the board’s function is to maximize shareholder value. As Judge Slight notes, Delaware has adopted the shareholder primacy doctrine. Delaware is “not a multi-constituency jurisdiction.” Even so, in a case where the board’s failure to account for ESG issues causes corporate trauma, there may be exposure to board members under a failure-of-oversight theory. The bounds of this theory have yet to be drawn by Delaware courts.

Advice about Practice in the Court of Chancery

Judge Slight provides helpful advice for litigators who don’t customarily practice in the Chancery Court. First, as mentioned, there is no right to a jury. Second, the judges all have high levels of expertise in business litigation. “There is no need for a tutorial” for the judge to understand the issues in your case. Assume that the judge

has a “level of knowledge that allows you to get to the heart of your case without spending a lot of time that can be distracting and that is not necessary.”

Further, Judge Slight observes, the rules of evidence “hover.” By that, he means that the judges are more flexible on admitting evidence than in a jury trial. Motions in limine are generally unnecessary. The same is true for objections, except where admitting the proffered evidence would be an egregious departure from the rules (which would rarely happen in Chancery). For example, a judge will typically allow hearsay evidence for the weight, if any, that the judge decides to give it.

In other words, a trial in Chancery is a “get-to-the-point process that is either very satisfying to trial lawyers or very frustrating to trial lawyers.” Judge Slight continues: “Some lawyers who are masters of the rules of evidence are very frustrated when they come to Chancery.” For instance, exhibits are presented before trial and introduced *en masse* at trial. There is no need to introduce exhibits through a witness. If there is an objection to an exhibit, argue this in your closing brief.

Finally, Judge Slight observes with great satisfaction, “there is an expectation of civility.” The court “has a very low tolerance for lawyers who won’t grant extensions or who make silly objections in discovery or who make motions to compel for the sake of ratcheting up the costs. There is no bandwidth for dealing with nonsense.” Chancery “will come down hard” on an attorney who will not grant a reasonable extension. Reflecting further, he mentions that “lawyers of a certain age say after trying a case, ‘This is the way it used to be. We fought the good fight, shook hands, and congratulated each other on a good effort.’” “This mentality is helpful and necessary, especially in a court where 35-40% of the cases are handled in an expedited manner.” To all that, the authors say, “hear! hear!”

NOTES

1. *See* MCL 600.8039(3) (“All written opinions in business court cases shall be made available on an indexed website.”)

2. Another resource is the interactive court data dashboard. <https://www.courts.michigan.gov/publications/statistics-and-reports/interactive-court-data-dashboard/>. This allows users to view a myriad of data about Michigan courts, including the business courts. This includes the number of “CB – Business Claims” filed since 2013 and the courts where such claims were filed, the counties in which business court judges are appointed, case dispositions, and cases pending at year-end. This tool provides a helpful way to view important Michigan business court statistics. Users are recommended to watch the brief videos posted below the dashboard on the website to help understand how to effectively use this resource.

3. <https://www.courts.michigan.gov/administration/trial-court/>.

4. *See Detroit Fire Fighters Ass’n, LAFF Local 344 v City of Detroit*, 482 Mich 18, 34, 753 NW2d 579 (2008) (irreparable harm; movant’s harm outweighs harm to non-movant; likely to prevail on the merits; and harm to public interest)

5. *Wilson v Taylor*, 457 Mich 232, 577 NW2d 100 (1998).

6. Expedited cases are not on a separate docket. The Chancellor assigns cases as they come in and determines whether they are expedited cases.



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Drafting and Negotiating Price Adjustment Mechanisms in M&A Deals

By Joseph J. DeVito and Lillian Belanger-Katzman

Preserving Enterprise Value

During the initial meeting with a new client who is contemplating a sale transaction process, with all of their advisors present, the business owner turns to the deal attorney and says, “I know the investment bankers run the process and once they get me the right price, do you just draft the agreements?”

While many attorneys may simply respond “yes, that is correct,” the savvy deal attorney may say, “In part, but my main job is to bar the barn doors so that the money these bankers get for you on the front side of the deal doesn’t go out the back door at or after closing.” The savvy attorney then proceeds to explain that the stated price in the Letter of Intent (the “Initial Price”) is not the price you will receive at closing, in fact, it may be materially less, unless we negotiate and draft pro-seller price adjustment provisions into the definitive purchase agreement. These considerations are paramount to the deal attorney as, according to the SRS Acqui-om 2022 M&A Claims Insights Report, more than 90% of deals included a purchase price adjustment (PPA) mechanism, 88% of which resulted in an adjustment; 48% of deals had buyer-favorable claims; and 40% had seller-favorable surpluses. The client is now laser focused and asks the attorney what types of price adjustment mechanisms are in a sale or business transaction? How does an attorney safeguard against erosion of the enterprise value created and the resulting price negotiated by the investment bankers? The savvy deal attorney may then explain something similar to the following:

Deal Pricing Assumptions

Deal pricing is based upon certain assumptions that must be verified or stipulated to in order to finally determine and/or adjust the Initial Price.

Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)

For example, an indication of interest may state the Initial Price of \$100 million is based upon a multiple of five (5) times reported EBITDA of \$20 million. The savvy deal attorney will require that the definitive agreement stipulate a fixed amount of \$100 million and reject any closing or post-closing adjustments to the price based on a reexamination of the EBITDA calculation, which should always be confirmed during due diligence before execution of the definitive agreement. Further, with respect to any earnout, the definition of EBITDA in the definitive agreement should match the methodology and accounting principles utilized in calculating the Initial Price. This ensures, for example, that one-time non-recurring expenses incurred during the calculation period are added back to EBITDA for the purpose of calculating the earnout level and attainment of the target as they were in determining the Initial Price. EBITDA definitions can become very long and involved, and deal lawyers should work closely with the investment bankers and financial executives of the business to understand and draft such protective intricacies into the definition.

Net Working Capital

Following the enterprise valuation methodology, the most commonly occurring adjustment to price is the assumption that, at closing, the target company’s balance sheet will include adequate net working capital assets to enable the company to continue to produce the same EBITDA upon which the price is based without requiring the purchaser to infuse additional capital into the company immediately (short term) following the closing. This does not necessarily mean the company has to have cash on the balance sheet, rather net current “financeable” assets (Accounts Receivable (AR) and Inventory) such that a lender would advance enough cash to operate in the ordinary course for the short term. This allows the company to con-

vert current assets to cash for operations and generate additional current assets (AR and Inventory) which would likewise be converted to cash without the need for additional paid in capital.

It is sometimes analogized that the seller must have enough gas in the tank (or charge in the battery) to get to the next gas station (charging station). The “target” amount of net working capital that must be present at closing is a matter of debate and negotiation and can be based upon industry and sometimes company-specific factors. The deal attorney should work closely with the investment bankers to understand clearly the methodology agreed upon and utilized in setting the net working capital closing target amount. Once agreed upon, the exact same methodology should be recited in the definitive agreement (usually in a schedule) along with a sample calculation based upon a historical snapshot from the company’s financial statements. These drafting techniques largely eliminate ambiguity in the final calculation of net working capital as to the target and the resulting positive or negative adjustment to the purchase price. It is important to note here that some buyers will resist an upward adjustment to the price, reasoning that the mechanism is only intended to protect buyers from having to inject capital at closing. However, the savvy deal attorney will negotiate for the possibility of a positive adjustment should the net working capital exceed the target, reasoning in turn that transactions of this type are also based on a cash free/debt free balance sheet. The savvy attorney will further note that if there is excess net working capital at closing the seller must have either expended cash or incurred indebtedness, either of which likely results in a benefit or windfall to the buyer absent an upward price adjustment. This brings us to the final adjustment mechanism most commonly seen in a definitive transaction document, the net cash/debt adjustment.

Net Cash/Debt

The net cash/debt adjustment mechanism is generally very straightforward and simple in concept. The seller gets to keep or receive an upward adjustment for all “cash” left in the company at closing and must pay off with or deduct from closing proceeds any “indebtedness” remaining with the company at closing.

Where things become less apparent and are subject to interpretation and negotiation are certain debt-like or cash-like items, which can be included in the definition of “cash” and “indebtedness.” In a transaction, cash is not always cash, and debt is not always debt. More specifically, transaction counsel must work with the financial team to identify items, which, under applicable or agreed upon accounting principles, should be included in the respective definitions of “cash” and “indebtedness.” Some prime examples may be capital leases, aged payables, and obligations owing under or accrued for pension plans. But despite these more obvious items, there is room to negotiate them out of the definition if the right arguments can be made. Take for example newly leased equipment, the entire useful life of which will inure to the benefit of the buyer; accounts payable that, while aged, are supported by ample accounts receivable and therefore should remain a part of the net working capital true-up; and that the contingent and variable nature of pension obligations are so uncertain, especially in a raising rate environment, that they may be reduced to zero or even turn positive. As to cash, the concept of restricted cash should be addressed and perhaps excluded from the definition of cash for purposes of adjusting the price because, although it is on the balance sheet, it is otherwise spoken for. Conversely, certain prepayments on expenses and deposits made by the company should be included in the definition of cash as they reduce a buyer’s future cash requirements.

Specialized Adjustment Mechanisms

More and more frequently transaction counsel are encountering price adjustment mechanisms that are intended to address the special or specific attributes of a particular industry, company, or circumstance involved in the subject transaction. Examples include (a) adjusting the price to make a seller “whole” for additional taxes resulting from the buyer’s preferred transaction structure; (b) price adjustments based on the level of the original cost of equipment held for sale or lease by the target company; (c) sharing of certain risks to resolve negotiations over contingent indemnification items identified in due diligence such as unresolved tax audits where the parties stipulate to a reduction in the price based upon a CPA’s estimate of exposure; and (d) sharing of transaction expenses over a cer-

Deal pricing is based upon certain assumptions that must be verified or stipulated to in order to finally determine and/or adjust the Initial Price.

tain negotiated threshold, such as the price for representation and warranty insurance premiums or escrow fees.

In practice, the Initial Price may be subject to the more customary adjustment mechanisms, but transaction counsel must be aware of and open to an almost limitless amount of deal specific assumptions upon which the Initial Price is based and therefore subject to adjustment either prior to, at, or after the closing depending upon the timing and availability of financial information necessary to make such adjustments.



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Preparing for the Corporate Transparency Act

By Mark R. High and Alexis Lupo

The Corporate Transparency Act (the “CTA”) was passed by Congress on January 1, 2021, as part of the National Defense Authorization Act for Fiscal Year 2021, Pub L No. 116-283, 134 Stat 338 (2021). The CTA requires the U.S. Department of the Treasury to create a national database to collect beneficial ownership information for many business entities.¹

This general idea has been around for many years, certainly dating back to a bill championed by the late Senator Carl Levin in 2008, entitled the Incorporation Transparency and Law Enforcement Assistance Act. The CTA heralds an era of beneficial ownership reporting, joining many other countries around the world with similar reporting requirements.

The CTA, as detailed as it is, contemplated that the U.S. Department of the Treasury would flesh out many details in a set of regulations. On December 8, 2021, the department released a Notice of Proposed Rulemaking, and the public comment period for that ended on February 7, 2022.² On September 30, 2022, the Financial Crimes Enforcement Network (“FinCEN”), which is part of the U.S. Department of the Treasury, issued a final rule regarding beneficial ownership information reporting requirements.³ The reporting requirements are set to take effect on January 1, 2024. It is imperative that the business bar becomes familiar with the act, so it will be ready to comply with the requirements.

Background

The CTA is intended to protect U.S. national security, provide information to law enforcement, and promote financial transparency. With the CTA, Congress is trying to address the U.S. deficiencies in beneficial ownership information reporting as noted by the Financial Action Task Force (FATF), established in 1989 at the G7 Summit. The FATF developed measures to combat money laundering and issued a report containing 40 recommendations, which were initially adopted in 1990 and have been revised several times since then. Recommendations 24 and 25 address beneficial ownership reporting and indicate

that governments should take measures to prevent the misuse of legal persons, such as business entities and trusts, for money laundering or financing terrorism.

Internationally, the beneficial owner definition and beneficial ownership reporting threshold percentage vary from country to country. In the United Kingdom, it is 25% and includes “persons of significant control,” which is a bit subjective (but mirrored in the CTA). The information is publicly available through the Companies House public registry, and you can even find out the date of a reporting shareholder’s birthday. In Hong Kong and the Cayman Islands, the reporting threshold is only 10%. In the Caymans, directors’ lists are publicly available, but shareholders are only available to competent authorities and must be filed with the registered agent. In Brazil, all shareholders are defined as beneficial owners, and thus need to report, regardless of their ownership percentage. Some Canadian provinces are implementing their own reporting requirements, but the federal government has not yet settled on its approach.

Key Definitions

The CTA requires companies to collect and report the personal identifying information of a nonexempt company’s current “beneficial owners,” as well as the personal identifying information of the person who was responsible for filing the company’s formation documents (an “applicant”). This information must be reported to FinCEN. The information will be maintained in a secure database by FinCEN and made available to financial institutions and law enforcement.⁴

In brief, a “reporting company” is a company that is either formed under the laws of a state by filing with a secretary of state or other equivalent state agency (“SoS”), or Indian tribe, or is a foreign company that is registered to do business in the United States through having filed a registration notice with an SoS. This would include corporations, LLCs, limited partnerships, limited liability partnerships, and business trusts. This

The CTA is intended to protect U.S. national security, provide information to law enforcement, and promote financial transparency.

also includes professional corporations and professional limited liability companies. Depending on applicable state law, this would not include sole proprietorships and general partnerships.⁵

“Beneficial owners” are natural persons who, directly or indirectly, own 25% or more of the reporting company’s equity interests or exercise “substantial control” over the reporting company.⁶ The emphasis is on obtaining information regarding individual owners. The CTA’s purpose is to tie each company to controlling individuals and not permit them to hide behind what the CTA considers are potential “shell companies.” The CTA is trying to identify natural persons who are the ultimate sources of funds invested into the entity. That information will be available to law enforcement and financial institutions that can then restrict the individuals’ financial activities or it can even aid in prosecuting bad actors, whether foreign or domestic.

Under the final rule, “substantial control” covers a company’s senior officers, persons with the authority to appoint or remove any senior officer or a majority of Board members, and persons otherwise having the ability to provide direction or substantial influence on the company’s major decisions.⁷ The final rule defines “senior officer” as “any individual holding the position or exercising the authority of a president, chief financial officer, general counsel, chief executive officer, chief operating officer, or any other officer, regardless of official title, who performs a similar function.”⁸

A “company applicant” is any natural person who files the paperwork to form or register a reporting company under U.S. law. The regulations make clear that both the actual filer and the person who directed the filing are company applicants.⁹ It appears that not more than two people are to be identified as company applicants in a reporting company’s filing. Only reporting companies formed or registered on or after January 1, 2024, need to report their applicants.

The “personal identifying information” that would need to be provided consists of the following: the individual’s name; birth date; current residential address, unless it is a company applicant who forms or registers entities in the course of the company applicant’s business; a unique identifying number from an accepted document, such as a state driver’s license or a U.S. or foreign passport; and, a copy of the driver’s license, passport,

or other document from which the unique identifying number was obtained.¹⁰

While the information required for each individual seems simple enough, the task of gathering this information from all covered individuals could prove to be challenging.

Exempt Entities

Since the CTA is targeting “shell companies,” the act contains a number of exceptions for certain types of businesses, including those which are in regulated industries or are considered “large operating companies.” There are 23 specific exemptions to the reporting company definition.¹¹ These will need to be examined closely to see whether a reporting obligation exists. Among the specific exempt businesses are the following:

- Publicly traded securities issuers;
- Domestic or tribal (but not international) governmental entities;
- Banks, domestic credit unions, and depository institution holding companies;
- Money-transmitting businesses;
- Securities brokers and dealers;
- Securities exchange or clearing agencies;
- Entities governed by the Securities Exchange Act of 1934 or registered under the Commodity Exchange Act;
- Registered investment companies and advisors;
- Venture capital fund advisors;
- Insurance companies and state-licensed insurance producers;
- Accounting firms registered under the Sarbanes-Oxley Act;
- Public utilities;
- Financial market utilities;
- Pooled investment vehicles;
- Tax-exempt entities (including non-profits and trusts) and entities assisting tax-exempt entities;
- Large operating companies;
- Subsidiaries of certain exempt entities; and
- Inactive entities.¹²

“Large operating companies” are those over certain operational thresholds for personnel and sales, and having a physical office presence in the U.S. They need to employ more than 20 individuals on a full-time basis in the U.S., report more than \$5 million in gross receipts or aggregate sales (either independently or consolidated with subsid-

aries or other related operating entities), and maintain physical office space within the U.S. that is exclusively owned or leased by the entity or its affiliates.¹³

That “large operating companies” definition contains a number of terms that would benefit from some closer review. The regulations clarify, for example, that they will count a company’s full-time employees in the same manner as defined by the Internal Revenue Service.¹⁴ This may still raise concerns for companies with, for example, a large number of seasonal workers, or that rely on temporary workers or even independent contractors. Also, the final rule does not permit companies to consolidate the employee count across affiliated entities.

The \$5 million in revenues standard also deserves a closer look. The regulations clarify that this number is calculated as either gross receipts or aggregate sales of the company within the U.S., as reported on the company’s federal tax return for the prior year. This indicates that newly formed independent companies will not be eligible for this “large operating companies” exemption, since they will not have filed a tax return yet. (Newly formed subsidiaries of companies that meet one of the other exempt categories might avoid filing under the subsidiary exemption.)

The \$5 million number is based on a company’s revenues either as a stand-alone entity or on a consolidated basis with its affiliated entities, as reported on the group’s consolidated return.¹⁵ Unlike in several other areas (most notably, the Hart-Scott-Rodino Anti-Trust Improvements Act), the \$5 million number does not seem to be indexed for inflation, which means that the number of companies that can take advantage of this “large operating companies” exemption should grow over time.

Finally, to meet the “large operating companies” exemption, the entity must maintain a physical office space within the U.S. that is exclusively owned or leased by the entity or its affiliates for business purposes.¹⁶ It cannot be a shared space (except if it is being shared with affiliated entities). This would seem to leave out companies that rely on co-working spaces, or have some other decentralized working arrangement.

Another exemption applies to inactive entities. An inactive entity is one that (1) existed on or before January 1, 2020, (2) is not engaged in active business, (3) is not owned, di-

rectly or indirectly, wholly or partially, by a foreign person, (4) has not had any change in ownership in the preceding twelve months, (5) has not sent or received funds exceeding \$1000 in the preceding twelve months, and (6) does not hold any assets, including any ownership interest in another entity.

FinCEN projects that the exemptions will not apply to very many entities. In the regulatory impact analysis included with the final rule, FinCEN estimated only 11% of entities will be exempt.¹⁷

Reporting Requirements—New Entities

When the CTA’s reporting requirement becomes effective, most companies formed after the effective date will be required to report at least initially. New reporting companies will not be able to meet the “large operating companies” exemption because it requires “more than \$5 million in revenue” from the prior year’s tax return. Thus, until the entity has filed a tax return, it cannot meet at least one of the elements for that exemption. If an entity later meets the requirements of an exemption, then the entity is to file an updated report with FinCEN within 30 calendar days after meeting the exemption criteria to report this change.¹⁸

Reporting Requirements—Beneficial Owners

A “beneficial owner” is an individual who, directly or indirectly, owns or controls 25% or more of a reporting entity, or exercises substantial control over the entity. The intent here is to identify the ultimate individual owner or owners of each reporting company, so that FinCEN can collect the required personally identifiable information from each individual and thereby be able to enforce anti-money laundering rules, or at least, and probably more practically, discouraging bad actors from even investing funds with shady provenance in U.S.-based entities.

Reviewing the “beneficial owner” definition, the 25% ownership rule might seem, at first blush, to provide a bright-line test. Digging a bit deeper, that line might prove illusory in many instances. One can quickly think of situations where a preferred shareholder, for example, might have voting rights in a corporation but only in limited circumstances. Or an LLC with multiple classes of members who, again, have voting rights but only in certain circumstances. Or a company

Since the CTA is targeting “shell companies,” the act contains a number of exceptions for certain types of businesses, including those which are in regulated industries or are considered “large operating companies.”

When the CTA's reporting requirement becomes effective, most companies formed after the effective date will be required to report at least initially.

with a “waterfall” distribution, where someone might be entitled to 100% of a company's assets upon dissolution, but only after preference payments have been made to three more senior membership classes.

The regulations attempt to provide some guidance here. First, they specify that ownership interests should be calculated by including any options or similar interests as if they had been exercised. Then, for companies that issue capital or profits interests (essentially, entities taxed as partnerships), the individual's ownership interests are the individual's capital and profit interests in the entity, calculated as a percentage of the total outstanding capital and profit interests of the entity. For corporations, the applicable percentage shall be the greater of (1) the total combined voting power of all classes of ownership interests of the individual as a percentage of total outstanding voting power of all classes of ownership interests entitled to vote, and (2) the total combined value of the ownership interests of the individual as a percentage of the total outstanding value of all classes of ownership interests. If neither of these “capital or profits” or “voting or value” approaches provides an accurate number with “reasonable certainty,” then any individual who owns or controls 25% or more of any class or type of ownership interest of a reporting company shall be deemed to own or control 25% or more of the ownership interests of the reporting company.¹⁹

The concept of substantial control could be even harder to pin down. In addition to the situations listed above, which might be viewed as providing substantial control even if they do not trigger the 25% test, it could be difficult to determine when a relationship might amount to “control.” The CTA specifically provides that control can be had directly or indirectly through any contract, arrangement, understanding, relationship, or otherwise. The regulations do say that a company's senior officers, and persons with the authority to appoint or remove senior officers or a majority of the board members, are each considered to have substantial control for the purpose of determining who is a “beneficial owner” who must report their personal information. The regulations further target any other role where a person provides direction or substantial influence on a reporting company's major decisions, including by acting as a trustee of a trust or by controlling one or

more intermediate entities that collectively exercise substantial control.²⁰

Interestingly, the rules do not identify corporate directors or LLC managers as senior officers. That suggests we need to review them under the substantial control standards. It seems that managers of manager-managed LLCs would generally meet that test, as they often have authority to take significant actions on the company's behalf. Directors, on the other hand, do not have individual authority but only act as part of a board. That indicates that most board members who are not otherwise beneficial owners or senior officers should not be included in a reporting company's filing solely because of their board position.

The CTA does identify a number of individuals who are excluded from the beneficial owner definition. These include the following:

- Employees whose ownership or control derive solely from their status as employees;
- Individuals acting as a nominee, custodian, or agent;
- Minors (although the parent or guardian may have a reporting obligation);
- Individuals with only a right of inheritance; and
- Creditors, unless they otherwise meet the beneficial ownership requirements.²¹

Reporting Requirements— Personally Identifiable Information

The CTA requires filing with FinCEN personally identifiable information for each beneficial owner of a reporting company and each applicant with respect to that reporting company. The specific information includes the individual's full legal name, date of birth, current residence address (or business address of applicants that formed the entity in the course of their business), and the unique identifying number from an acceptable identification document or FinCEN identifier. An acceptable identification document is defined in the act—for example, a nonexpired driver's license or passport. A copy of the identification document must also be submitted. As an alternative to a driver's license or passport number, an individual may register with FinCEN to obtain a FinCEN identifier number under procedures still being finalized.²² This could be useful

for individuals involved with a number of reporting companies.

Reporting Requirements—Applicants

In addition to beneficial owners, “company applicants” of newly formed or registered reporting companies must also file their personal identifying information. The CTA defines an “applicant” as a natural person who files the paperwork to form a reporting company under U.S. law or to register a foreign company to do business in the U.S. The final regulations clarify that there are no more than two applicants who need to be identified—both the actual filer, and the person who directed the filing.²³

This is a substantial change from the proposed regulations, which seemed to require that applicants be identified and reported for all reporting companies, not just for those formed after the act’s effectiveness. This lessens the burden substantially for existing companies (and eliminates what could have been some tough issues for attorneys and others who may have formed many companies during their careers).

Reporting Requirements—Filing

The next question is to determine who has the filing obligation. The CTA identifies the reporting company as the one responsible for reporting its beneficial owners, but there is some indication in the statute that applicants may also have reporting requirements. Perhaps the regulations adopting the final reporting form will indicate whether an applicant can even submit a filing.

Reporting Requirements—Timing, Updates, Penalties

The deadline for new entities to file the report is very soon after formation. Newly formed domestic reporting companies and foreign reporting companies newly registered to do business within the U.S. on or after January 1, 2024, must file the initial beneficial ownership report with FinCEN within 30 days after receiving notice of their formation or registration.²⁴ Thus, this date may vary between jurisdictions, depending on their administrative filing procedures. FinCEN has recently proposed to extend this initial filing deadline to 90 days after formation or registration, but only during 2024. This proposal had not been finalized at the time we submitted this article.

Existing entities formed before January 1, 2024, will have to make their initial filing before the end of 2024.

Entities will have 30 days to report changes, corrections, or updates in their organizational information or their beneficial ownership information.²⁵ Entities formed before their ownership and management structures are finalized will need to observe the 30-day-update requirements during the whole set-up stage.

Entities that become exempt after making a filing will need to make an updated filing to show that they are no longer a reporting company.²⁶

The CTA provides for civil and criminal penalties for any person willfully violating the reporting obligation either by providing false or fraudulent beneficial ownership information or willfully failing to report or update beneficial ownership information. Such person shall be liable for a civil penalty of up to \$500 for each day a violation continues or has not been remedied and may be fined up to \$10,000 and imprisoned for up to two years, or both, for a criminal violation.²⁷ It appears that the persons subject to these penalties are those who cause the failure to report or update (including perhaps a noncooperative beneficial owner), and the senior officers of the reporting company (including its president, CEO, COO, CFO, general counsel, and any other individuals exercising similar functions).²⁸

Information Disclosures

A beneficial owner’s reported information is not to be disclosed except to certain governmental and financial entities under procedures described in the act. The CTA established penalties if FinCEN were to disclose the beneficial ownership information improperly. FinCEN may only disclose the information upon a request following the appropriate protocols from a federal agency engaged in national security, intelligence, or law enforcement activity, or a request from a state, local, or tribal law enforcement agency after a court of competent jurisdiction authorizes the agency to seek the information in a criminal or civil investigation. The CTA also allows disclosure to a federal agency following a request from law enforcement of another country; a financial institution subject to customer due diligence requirements, with the consent of the reporting company; and a

A beneficial owner’s reported information is not to be disclosed except to certain governmental and financial entities under procedures described in the act.

federal regulator complying with additional requirements.

Implementation Timeline

FinCEN has acknowledged that they are behind on the implementation timeline. Final regulations have been issued regarding the reporting requirements, and they call for reporting to start at the beginning of 2024 as reported above. Final regulations have not been issued, however, regarding the reporting form or the procedures for obtaining a FinCEN identifier number. Members of Congress have noted these delays, and just the general task of educating the public regarding the CTA's requirements, so it is possible that implementation gets pushed out further, but the 2024 target date remains as of this writing.²⁹

Special Challenges for Private Practitioners

As indicated above, the CTA raises a number of practical, as well as ethical, issues for attorneys with respect to their clients. Perhaps chief among them relates to an attorney's status as an applicant. If an applicant has reporting obligations with respect to a newly formed reporting company, first, is an attorney breaching attorney-client confidentiality requirements if it submits beneficial owner reports for a reporting company that itself has not honored its obligations? Of course, an attorney helping to form an entity may not ordinarily have direct access to beneficial owner information and so may want to obligate the client to provide these materials as part of an engagement letter, as detailed below. If applicants are subject to monetary penalties and worse for failing to report, they will have strong incentives to make any required filings themselves.

State Filing Office Obligations

State filing offices will be required to inform applicants for incorporation or organization of their obligations under the CTA and provide links to the reporting forms and instructions. Notification activities are required around annual report and annual statement filings as well.³⁰ State filing offices must also cooperate with and provide the information requested by FinCEN for purposes of maintaining an accurate, complete, and highly useful database for beneficial ownership information.³¹

Actions to Take Now

With the final reporting regulations released, the CTA's registration requirements are poised to take effect at the beginning of 2024 for newly formed companies. Existing entities will need to file before the end of 2024. Enforcement against noncomplying entities may quickly follow. Especially given that "applicants" are likely to be easy targets for enforcement, it is essential that lawyers and their law firms become familiar with the reporting requirements and begin implementing strategies that will give them a fighting chance at prompting compliance by their clients.

A first step is the general good advice to tighten your new client intake procedures. It will be essential to know where your new clients have come from, what their background is, and how they found you. The saying "An ounce of prevention is worth a pound of cure" might have been designed just for this circumstance.

We suggest that lawyers should start by adding a provision to engagement letters, committing a new client to observe all CTA filing requirements. Given that the law firm may have its own filing requirements related to entities that it helps form, this should go a step further, committing the new client to provide all information required for CTA compliance. If the anticipated owners of the entity can be added to the engagement letter, obtaining their individual commitments to providing necessary information, that would be even better. It could be useful to include a provision that acknowledges that personal identifying information is not confidential, or waiving its confidentiality, when used in complying with the CTA. Specifying that CTA compliance, if undertaken by the law firm, is nonetheless for the client's benefit and at the client's cost would further protect a law firm and its revenues.

Actually gathering the required personal identifying information at the outset would seem to be reasonable. We can foresee lawyers adopting the "Know Your Customer" procedures that banks have been developing for a number of years now. Larger firms may want to designate a CTA compliance specialist to coordinate this process. Keeping up with newly formed entities during the first year of enforcement will be challenging but achievable. Evaluating and contacting all existing clients before that first anniversary of effectiveness, and then doing the follow-up

With the final regulations released, the CTA's registration requirements are poised to take effect at the beginning of 2024 for newly formed companies. Existing entities will need to file before the end of 2024.

required to keep the filings current, will be an on-going challenge.

Substantively, we recommend that CTA compliance provisions, and beneficial ownership information commitments, be included in every agreement between a potential reporting company and its beneficial owners (remembering that the definition includes not just direct equity owners, but also indirect owners, option holders, and those who meet the definition of “substantial control,” such as officers and other management personnel). Formation documents, bylaws, operating agreements, shareholder agreements, subscription agreements, and employment agreements are all good places to include commitments to provide necessary information. Again, it would be prudent to collect the required information at the earliest possible opportunity, recognizing that anyone collecting that information needs to have a secure way to keep it confidential and updated.

Big Picture Issues

Thinking further afield, will these beneficial owner information filings become the subject of discovery requests in litigation, be requested by state or local regulators (and the news organizations that cover them), or even become a due diligence topic in company transactions? Given that each filing will be certified as true and accurate when made, it seems logical that they will be attractive targets for all sorts of outsiders. The CTA strictly limits who can access the information filed with FinCEN, but that information, once collected, might just naturally escape its boundaries. Traditionally, equity owners have been shielded from liability and at least some aspects of disclosure by layering holding companies in between operating companies and their actual owners. That has, of course, allowed abuses to happen, but the resulting “cure” may catch some people and their planners by surprise.

Perhaps this doom and gloom can be somewhat tempered by keeping in mind that nonexempt reporting companies will primarily be those that do not meet the “large operating companies” exemption. Although there are several aspects to that definition, and failing to meet any of those aspects might cause a filing to be required, many clients of large law firms may not ultimately be subject to CTA reporting. On the other hand, those that will, or might be, would generally be smaller companies, less familiar with a

national regulatory regime and with fewer resources available to devote to compliance. Think about the dry cleaners, pizza parlors, convenience stores, real estate agencies, auto repair shops, rental property owners, and so on, that might not meet the \$5 million in revenues or 20 full-time employee tests—the proverbial mom-and-pop stores that, by FinCEN’s estimate, make up almost 90% of the business entities in this country. That is where the real compliance battleground may be.

Conclusion

The CTA establishes a monumental change in the reporting requirements for many businesses. The sheer volume of information required to be collected and filed is hard to imagine. The Business Law Section will continue to follow this process as it evolves. We provided updates at the Business Law Institute this past October, and we will probably again at least in 2024 when we will have some experience with this. Fortunately, we are all navigating this new change together.

[L]awyers should start by adding a provision to engagement letters, committing a new client to observe all CTA filing requirements.

NOTES

1. 31 USC 5336.
2. 86 FR 69920.
3. 87 FR 59498.
4. 31 USC 5336(b).
5. 31 CFR 1010.380(c)(1).
6. 31 CFR 1010.380 (d).
7. 31 CFR 1010.380 (d)(1).
8. 31 CFR 1010.380 (f)(8).
9. 31 CFR 1010.380 (e).
10. 31 CFR 1010.380 (b)(1)(ii).
11. *See* 31 CFR 1010.380(c)(2).
12. 31 USC 5336(a)(11)(B).
13. 31 USC 5336(a)(11)(B)(xii) and 31 CFR § 1010.380(c)(2)(xxi).
14. 31 CFR 1010.380(c)(2)(xxi)(A).
15. 31 CFR 1010.380(c)(2)(xxi)(C).
16. 31 CFR 1010.380(c)(2)(xxi)(B) and 31 CFR § 1010.380 (f)(8).
17. “...FinCEN estimates that the total number of existing exempt entities as of 2024 is approximately 4,024,577. Subtracting this number from the estimate of 36,581,506 total existing entities as of 2024, FinCEN estimates that there are 32,556,929 entities that will meet the definition of a reporting company as of 2024, excluding exemptions.” 87 FR 59568.
18. 31 USC 5336(a)(2).
19. 31 CFR 1010.380(d)(2)(iii).
20. 31 CFR 1010.380(d)(1).
21. 31 USC 5336(a)(3)(B).
22. 31 USC 5336(b)(2)(a).
23. 31 CFR 1010.380(e).
24. 31 CFR 1010.380(a)(1).
25. 31 CFR 1010.380(b)(3).

26. 31 CFR 1010.380(b)(3)(ii).
27. 31 USC 5336(h)(3)(A).
28. 31 CFR 1010.380(g).
29. <https://financialservices.house.gov/news/documentsingle.aspx?DocumentID=408863>.
30. 31 USC 5336(e)(2)(A).
31. 31 USC 5336(d)(2).



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Traps for the Unwary: Latent Tax Issues in Mergers and Acquisitions

By Erin Haney, Jay Long, and Wayne Roberts

Merger and acquisition transactions require counsel to review and negotiate matters ranging from real estate and intellectual property to labor and tax. For many business attorneys, it is easy to overlook tax issues that are not traditional federal income tax matters. This article is intended to highlight certain areas in which tax matters may surprise practitioners and clients, and to offer suggestions for addressing these types of issues.

Federal Employer Identification Numbers (“EINs”)

Retention of an existing EIN can be a significant consideration in the context of a merger or acquisition. This is particularly true with respect to entities that receive payments from government sources such as Medicare or Medicaid. Changes to an entity’s EIN can also introduce additional complexity to more commonplace activities like payroll administration and banking. In IRS Publication 1635, *Understanding Your EIN*, the IRS provides the following general guidance with respect to instances in which an entity will need to obtain a new EIN.

Corporations

You will need a new EIN if any of the following are true:

- You are a subsidiary of a corporation and currently use the parent’s corporate EIN.
- You become a subsidiary of a corporation.
- The corporation becomes a partnership or a sole proprietorship.
- You create a new corporation after a statutory merger.
- You receive a new corporate charter.

You will not need a new EIN if any of the following are true:

- You are a division of a corporation.
- After a corporate merger, the surviving corporation uses its existing EIN.
- A corporation declares bankruptcy. However, if a liquidating trust is established for a corporation that is in bankruptcy, an EIN for that trust

is required. See Treas. Reg. 301.7701-4(d).

- Your business name changes.
- You change your location or add locations (stores, plants, enterprises or branches).
- You elect to be taxed as an S Corporation by filing Form 2553.
- After a corporate reorganization, you only change identity, form, or place of organization.
- The corporation is sold and the assets, liabilities, and charters are obtained by the buyer.¹

Partnerships

You will need a new EIN if any of the following are true:

- You incorporate.
- One partner takes over and operates as a sole proprietorship.
- The partnership is terminated (no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership) and a new partnership is begun.

You do not need a new EIN if any of the following are true:

- The partnership declares bankruptcy.
- The partnership name changes.
- The location of the partnership changes or new locations are added.
- The partnership terminates under IRC 708(b)(1)(B). A partnership shall be considered terminated if within a 12-month period there is a sale or exchange of at least 50% of the total interest in partnership capital and profits to another partner. If the purchaser and remaining partners immediately contribute the properties to a new partnership, they can retain the old partnership EIN.²

Changes in Entity Type

The IRS website states that “[g]enerally, businesses need a new EIN when their ownership or structure has changed,”³ and section

Retention of
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21.7.13.4.3.1 of the Internal Revenue Manual⁴ confirms that a new EIN is generally required when an entity changes entity type (e.g., a partnership becomes a sole proprietorship or a sole proprietorship incorporates). However, the IRS has also indicated that a new EIN is not required upon “[c]onversion at the state level with business structure remaining unchanged.”⁵ In addition, changes to entity classification effectuated by filing a Form 8832-classification election do not require a new EIN.⁶

These policies may provide additional flexibility for an “eligible entity” in merger and acquisition transactions. Although the general guidance provided in Publication 1635 suggests that a corporation becoming a partnership or sole proprietorship will require a new EIN, it may be possible to prevent this result. For example, one potential alternative is to form a new LLC (“New LLC”) that files Form 8832 electing to be an association taxed as a corporation. Merging the old corporation (“Old Co.”) into New LLC in an F-reorganization would result in New LLC as the surviving entity, but New LLC would be using Old Co.’s EIN under Revenue Ruling 73-526.⁷ Because New LLC’s election to be treated as a corporation was an election by a “newly formed eligible entity,” New LLC would be eligible to make another “check-the-box” election on Form 8832 to elect partnership status while retaining the EIN from Old Co.⁸

A similar solution may exist when transitioning from a partnership to a corporation or a single-owner structure. As described in Revenue Ruling 95-37, the conversion of a partnership into an LLC taxed as a partnership does not require the new LLC to obtain a new EIN.⁹ The resulting LLC may subsequently file Form 8832 to elect treatment as an association taxable as a corporation (and maintain its EIN based on Treas. Reg. 301.6109-1(h)(1)). If the LLC taxed as a corporation then undergoes a corporate conversion under state law, there would be no change to its taxable status and the IRS could process this change as a name change. Alternatively, the LLC could reduce its membership to a single member, which would automatically result in classification as a disregarded entity. A disregarded entity that has an EIN may continue to use its own EIN for employment tax purposes, but the parent entity’s EIN must be used for other tax purposes.¹⁰ There are many variations in EIN questions, and

each situation should be analyzed based on the specific facts. In cases in which maintaining an entity’s EIN is important, this analysis should be undertaken early in the process.

Sales and Use Taxes

The sales and use tax implications of an asset sale present another area of frequent confusion for attorneys in connection with mergers and acquisitions. Despite the popular misconception that an asset sale involving the transfer of a business is exempt from sales and use taxes under some type of generally applicable “bulk sale” rule, a number of states, including Michigan, do not have blanket exemptions for “bulk sales.” In fact, the term “bulk sale” is typically not used in state sales and use tax exemption provisions. State tax statutes in each state should be carefully analyzed to evaluate the available exemptions and the extent to which each exemption applies. In Michigan, there are applicable exemption provisions relevant to corporate transactions, which are summarized below.

Sale for Resale Exemption

The Michigan Sales Tax Act provides a sales tax exemption for a sale of tangible personal property that is not a “retail sale” under applicable law (i.e., generally a sale of property that is not going to be used or consumed by the purchaser).¹¹ The Use Tax Act exempts tangible personal property that will be resold by the purchaser.¹² The practical result of these exemptions is to allow an acquirer to buy a target’s finished goods inventory without paying sales or use taxes. However, it is important to note that property that is ultimately removed from finished goods inventory and used or consumed by the purchaser will generally require the purchaser to self-assess and remit use tax to the Michigan Department of Treasury.¹³

Industrial Processing Exemption

The Michigan General Sales Tax Act and the Use Tax Act include corresponding exemptions for “industrial processing” as well.¹⁴ Identifying “industrial processing” is a highly fact-specific inquiry, but generally these exemptions will be applicable in industries such as manufacturing, food processing, and recycling.¹⁵ In the context of mergers and acquisitions, the industrial processing exemptions often allow for the transfer of machinery and equipment used in a manufacturing process without generating a sales

tax obligation to the seller or a use tax obligation to the purchaser.

Isolated or Occasional Sales

Sales Made Outside the Ordinary Course of Seller's Business

MCL 205.54d(i) provides a sales tax exemption for transactions that are outside the ordinary course of the seller's business. Note, however, that a transaction that is not part of a taxpayer's *primary* line of business could be treated by an auditor as being conducted in the "ordinary course" of the seller's business.¹⁶ There is no corresponding use tax exemption for a buyer based on the seller's course of business, and the transaction may generate a use tax obligation to a buyer in limited instances in which the transaction is not covered by the definition of a "purchase or transfer of a business" described *infra*. Although the legal incidence of the use tax is on the consumer or purchaser, some buyers may attempt to shift the liability for this tax to the seller by drafting a blanket tax covenant stating that all taxes are the responsibility of the seller.¹⁷

Isolated Sale by a Person Not Required to Have a Sales Tax License

MCL 205.54d(j) provides a sales tax exemption for transactions in which tangible personal property is sold in an isolated transaction by the property owner when the property owner does not have a sales tax license (and is not required to have a sales tax license). Like the sales tax exemption available for sales made outside the ordinary course of the seller's business, this sales tax exemption does not have a corresponding use tax exemption, and an unsuspecting buyer may need to evaluate applicable use tax exemptions or be prepared to self-assess and remit the necessary tax.

Purchase or Transfer of Business

MCL 205.94g provides an exemption from Michigan use tax for property purchased as "part of the purchase or transfer of a business."¹⁸ This is the principal use tax exemption for purchasers in Michigan in merger and acquisition transactions. The term "purchase or transfer of a business" is specifically defined by the statute as being one or more of the following:

- a) The purchaser or transferee has acquired and intends to use the seller's or transferor's trade name or good

will.

- b) The purchaser or transferee intends to continue all or part of the business of the seller or transferor at the same location or at another location.
- c) The purchaser or transferee acquired at least 75% of the seller's or transferor's tangible personal property at one or more of the seller's or transferor's business locations.¹⁹

This use tax exemption does not apply to the purchase or transfer of inventory items or to a purchase or transfer of a motor vehicle, ORV, mobile home, aircraft, snowmobile, or watercraft. Generally, inventory will be exempt from sales and use tax in an asset acquisition under the exemptions available for inventory purchased for resale if a properly completed and signed resale exemption certificate is obtained by the seller. See discussion *supra*. A vehicle, ORV, manufactured housing, aircraft, snowmobile, or watercraft that has been subject to Michigan sales or use tax once may be exempt from sales and use taxes if it is transferred in connection with the "organization, reorganization, dissolution, or partial liquidation" of a business and the beneficial ownership of the item is *not* changed.²⁰ However, in many cases, a merger or acquisition will involve a change in beneficial ownership. Therefore, the facts of a business transfer must be closely examined when determining the taxability of vehicle transfers in connection with the transaction.

Transfers Involving Real Property

When assessing the tax implications of mergers and acquisitions, it is crucial for attorneys to carefully review the assets held by the transferring entity. Entities that hold real property pose an additional layer of complexity in merger and acquisition transactions. Performing due diligence to identify areas of potential tax exposure early in the transaction will better position attorneys to make informed decisions and plan for potential tax liabilities. In Michigan, the following are often relevant in the course of the sale of equity interest in an entity that owns real property.

State Real Estate Transfer Tax

The State Real Estate Transfer Tax ("SRETT") is imposed on certain written instruments involving the sale or exchange of real property when such instrument is recorded.²¹ The rate of tax is generally \$3.75 for each \$500 of the total value of the transferred property.²²

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Although the parties may agree to shift this burden to the buyer in the purchase agreement, the statute provides that the seller is liable for paying the tax to the county treasurer in the county in which the real property is located.²³ The SRETT was amended in 2009 to apply to contracts for the transfer of a controlling interest in an entity (e.g., partnership, association, limited liability company, trust, etc.) if the real property owned by that entity comprises 90% or more of the fair market value of the assets of the entity.²⁴ A transfer of a controlling interest in an entity occurs when more than 80% of the value or interest in that entity is transferred.²⁵ Unless a tax exemption applies, SRETT must be paid not later than 15 days after the transfer of a controlling interest in an entity that satisfies the requirements of the statute.²⁶

Property Tax Uncapping

Real property located in Michigan, unless exempt, is subject to property taxes.²⁷ The amount of property tax due is calculated based on the property's taxable value and the local tax millage rate. Although the taxable value of real property is subject to annual increases or decreases, any increase in a property's taxable value is generally "capped" and cannot be more than the increase in the consumer price index or 5%, whichever is less.²⁸ When there is a change in ownership in the real property, however, the property's taxable value is reassessed at its current true cash value (which is generally equal to fair market value).²⁹ In other words, the property's taxable value, and therefore tax base, is uncapped and adjusted based on fair market value.³⁰ A change in "ownership" for purposes of real property uncapping can occur if there is a conveyance of more than 50% of the interest in a legal entity that owns real property.³¹ Because the amount of ownership interest conveyed is cumulative from the date of the last transfer of ownership, property tax uncapping cannot be avoided by transferring multiple equity interests of less than 50% of the same entity in separate tranches.³² For entities that own real property that has not been transferred in many years, the property's taxable value can be significantly less than its current true cash value. This can lead to a large (and often unexpected) prospective tax burden on the buyer.

S-Corporation Considerations

In the course of conducting due diligence, negotiating, preparing and filing documents,

arranging financing, and the other tasks that accompany a merger or acquisition, it can be easy to overlook compliance with the requirements necessary to make or maintain a valid S-election. Issues with S-corporation eligibility can arise from both the seller's perspective and the buyer's perspective. A seller may be surprised when the buyer questions the validity of a prior S-election, while a buyer may be concerned with making or continuing a proper S-election. The consequences of an invalid or inadvertently terminated S-election can be numerous. An invalid or terminated S-election by an entity that would otherwise be treated as a subchapter C corporation will require tax to be paid at the entity level (and again at the shareholder level if dividends are issued). In addition, after termination, a corporation is generally not permitted to reelect S-status until the fifth taxable year after the termination.³³ If the identity of shareholders has changed (e.g., due to estate planning or the death of a prior shareholder), there is a risk that a new shareholder does not qualify as a valid S-corporation shareholder. This may become problematic for grantor trusts when grantor trust status terminates after the death of the grantor. In such a case, an election to be treated as an electing small business trust (an "ESBT") or a qualified subchapter S trust (a "QSST") must generally be made within two years of the grantor's death in order to maintain the S-election made by the entity.³⁴

There are late-election provisions available with respect to S-corporations in specific instances. For example, Revenue Procedure 2004-35 provides a process to obtain automatic relief for late shareholder consents for spouses of S-corporation shareholders in community property states. Revenue Procedure 2013-30 provides the methods by which taxpayers request relief with respect to late S-elections, late qualified subchapter S subsidiary elections, late ESBT elections, and late QSST elections. Most recently, the IRS issued Revenue Procedure 2022-19, which provides guidance regarding issues that the IRS generally will not view as having invalidated or terminated an S-corporation election, as well as a procedure to provide retroactive relief for "non-identical governing provisions" that would otherwise result in an S-corporation having more than one class of stock. Although these revenue procedures are valuable when elections have not been properly or timely made, they are generally

labor-intensive and it is more efficient to address the necessary elections at the beginning of a transaction.

F-Reorganization Timing

Timing considerations in F-reorganizations are closely related to (and may overlap with) concerns about the validity of S-elections. In recent years, reorganizations under IRC 368(a)(1)(F) (“F-reorganizations”) have become widely used in transactions in which a closely held business taxed as an S-corporation is acquired by a private-equity buyer. This type of transaction structure is often advantageous for buyers and sellers because it allows the buyer to take a stepped-up basis in the target entity’s assets while also facilitating a tax-deferred rollover for the sellers (the sellers can exchange their equity in the target entity for interests in the buyer entity as a means of continuing their investment in the business).³⁵ Although these transactions often occur on an accelerated timetable, it is important that the steps necessary to complete an F-reorganization occur in the correct sequence.³⁶ An error in sequencing the transactions can trigger significant tax consequences and other unexpected complications. Generally, the acquisition of a target entity (“Target”) begins with the formation of a new entity (“NewCo”) as a holding company. The Target shareholders contribute their shares of Target to NewCo in exchange for shares of NewCo in a transaction that qualifies as a tax-deferred reorganization under IRC 368(a)(1)(F). In connection with this contribution, Target becomes a wholly owned subsidiary of NewCo and NewCo elects to treat Target as a qualified subchapter S subsidiary (“QSub”) by filing Form 8869. In many cases, the QSub election, which completes the F-reorganization, is followed by a conversion of the QSub to a limited liability company under a state conversion statute. PLR 201724013 illustrates one key timing issue that may arise in such transactions.³⁷ In that case, Target’s QSub election was made after Target had been converted to an LLC. As a result, Target was not a “domestic corporation” at the time the election was made, and the IRS determined that it was not an eligible entity for purposes of making the QSub election.³⁸ This fact would have rendered the F-reorganization technically invalid. Despite this technical problem, the taxpayer in this case was granted relief under IRC 1362(f) (Target’s QSub election was accepted

as valid) because the taxpayer successfully established that the circumstances resulting in the ineffective election were inadvertent. Although relief was obtained for the taxpayer at issue, this ruling highlights the nuances and risks involved in structuring an F-reorganization. In practice, it is prudent to ensure that a QSub election is made in a manner that leaves a reasonable time before there is an entity conversion. In every F-reorganization, careful documentation and retention of certified mailing receipts and similar items are advisable risk-mitigation strategies.

Potential IRC 83(b) Election Requirements

Generally, under IRC 83(a), an individual receiving property in exchange for services must include the fair market value of the property in gross income for the year in which the recipient’s rights to the property “are transferable or are not subject to a substantial risk of forfeiture.”³⁹ With respect to grants of stock options and other types of compensation that vest over time, the recipient will recognize the income as the benefits vest. However, IRC 83(b) allows the recipient to elect to recognize all income in the year of the transfer, regardless of the risk of forfeiture.⁴⁰ This may be an attractive option in cases in which the property received is expected to increase in value over time. In connection with a section 83(b) election, the transferor generally recognizes the entire compensation expense deduction in the year of the transfer. In a merger or acquisition transaction involving a compensatory agreement under which a selling member, partner, or shareholder is required to provide future services to the buyer and a “substantial risk of forfeiture” exists, there may be IRC 83(b) election issues. Many instances in which these issues arise unexpectedly are due to future service requirements imposed on sellers. If the buyer of the entity ultimately resells the acquired entity, this future sale may also be affected by current elections regarding IRC 83(b) as a future buyer may investigate contingent compensation agreements and review whether IRC 83(b) elections have been properly made.

Taxation of Interest Earned on Escrow Funds

Escrow accounts are common in merger and acquisition transactions, and they provide important financial protections for both par-

Escrow accounts are common in merger and acquisition transactions, and they provide important financial protections for both parties during the post-closing period.

ties during the post-closing period. Many escrow accounts earn interest, but treatment of this interest can lead to disagreements between buyer and seller. Generally, a Form 1099-INT is issued to the buyer (thereby obligating the buyer to report interest income on its tax return), but the interest is actually paid to the seller when the escrow funds are released. Because of this imbalance, a buyer may ask a seller to agree to pay the related tax or include a provision in the agreement requiring the seller to pay the tax. However, when the buyer takes a deduction for the amount paid to the seller, the deductible amount will typically include the interest. This can create a buyer windfall in which the buyer receives the double benefit of a deduction as well as a “reimbursement” for taxes. If this issue is identified early in negotiations, buyers and sellers can resolve it early in the process. One approach that has been used to avoid the problem is the use of a noninterest bearing escrow account, which often is an agreeable option.

The foregoing discussion, while not exhaustive, provides an overview of some of the tax-related issues that Michigan business law practitioners should consider when navigating a merger or acquisition transaction. Although experienced tax counsel is always recommended in transactions, a basic understanding and awareness of the types of issues discussed above is helpful to any practitioner, and may promote efficient issue-spotting and resolution in many situations.

NOTES

1. Internal Revenue Service, Publication 1635 (Rev. 2-2014), *Understanding Your EIN*, available at <https://www.irs.gov/pub/irs-pdf/p1635.pdf>, last accessed July 26, 2023.

2. Publication 1635 further specifies, “A partnership shall be considered terminated if within a 12-month period there is a sale or exchange of at least 50% of the total interest in partnership capital and profits to another partner. If the purchaser and remaining partners immediately contribute the properties to a new partnership, they can retain the old partnership EIN.” This reference to “technical terminations” under IRC 708 indicates that the IRS has not revised this publication to conform to current legal developments. However, the 2017 amendment to IRC 708 appears to provide increased guidance in the context of EIN retention. Specifically, a “resulting partnership” following a merger or consolidation of two or more partnerships constitutes a continuation of one of the merging or consolidating partnerships if the members of the prior partnership own an interest of more than 50% in the capital and profits of the resulting partnership. A partnership resulting from the division of one partnership into two or more partnerships will be a

continuation of the prior partnership if the members of the prior partnership have an interest of more than 50% in the capital and profits of the resulting partnership.

3. Internal Revenue Service, *Do You Need a New EIN?* (last reviewed or updated Mar 17, 2023), available at <https://www.irs.gov/businesses/small-businesses-self-employed/do-you-need-a-new-ein>, last accessed July 26, 2023.

4. Internal Revenue Manual (“IRM”) Section 21.7.13.4.3.1 (10-01-2007), available at https://www.irs.gov/irm/part21/irm_21-007-013r, last accessed July 26, 2023.

5. Internal Revenue Service, *Do You Need a New EIN?* (last reviewed or updated 17-Mar-2023), available at <https://www.irs.gov/businesses/small-businesses-self-employed/do-you-need-a-new-ein>, last accessed July 26, 2023. Also see IRM Section 3.13.2.27.13 (Jan 3, 2022), available at https://www.irs.gov/irm/part3/irm_03-013-002r#idm139897855145664, last accessed 7.26.2023; Revenue Ruling 73-526, 1973-2 C.B. 404 (an EIN is retained by an entity that undertakes “a mere change in identity, form, or place of organization” as described in IRC 368(a)(1)(F)) and Private Letter Ruling (“PLR”) 200528021 (released July 15, 2005) (a corporation that converts to an LLC under a state conversion statute will retain the corporation’s previously assigned EIN).

6. Internal Revenue Manual Sections 21.7.13.4.3.1-4 (various dates), available at https://www.irs.gov/irm/part21/irm_21-007-013r, last accessed 7.26.2023. *Also see* Treas. Reg. 301.6109-1(h)(1) (any entity with an EIN will retain that EIN if its federal tax classification changes under IRC 301.7701-3).

7. Rev. Rul. 73-526, 1973-2 C.B. 404.

8. *See* Treas. Reg. 301.7701-3(c)(1)(iv) (“an election by a newly formed eligible entity that is effective on the date of formation is not considered a change for purposes of this paragraph (c)(1)(iv)”).

9. Rev. Rul. 95-37, 1995-1 C.B. 130.

10. *See* Treas. Reg. 301.6109-1(h)(2)(i) and Rev. Rul. 2001-61, 2001 I.R.B. 573.

11. MCL 205.51(1)(b).

12. MCL 205.94(1)(c).

13. MCL 205.92(g).

14. MCL 205.54t and MCL 205.94o.

15. *Id.*

16. *See, e.g., Bruskey v Department of Treasury*, 340 Mich App 42, 985 NW2d 237 (2022).

17. A contractual shift of the sales or use tax liability can be effective as between the parties, but generally has no effect with respect to a particular party’s liability to the Michigan Department of Treasury.

18. MCL 205.94g(1).

19. MCL 205.94g(3).

20. MCL 205.93(3)(c).

21. MCL 207.523.

22. MCL 207.525 (1).

23. *See* MCL 207.523(2).

24. MCL 207.523(1)(c).

25. MCL 207.522.

26. MCL 207.523.

27. MCL 211.1.

28. Mich Const 1963 art 9, §3.

29. MCL 211.27(1).

30. MCL 211.27a(3).

31. *See Signature Villas, LLC v City of Ann Arbor*, 269 Mich App 694, 714 NW2d 392 (2006).

32. *Transfer of Ownership Guidelines*, Prepared by the Michigan State Tax Commission, Issued Oct 30, 2017, available at https://www.michigan.gov/-/media/Project/Websites/treasury/MISC_9/TransferOwner-

shipGuidelines.pdf?rev=0e0f227ee9694952b2f0bafc02f42601 (last accessed July 26, 2023).

33. IRC 1362(g).

34. IRC 1361(c)(2)(A)(ii.)

35. Typically, the deferral is provided through a contribution of equity by the seller to a partnership under IRC 721.

36. See Rev. Rul. 2008-18.

37. PLR 201724013 (released June 16, 2017).

38. IRC 1361(b)(3)(B). Also see Treas. Reg. 1.1361-3(a)(1) (“The corporation for which the QSub election is made must meet all the requirements of section 1361(b)(3)(B) at the time the election is made and for all periods for which the election is to be effective.”)

39. IRC 83(a).

40. IRC 83(b).



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Board Duties and Derivative Actions in Michigan after *Murphy v Inman*

By Justin G. Klimko

Owners of corporations and LLCs frequently become embroiled in disputes that end up in court. A threshold question often presented is whether particular claims may be brought individually or must instead be brought in a derivative action. The answer may determine whether a claim can survive a motion to dismiss.

Until recently, Michigan's law regarding the derivative/direct distinction started with the presumption that a claim was derivative, and then it examined whether the claim fit a recognized exception to the presumption.¹ That changed with the Michigan Supreme Court's 2022 opinion in *Murphy v Inman*.² The question is now evaluated under a much simpler two-part analysis borrowed from Delaware caselaw that should bring greater clarity and understanding.

Nature of the Claim in *Murphy*

Murphy v Inman involved a claim by a former shareholder of Covisint Corporation against the board in connection with a cash-out merger in which OpenText Corporation acquired Covisint. In the merger, the Covisint shareholders were forced to surrender their shares in exchange for cash and ceased to have any continuing interest in Covisint. Although the merger was approved by a shareholder vote, the plaintiff claimed that the shares were sold on the cheap, asserting that the directors violated their duty to procure the best available price for the shares.

The defendants sought dismissal on various grounds, including that the case was derivative in nature and that the shareholder had failed to comply with the demand and other procedural requirements applicable to derivative claims, as discussed below. The trial court granted dismissal on this ground and the Court of Appeals affirmed.³

A unanimous Supreme Court reversed and remanded the case to the trial court for further proceedings. In a far-reaching opinion with major implications for shareholder litigation, the Supreme Court held that (i)

directors have common law duties to shareholders that were not abrogated by the adoption of the Michigan Business Corporation Act, (ii) directors have a fiduciary duty to maximize shareholder value in the context of a cash-out merger, (iii) in determining whether an action is direct or derivative, Michigan courts must apply a test adopted from Delaware caselaw, and (iv) a shareholder claim that directors breached their duties in a cash-out merger by negotiating an inadequate and unfair price may be brought directly.

Derivative Actions

In the corporation context, a derivative action is one brought by a shareholder to enforce corporate rights. The Michigan Business Corporation Act ("BCA") defines it as "a civil suit in the right of a domestic corporation or a foreign corporation that is authorized to or does transact business in this state."⁴ The *Murphy* court noted that "...[A] suit to enforce corporate rights or to redress injury to the corporation is a derivative suit; although it may be brought by the shareholder, the action itself belongs to the corporation."⁵ Generally speaking, a suit to enforce corporate rights "must be brought in the name of the corporation and not that of a stockholder, officer, or employee."⁶

The BCA imposes certain requirements on shareholders wishing to commence derivative actions. Most notable is the requirement that a demand be served on the corporation to take suitable action to address the claim.⁷ The shareholder must wait 90 days after serving the demand prior to proceeding with the action.⁸ There are other requirements intended to insure that the plaintiff is a proper representative to pursue the corporate claim,⁹ and provisions enabling the corporation to seek dismissal of a derivative proceeding as not in the best interests of the corporation.¹⁰ All of these provisions recognize that the claim belongs to the corporation, that any recovery will go to the corporation, and that the cor-

poration generally has the right to assume control of the claim.

Distinguishing Actions

If a claim may be brought directly, the procedural and other requirements applicable to derivative proceedings will not apply. Prior to *Murphy*, Michigan law treated all claims based on corporate behavior as derivative unless they satisfied one of two exceptions. As explained by the *Murphy* court:

Our Courts, in distinguishing between a direct and derivative shareholder suit, have recognized two exceptions to this general rule where (1) the individual “has sustained a loss separate and distinct from that of other stockholders generally,” [citation omitted], or where (2) the individual shows a “violation of a duty owed directly to the individual that is independent of the corporation,” [citation omitted].¹¹

The *Murphy* court found fault with this approach, because it started with a presumption not justified analytically:

Therein lies the problem with the general rule-exception framework that Michigan courts have applied to distinguish direct and derivative actions brought by shareholders. By assuming that the claim belongs to the corporation and then looking to whether an exception exists to permit the claim to be brought directly, our courts overlook the fundamental inquiry at the heart of the distinction between direct and derivative shareholder actions: the nature of the wrong alleged by the complaining shareholder.¹²

In other words, permitting a claim to proceed directly only if it satisfies an exception to derivative treatment fails to consider whether the claim is derivative in the first place. If the claim is not a derivative claim, no exception is needed. The prior Michigan approach failed to consider this threshold issue.

The *Murphy* Court instead looked to the Delaware Supreme Court’s analysis in the case of *Tooley v Donaldson, Lufkin & Jenrette, Inc.*¹³ Adopting the *Tooley* approach, the court established a new rule in Michigan for analyzing whether shareholder claims may be brought directly or only derivatively:

In sum, we hold that in order to distinguish between direct and derivative actions brought by shareholders of a corporation in Michigan, courts must

ask (1) who suffered the alleged harm, and (2) who would receive the benefit of any remedy recovered. The second question logically follows from the first. If the answer to both questions is the corporation, the action is derivative. If the shareholder suffers the harm independent of the corporation and receives the remedy rather than the corporation, the action is direct.¹⁴

This greatly simplifies the approach to determining whether claims are direct or derivative. In applying the new test, the court stated that the threshold inquiry is whether the plaintiff has demonstrated an ability to prevail without showing injury to the corporation; if the answer is yes, then the answer to the second question logically follows because the plaintiff will receive the benefit of the recovery.¹⁵ In those cases, the action may be brought directly.

Application in Cash-Out Merger Context

Applying the newly articulated rule, the court found that *Murphy*’s claim could be brought directly and was not required to be asserted in a derivative action. It found that the nature of the claim invoked the separate interests of the shareholders, noting that paying an inadequate price to acquire corporate shares implicates no interests of the corporation and that “the shareholders of the target corporation suffer the harm directly and exclusively.”¹⁶ The court also noted that any remedy for an inadequate price would have to go to the shareholders rather than the corporation. Otherwise, *OpenText* would receive a windfall, having paid too little to acquire the corporation and then receiving the damage award (presumably from insurance), a result the court said “defies logic.”¹⁷

Common Law Fiduciary Duties

The *Murphy* case involved fiduciary duties owed by directors to shareholders, and the court addressed the nature and source of those duties. Plaintiff argued that the Covisint directors owed him duties both under the BCA and at common law. Defendants countered that the BCA is the sole source of any duties owed by directors, and that any common law duties that may have existed were abrogated by adoption of the BCA.¹⁸ The court determined that fiduciary duties existed at common law and that directors owed those duties directly to sharehold-

The BCA imposes certain requirements on shareholders wishing to commence derivative actions.

The *Murphy* case involved fiduciary duties owed by directors to shareholders, and the court addressed the nature and source of those duties.

ers, in addition to duties owed to the corporation.¹⁹ Addressing the claim of abrogation, the court stated “the mere existence of a statute does not necessarily mean that the Legislature has exercised” its authority to replace the common law and that “the overriding question is whether the Legislature intended to abrogate the common law.”²⁰ Analyzing the Michigan General Corporation Act, in existence prior to adoption of the BCA, and the language of the BCA itself, the court concluded that the statutes had never created a right to a direct shareholder action and so could not be deemed, by adoption of the BCA, to have eliminated such a right by statute, and that the legislature had not otherwise indicated an intent to abrogate common law duties.²¹ The court stated that while the BCA “discusses the standard by which corporate directors are to discharge their managerial duties owed to the corporation It does not inform us about the fiduciary duties that directors owe to the shareholders....”²² The BCA simply does not address duties owed to shareholders, and “[b]ecause the Legislature is presumed to know that such duties exist at common law, we will not infer wholesale abrogation of all common law fiduciary duties from this silence.”²³

Adoption of the *Revlon* Standard

The *Murphy* case dealt with claims related to a cash-out merger. The court recognized that such transactions involve sale of control of the corporation and in that context, the duties of directors change. When considering such a transaction, “directors of the target corporation no longer perform purely managerial duties on behalf of the corporation” but rather “are charged with negotiating the share price that the target corporation’s shareholders will receive as cash.”²⁴ Where change of control is inevitable, there is no longer any corporate strategy to protect or defend, and instead the directors are charged with procuring the best price reasonably available. The seminal case in this regard is the 1986 Delaware Supreme Court case of *Revlon, Inc v MacAndrews & Forbes Holdings, Inc*,²⁵ which articulated the rule that in this context, directors “must focus on one primary objective—to secure the transaction offering the best value reasonably available for the stockholders.”²⁶

Federal cases decided under Michigan law have applied the *Revlon* standard,²⁷ but Michigan courts have not previously done

so. The *Murphy* court specifically applied the *Revlon* standard, stating:

In the context of a cash-out merger transaction in which the decision to sell the target corporation has been made, directors of the target corporation must disclose all material facts to shareholders regarding the merger and must exercise their fiduciary duties with one goal in mind: maximizing shareholder value by securing the highest value share price reasonably available.²⁸

This language specifically recognized that common law fiduciary duties include a duty of disclosure when shareholders are asked to take action. This state law duty is in addition to any duties of disclosure imposed under federal securities laws and would apply even to privately held companies without registered or tradable shares.

Conclusion

Murphy v Inman has ushered in new rules in Michigan for determining whether an action is derivative or direct. The new test abolishes previous presumptions and asks two simple questions in analyzing the issue—who was harmed, and who will benefit from any relief? In the context of a cash-out merger, the court recognized that a corporation has no interest in who owns shares or how much owners paid to acquire them; any breach of duty in arriving at the price injures the selling shareholders directly. *Murphy* also explicitly applies the *Revlon* rule to contests for change in control. This continues the line of cases tracing back to *Dodge v Ford Motor Co*²⁹ that held a corporation is to be operated primarily for its shareholders’ benefit.

Though *Murphy* dealt with a cash-out merger of a publicly held corporation, its holdings have implications for privately held companies and for noncorporate business entities. There is no reason the two-part test it adopted for classifying claims should not be applied to actions involving other types of entities, such as LLCs. Additionally, the Supreme Court’s holding that common law duties to shareholders were not abrogated by adoption of the BCA also affects the relations of directors and shareholders in privately held corporations.

NOTES

1. See notes 11 and 12 *infra* and accompanying text.
2. 509 Mich 132, 956 NW2d 233 (2022).
3. *Murphy v Inman*, No 345758 (Mich Ct App Apr 20, 2020) (unpublished).
4. MCL 450.1491a(a).
5. *Murphy v Inman*, 509 Mich 132, 160-161, 983 NW2d 354 (2022), citing *Dean v Kellogg*, 294 Mich 200, 207, 292 NW 704 (1940).
6. *Michigan Nat'l Bank v Mudgett*, 178 Mich App 677, 679, 444 NW2d 534 (1989).
7. MCL 450.1493a(a).
8. MCL 450.1493a(b). The demand requirement and 90-day waiting period were added to the statute to avoid litigation over whether demand is futile, which in some states such as Delaware can excuse demand but which historically led to significant proceedings in its own right. See Schulman, Moscow, and Lesser, *Michigan Corporation Law & Practice* (rev. ed., 2022 supp.), §4.25. The waiting period may not apply if the corporation has rejected the claim or if irreparable injury would result to the corporation from waiting.
9. See, e.g., MCL 450.1492a.
10. MCL 450.1495.
11. *Murphy v Inman*, 509 Mich at 160.
12. *Id.* at 161-162.
13. 845 A2d 1031 (Del 2004).
14. *Murphy v Inman*, 509 Mich at 165.
15. *Id.* at 163-164.
16. *Id.* at 167.
17. *Id.*
18. *Id.* at 161.
19. *Id.* at 152.
20. *Id.* at 153.
21. See discussion *id.* at 156-158.
22. *Id.* at 158.
23. *Id.* at 159.
24. *Id.* at 150.
25. 506 A2d 173 (Del 1986).
26. *Murphy v Inman*, 509 Mich at 150, quoting *Revlon, Inc v MacAndrews & Forbes Holdings, Inc*, 506 A2d at 182.
27. See, e.g., *Plaza Sec Co v Fruehauf Corp*, 643 F Supp 1535 (ED Mich 1986).
28. *Murphy v Inman*, 509 Mich at 152.
29. 204 Mich 459, 170 NW 668 (1919).



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Corporate Law Issues from a National Perspective: An Essay on a Director's Duty of Oversight – Caremark and Marchand*

By Gerard V. Mantese

"I Assure You, I am Spiritually and Emotionally and Ethically and Morally in Favor of Whoever Wins." -- Stewie, Director of the Waystar Royco Board of Directors, expressing his philosophy on conflicting positions of directors in the television series, *Succession*.

Succession, the award-winning television series, has riveted millions of viewers as it depicts the intrigue and conflict among the board of directors, the founder, and his extended family members over the fate of the company. Intergenerational disputes among shareholders or LLC members often involve bruising conflict over entity control, fortunes, fame, and long-simmering emotions. This conflict frequently places great stress on the decision making of directors.

In fact, the U.S. is about to witness the greatest transfer of wealth in its history, as older generations are expected to transfer \$61 trillion to their heirs between 2018 and 2042.¹ Part of this wealth transfer will undoubtedly include interests in profitable, closely held companies. This transition of power may, in turn, create conflict among the shareholders and differing views at the board level on the direction and management of the company. Will new owners, many of whom will elect themselves as directors and officers, understand their duties as directors and officers? But whether a director is newly elected or has served for decades, the director must understand these duties.

Directors are the architects of corporate policy. They set goals, determine direction of the company, hire and fire officers, and ultimately control the fate of the company. They wield great power in corporations. This article generally explores the specific duty of a director under Delaware caselaw to conduct oversight of the company's executives, the

proper workings of the company, and the company's compliance with the law.

Fiduciary Duties of Directors

MCL 450.1541a

The fiduciary duties of directors in Michigan are set forth both in statutes and by case-law. While interestingly not using the words "fiduciary duties," MCL 450.1541a, in pertinent part, sets forth fiduciary duties of directors and officers as follows:

- (1) A director or officer shall discharge his or her duties as a director or officer including his or her duties as a member of a committee in the following manner:
 - (a) In good faith.
 - (b) With the care an ordinarily prudent person in a like position would exercise under similar circumstances.
 - (c) In a manner he or she reasonably believes to be in the best interests of the corporation.²

Caselaw

Just last year, the Michigan Supreme Court held that the Legislature "did not abrogate directors' common-law fiduciary duties owed to the shareholders of a corporation" when the Legislature codified directors' duties to the corporation in MCL 450.1541a. *Murphy v Inman*, 509 Mich 132, 157, 983 NW2d 354 (2022). Under the common-law, directors of a corporation have fiduciary duties of good faith, loyalty, transparency, and due care to the shareholders. See, e.g., *Murphy*, 509 Mich at 147 (citing *Thomas v Satfield Co*, 363 Mich 111, 118, 108 NW2d 907 (1961)); *Murphy*, 509 Mich at 148 (citing *Reed v Pitkin*, 231 Mich 621, 204 NW 750 (1925)); and *Lumber Village, Inc v Siegler*, 135 Mich App 685, 695, 355 NW2d 654 (1984).³

*The author would like to thank Gregory A. Markel, Esq., Chair of the New York Litigation group and co-chair of the National Commercial and Securities Litigation practice of Seyfarth Shaw LLP, for his peer review of this article.

Directors also have a duty to manage the corporation so “as to produce to each stockholder the best possible return for his investment.” *Thompson v Walker*, 253 Mich 126, 134-35, 234 NW 144 (1931).

Like many other states, Michigan often looks to Delaware for guidance on matters of corporate and LLC law. *See, e.g., Murphy*, 509 Mich at 149, fn 33 (“Delaware is commonly understood to be the leading state on matters of corporate law ...”). Therefore, this article examines Delaware law⁴ on an interesting and still-developing issue of corporate law dealing with the oversight duties of a director to monitor the operations of a company. This duty of oversight may be considered a component of the duty of due care.

A “Caremark” Claim Premised on a Duty of Oversight

In re Caremark Int’l Inc v Derivative Litig, 698 A2d 959 (Del Ch 1996), is a leading case dealing with corporate governance. *Caremark* involved a derivative suit against the directors alleging they breached fiduciary duties by failing to exercise the duty to oversee the actions of executives. *Caremark International* was indicted for, and pled guilty to, mail fraud arising out of, among other things, improper referral payments made to physicians and others to induce them to distribute drugs that *Caremark* marketed. *Caremark* paid fines and reimbursements of more than \$250 million.

The plaintiffs in *Caremark* filed a derivative action against the board, alleging that it failed to have in place an information and reporting system that was “in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations,” as to the possibly illegal referral relationships with physicians and others who might recommend their medications. *Caremark*, 698 A2d at 970.

The court stated that “such a test of liability—lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight—is quite high.” *Id.* at 971. Although the court found that the case against *Caremark*’s board of directors for failure to monitor was weak, it approved the settlement as fair because the board agreed to make modest but systemic changes to its monitoring mechanisms. *Caremark* came to be known as a leading case in

this area. Yet, it has never been applied in any reported Michigan appellate decision.

Marchand v Barnhill

More recently, a *Caremark* claim was addressed in *Marchand v Barnhill*, 212 A3d 805 (Del 2019). In *Marchand*, the Delaware Supreme Court permitted litigation to proceed against the directors of an ice cream manufacturer on a theory of failure of oversight. In 2015, a widespread listeria outbreak occurred in which three people died. The outbreak led the company to recall all of its products, shut down production at its plants, and lay off one-third of its workforce. The company’s shareholders suffered major losses and the company suffered a liquidity crisis, which required it to accept a dilutive private equity investment.

In assessing the duty of oversight, the Delaware Supreme Court noted that as the company made only a single product, ice cream, it could only thrive if its products were safe to eat. Yet, the complaint alleged that there was no evidence of any system of information flow to the board about either the hygiene of its plants or correction of the issues that arose with listeria and that the board did not have a protocol or board meetings established specifically devoted to food safety compliance. The court held that bad faith is established under *Caremark*, when “the directors completely fail to implement ... or having implemented such a system or controls, consciously fail to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.” *Marchand*, 212 A3d at 821. The court concluded, “under *Caremark*, a director may be held liable if she acts in bad faith in the sense that she made no good faith effort to ensure that the company had in place any ‘system of controls.’” *Id.* at 822. There, the court stated: “As to the *Caremark* claim, we hold that the complaint alleges particularized facts that support a reasonable inference that the Blue Bell board failed to implement any system to monitor Blue Bell’s food safety performance or compliance.” *Id.* at 809.

Under *Marchand*, then, boards are not required to know everything, nor are they required to prevent all misfortune from befalling the company. But they *are* required to exercise reasonable diligence and good faith in putting in place a system whereby they receive a reasonable amount of information about company operations, including wheth-

No Michigan state court appellate decision has yet applied *Caremark* or *Marchand*. Whether Michigan will follow this line of cases to enunciate a duty of oversight on the part of directors remains to be seen.

er the company is complying with the law and observing reasonable safety protocols.

Michigan Law

No Michigan state court appellate decision has yet applied *Caremark* or *Marchand*. Whether Michigan will follow this line of cases to enunciate a duty of oversight on the part of directors remains to be seen. One can argue, however, that such a duty is already implicit in the fiduciary duty of due care and good faith, which directors already have.

In any event, to the extent that a company is engaged in illegal conduct, Michigan's oppression statutes may also offer an avenue for redress. For example, MCL 450.1489 provides a shareholder with a cause of action against directors, or those in control of the corporation, for conduct that is "illegal, fraudulent, or willfully unfair and oppressive to the corporation or to the shareholder." See also MCL 450.4515, for analogous language applicable to LLCs.⁵

Conclusion

The contours of the duty of oversight, as stated by *Caremark* and *Marchand*, are not yet crystallized. While Michigan has yet to specifically deal with these concepts, they may be understood as related to directors' duties of due care and good faith. Although the law in Michigan regarding the duty to monitor or investigate is not yet clarified, directors would be well advised to act as if it is.⁶ With this in mind, I leave you with this haiku.

Ignorance is bliss.
But for directors, not this.
Can be dangerous.

cuit court found that "the management team and Board acted in bad faith to withhold payment of dividends." The court ordered four of the individual defendants and the company to pay damages to plaintiffs in the form of a dividend totaling \$2.1 million, including interest. The court also ordered the appointment of an independent outside director to the board. Prior to trial, the case generated *Franks v Franks*, 330 Mich App 69, 944 NW2d 388 (2019), where the Court of Appeals held that oppression requires a showing of intentional conduct and that the board of directors may not avail themselves of the business judgment rule defense where oppression is shown.

6. Note that such claims might be covered by directors' and officers' insurance. See MCL 450.1561, discussing when a corporation may indemnify directors and officers.



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NOTES

1. *The Wall Street Journal*, July 2, 2021.

2. The balance of this statute sets forth safe harbors for directors and officers in exercising their fiduciary duties.

3. See also Gerard V. Mantese, *The Fiduciary Duty – Et Tu, Brute?* Mich B J 52 (Sept 2020). (<https://mantese-law.com/wp-content/uploads/2021/03/The-Fiduciary-Duty-Gerard-Mantese-MI-Bar-Journal-September-2020.pdf>).

4. It should be noted that New York also recognizes a duty of oversight. See, e.g., *Kravitz v Tavliarios*, No 20-2579-cv (2nd Cir Nov 18, 2021).

5. A leading case on MCL 450.1489 is *Franks v Franks*, No 13-809-CBB (St Joseph County 2023), with G. Mantese and I. Williamson as co-lead counsel for plaintiffs. After an 11-day Zoom bench trial, the cir-

Michigan Supreme Court Ruling Greatly Limits Usury Savings Clauses – What Soaring Pine Means for the Future of Lending in Michigan

By Shanika A. Owens, Joseph M. Kuzmiak, Laura E. Johnson and Justin G. Klimko

A recent Michigan Supreme Court case has greatly limited the effectiveness of so-called “usury savings clauses” in loan agreements and, in doing so, has not only increased lenders’ risks regarding interest rates in loan or credit agreements but also raised some questions for legal practitioners as to other topics such as choice of law provisions and opinion letters relating to loan arrangements.

Michigan, like most states, has usury statutes that limit the interest lenders may charge in lending transactions. Usury savings clauses are common to virtually all commercial loan or credit agreements and are designed to avoid violation of usury laws. They typically state that the parties do not intend to charge interest above the legal limit and that any amounts determined to exceed the legal limit will instead be applied to principal or will be refunded to the borrower. These types of clauses may be triggered not because of a blatant violation of usury laws by the setting of a high interest rate but rather as a result of other charges and fees being characterized as “interest” and thus resulting in an overall interest rate that is above the limit. Courts have made clear that they will not be bound by the labels that parties place on charges and payments and may determine that items labeled as something else (e.g., fees, equity riders, reimbursements, etc.) should instead be treated as interest. This reclassification, along with changes in an external index on which a floating interest rate is based, can lead to violation of usury limits although unintended by the lending party. Usury savings clauses are inserted in loan or credit agreements to avoid this result. Historically, usury savings clauses have been enforceable under Michigan law. However, the recent Michigan

Supreme Court case of *Soaring Pine Capital v Park Street*¹ changes this approach.

Soaring Pine involved a loan from a non-bank lender to a company that used the proceeds to “flip” houses in Detroit that were subject to tax foreclosure—buy them, renovate them, and sell them. The borrower paid interest on the loan for a while but then stopped paying, and the lender sued to enforce the loan note. The note had a stated interest rate of 20%, which was already very high. In addition, there was a \$50,000 “up-front” fee, a \$1000 per house “success fee,” and other fees and charges. The borrower alleged that the fees and charges constituted disguised interest and, when added to the stated interest rate of the loan, caused interest on the loan to exceed 36%. The trial court agreed and held that the fees and charges constituted disguised interest, pushing the effective interest rate above the 25% criminal usury limit specified in MCL 438.41. The lender pointed to the usury savings clause in the loan documentation, arguing that if re-characterization of certain charges resulted in a usurious interest rate, the clause should be invoked to apply the excess interest to payment on the principal.

The trial court agreed with the borrower that the additional amounts caused the loan to exceed usury limits but held that based on the plain language of the contract, the usury savings clause was enforceable, so the note was not facially usurious. The trial judge found that the lender had in fact violated the criminal usury statute by *collecting* interest in excess of the statutory limit, but that the note did not on its face *charge* usurious interest because of the savings clause. As a result, the trial court barred the lender from collecting interest on the loan but did not bar collection

Historically, usury savings clauses have been enforceable under Michigan law. However, the recent Michigan Supreme Court case of *Soaring Pine Capital v Park Street*¹ changes this approach.

of the principal amount of the loan. The parties appealed and the Michigan Court of Appeals affirmed. Both parties appealed to the Michigan Supreme Court.

On appeal, the Michigan Supreme Court addressed two issues under Michigan usury law. The first is whether a court can enforce a “usury savings clause,” and the second is whether a lender commits a crime if it seeks to collect an unlawful interest rate by suing to enforce an agreement.

With respect to the first issue, the Supreme Court reversed the lower court and the Court of Appeals and held that the usury savings clause was not enforceable. “[A] usury savings clause is ineffective if the loan agreement otherwise requires a borrower to pay an illegal interest rate ... even if some of the interest is labeled something else, such as a ‘fee’ or ‘charge.’”² Much of the court’s analysis on this issue focused on public policy concerns, with the court ultimately finding that enforcement of the usury savings clause would be contrary to public policy, noting “[e]nforcing a usury savings clause in this circumstance would undermine Michigan’s usury laws because it would nullify the statutory remedies for usury, thereby relieving lenders of the obligation to ensure their loans have a legal interest rate. In short, a lender cannot avoid the consequences of contracting for a usurious interest rate simply by including a savings clause in the contract.”³ The court emphasized the risk that a rate will be found usurious (because, for example, charges or fees are recharacterized as interest) falls on the lender, which the court found “consistent with longstanding Michigan public policy that protects borrowers from excessive interest rates by placing the primary burden on the lender to know and comply with the law when imposing interest, fees, and charges on a loan.”⁴

The court also rejected defendant’s contention that the usury limits should not be applied in the case of sophisticated transaction parties. The court found no basis in the statutes or in applicable caselaw for such a distinction. Again, the court relied on public policy in protecting borrowers from unlawful interest rates.

Although the court was not willing to give effect to the usury savings clause at issue in *Soaring Pine*, it did recognize that savings clauses may be given effect when events outside of the parties’ control cause interest rates to increase. The court found applica-

tion under these limited circumstances to be consistent with public policy to permit the lender to recover at the maximum legal rate. This exception might apply, for example, when interest rates are tied to outside indices such as SOFR, independent prime rates, or Federal Reserve rates.

With respect to the second issue, the court held that *suing* to recover an illegally high interest rate is not, by itself, a violation of the criminal usury statute. The court stood on the principle of “free access to the courts” and aimed to avoid chilling effects on plaintiffs seeking to recover in collection suits. The court preferred that lenders use judicial proceedings, where courts presumably would protect borrowers from overreach, to self-help remedies.

The Michigan Supreme Court declined to rule on whether the fees and charges in the case at hand were in fact usurious and remanded the case to the trial court to determine whether the note was usurious on its face

A Historical Look at Michigan Usury Law

Like most states, Michigan has usury statutes that have been in place for many years and reflect public policy concerns. The statutes protect necessitous borrowers by prohibiting lenders from charging or collecting interest rates above prescribed rates.

Included among the suite of usury provisions in Michigan law is Michigan’s criminal usury statute, MCL 438.41, under which a lender is guilty of criminal usury when it knowingly charges or collects interest at a rate exceeding 25%. A lender found guilty of criminal usury may face imprisonment of up to five years in addition to \$10,000 in fines. MCL 438.32 bars lenders who impose a usurious interest rate from recovering any interest, fees, delinquency or collection charges, attorneys’ fees, or court costs from the borrower. The borrower who was subjected to the usurious interest rate is entitled to recover attorney’s fees and court costs from the lender. Additionally, if a lender is found to have knowingly charged a usurious interest rate, application of the wrongful-conduct rule may lead to the inability to recover principal as well as interest. For these and other reasons, parties to a loan, and especially lenders, strove to comply with usury laws in setting the terms of the loan and structuring the transaction. However, usury savings

clauses provided a level of protection in the event that other fees or charges were reclassified or extraneous events occurred increasing the interest rate.

Prior to the Michigan Supreme Court's ruling in *Soaring Pine*, courts interpreting Michigan's usury statutes have generally held usury savings clauses to be effective in preventing loan agreements from being facially usurious. The Bankruptcy Court of the Eastern District of Michigan held that a usury savings clause in a promissory note, which provided that the interest charged could not exceed the maximin rate per Michigan's usury statutes, prevented the loan from being facially usurious.⁵ The Michigan Court of Appeals arrived at a similar conclusion in reviewing a usury savings clause in a promissory note that was charging an effective interest rate of 27.5%. In finding that the note was not usurious on its face, the court said its conclusion was supported by the plain language of the note as "contracts must be construed so as to give effect to every word or phrase as far as practicable."⁶ The court added that "[t]o find the promissory note to be usurious on its face, we would have to ignore the qualification regarding the interest rate."⁷

Michigan law has long recognized the principle of freedom of contract and enforcement of contracts as written. "If the contractual language is unambiguous, courts must interpret and enforce the contract as written, because an unambiguous contract reflects the parties' intent as a matter of law."⁸ The Michigan Supreme Court in *Rory v Continental Ins Co*⁹ held that:

Unless a contract provision violates law or one of the traditional defenses to the enforceability of a contract applies, a court must construe and apply unambiguous contract provisions as written. We reiterate that the judiciary is without authority to modify unambiguous contracts or rebalance the contractual equities struck by the contracting parties because fundamental principles of contract law preclude such subjective post hoc judicial determinations of "reasonableness" as a basis upon which courts may refuse to enforce unambiguous contractual provisions.

However, the Michigan Supreme Court's ruling in *Soaring Pine* demonstrates that contractual provisions that violate public policy will not be enforced.

Take Away—Caution to Lenders

The *Soaring Pine* opinion means that the risk-mitigating effects of usury savings clauses, on which lending parties previously relied, have been significantly compromised. This may be particularly true in debt tranches below senior bank debt (such as mezzanine debt or debt provided by nonbank lenders), which often carry higher rates of interest. Lenders will want to check loan details and may need to restructure current contracts to ensure the documents are not facially usurious. Lenders already had the burden to draft agreements that would not violate usury laws, and as a result of the holding in *Soaring Pine* and the additional burden placed on lenders, the volume of lending in Michigan may be affected.

For lenders subject to Michigan law, a violation of usury laws may result in significant criminal and civil penalties. Criminal penalties include imprisonment of up to five years and fines of up to \$10,000. Civil usury penalties include the waiving of interest and the borrower's recovery of attorneys' fees. In addition, application of the wrongful-conduct rule may lead to the inability to recover principal as well as interest.

Potential Effect on Legal Opinion Letters

It has long been customary, in connection with commercial loan transactions, for borrower's counsel to deliver to the lender a legal opinion addressing various matters. The opinion letter addresses the recipient's concerns on certain legal matters affecting the borrower and the transaction itself, while the borrower's own representations and warranties in the loan agreement provide comfort on factual matters.¹⁰ Opinion preparers should not deliver an opinion that may mislead the opinion recipient regarding any matter the opinion addresses.¹¹

One of the key elements of such an opinion letter is the so-called "enforceability" opinion in which the opinion giver opines, subject to certain assumptions and qualifications, that the loan documents are enforceable in accordance with their terms. Over the last several decades, a significant body of literature has developed regarding the meaning and interpretation of legal opinions in business transactions. National groups such as the TriBar Opinion Committee and the ABA Business Law Section Legal Opinions

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Committee, as well as various state organizations,¹² have issued reports.¹³

The literature notes that as a matter of customary practice an enforceability opinion is understood to cover the enforceability of each and every provision of a loan agreement¹⁴ (subject to any stated exceptions). This includes the provisions relating to interest. Opining attorneys often take exceptions for usury provisions because of the uncertainty over which items, in addition to stated interest, a court would determine to constitute interest covered by usury statutes. Such an exception, however, typically only relates to whether the interest charged will be enforceable under existing usury laws. It does not speak to the enforceability of the usury savings clause, which is an independent contractual provision. Put differently, the typical exception says, colloquially, “we don’t opine on whether the interest you receive will exceed the permissible limits under applicable usury laws.” It does not say “we don’t opine on whether a court will apply the usury savings clause to avoid violation of usury laws.” Given the *Soaring Pine* opinion, in various loan transactions, opinion givers may wish to consider both a traditional usury exception and an exception for enforcement of the savings clause.

The Use of Choice-of-Law Provisions in Conjunction with Usury Savings Clauses

The rules governing which state’s law will apply to a dispute can be complex. Contract parties will often include a choice-of-law provision in their agreement to specify which jurisdiction’s laws will govern interpretation of the agreement. The typical commercial loan agreement specifies the governing law of the lender’s home jurisdiction. Can such a provision be effective to avoid the application of the *Soaring Pine* decision and preserve the validity of a usury savings clause?

Michigan generally follows the Restatement 2d Conflict of Laws (the “Restatement”) regarding choice of law.¹⁵ Section 187 of the Restatement says generally that a court will respect the parties’ choice of law, unless (i) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the choice, or (ii) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in

the determination of the particular issue *and* which would be the state of the applicable law in the absence of an effective choice of law by the parties. Federal courts construing Michigan law have noted that “Michigan choice-of-law rules and general equitable choice-of-law policies support enforcing parties’ agreed-upon choice-of-law clauses absent any strong public policy concerns to the contrary.”¹⁶ Furthermore, there is a balancing act between the parties’ expectations and the states’ public policy concerns. “Michigan [choice-of-law] rules ... require a court to balance the expectations of the parties to a contract with the interests of the states involved to determine which state’s law to apply.”¹⁷ Some courts have upheld a choice-of-law provision even when it was evident that the party was evading usury laws.¹⁸

The Sixth Circuit has explained that, in choice-of-law disputes,

[t]he fact ... that a different result might be achieved if the law of the chosen forum is applied does not suffice to show that the foreign law is repugnant to a fundamental policy of the forum state. If the situation were otherwise, and foreign law could automatically be ignored whenever it differed from the law of the forum state, then the entire body of law relating to conflicts would be rendered meaningless.¹⁹

Nonetheless, the Restatement recognizes that public policy considerations may lead to disregarding a choice-of-law provision and applying a different law. Due to the public policy issues cited by the Michigan Supreme Court in *Soaring Pine*, there is a strong possibility that a lender attempting to enforce a usury savings clause against a Michigan borrower in a Michigan court would be unable to rely on a choice of law provision specifying another state’s law as governing (for example, New York law). Borrowers can be expected to argue that application of a choice-of-law clause that would result in enforcement of a savings clause that would violate a fundamental public policy of Michigan law.²⁰ The Michigan Supreme Court noted in *Soaring Pine* that “courts have a duty to refuse to enforce a contract that is contrary to public policy.”²¹

A key factor in such a case may be venue. New York has a law²² providing that a choice of law provision in an agreement designating New York law is valid, even if the agreement has no reasonable relation to the state, pro-

Given the *Soaring Pine* opinion, in various loan transactions, opinion givers may wish to consider both a traditional usury exception and an exception for enforcement of the savings clause.

vided that the transaction is valued at a minimum of \$250,000.²³ A New York court would enforce the choice-of-law provision in a loan agreement that meets that threshold.

Applicability to Corporate Borrowers

Another question raised by *Soaring Pine* is whether the holding of the court with respect to usury savings clauses would similarly apply in a case where the borrower is a corporation (the borrower in *Soaring Pine* was a limited liability company). In its decision, the court noted that section 212 of the Michigan Limited Liability Company Act²⁴ provides that a domestic or foreign limited liability company may agree in writing to pay any rate of interest *so long as not in excess of the criminal usury limit*. This language supported the Supreme Court's argument that regardless of sophistication of the parties involved in a transaction, the defendant limited liability company cannot agree to interest rates above the criminal usury rate. The analogous provision of the Michigan Business Corporation Act does not contain this same qualification. Rather, it provides that a domestic or foreign corporation may, by agreement in writing, agree to pay a rate of interest in excess of the legal rate, and the defense of usury is prohibited.²⁵ The statute does not include any caveat or condition that the agreed rate may not exceed the criminal usury limit. It is possible that a corporation borrower would be unable to assert usury as a defense to payment in a similar case. However, it should be noted that Michigan's criminal usury statute prohibits charging or taking interest exceeding 25%, so a lender could commit a criminal violation of the statute even if the borrower could not assert usury as a defense. Given the court's emphasis in *Soaring Pine* on public policy and the dismissal of any distinction between sophisticated and "unsophisticated" parties to a transaction, it seems unlikely that the structure of a borrower (corporation vs. limited liability company) would enable a lender to avoid violating the statute by virtue of a savings clause, regardless of the borrower's defenses.

NOTES

1. *Soaring Pine Capital Real Estate & Debt Fund II, LLC v Park St Grp Realty Servs, LLC*, No 163320, ___ Mich ___, ___ NW2d ___ (June 23, 2023).
2. *Id.* at 2.
3. *Id.*
4. *Id.* at 7.
5. *In re Skymark Props II, LLC*, 597 BR 363, 390 (Bankr ED Mich. 2019) (the usury savings clause in that case stated, "It is the specific intent of the Borrower and Lender that this [Promissory] Note bear a lawful rate of interest, and if any court of competent jurisdiction should determine that the rate herein provided for exceeds that which is statutorily permitted for the type of transaction evidenced hereby, the interest rate shall be reduced to the highest rate permitted by applicable law, with any excess interest theretofore collected being applied against principal or, if such principal has been fully repaid, returned to Borrower on demand. More specifically, the calculation of Interest in this [Promissory] Note shall not exceed 25% when considering all fees or other costs which are interpreted as interest.").
6. *Karel v JRCK Corp*, No 304415 at *2 (Mich Ct App May 10, 2012) (unpublished) (quoting and citing *Klapp v United Ins Grp Agency, Inc*, 468 Mich 459, 467, 663 NW2d 447 (2003)).
7. *Id.* at *2.
8. *In re Smith Tr*, 480 Mich 19, 24, 745 NW2d 754 (2008).
9. 473 Mich 457, 461, 703 NW2d 23 (2005).
10. See Report of the Ad Hoc Committee of the Business Law Section of the State Bar of Michigan on Standardized Legal Opinions in Business Transactions, 14 MI Bus LJ 1, 21 (1991).
11. See Stanley Keller and Steven O. Weise, *Obtaining National Consensus on Key Opinion Practices: An Introduction to the Statement of Opinion Practices*, The Business Lawyer, Vol 74, 812 (Summer 2019).
12. See, e.g., Report of the Michigan Ad Hoc Committee on Legal Opinions (2010), available through the website of the Business Law Section of the State Bar of Michigan at <https://connect.michbar.org/businesslaw/council/committees/legalopinions>.
13. A good resource for these materials is the ABA Legal Opinions Resource Center available at https://www.americanbar.org/groups/business_law/resources/legal-opinions-resource-center/.
14. See, e.g., Third Party "Closing" Opinions, A Report of the TriBar Opinion Committee, 53 Bus Law 591 at fn 69 and accompanying text.
15. See *Chrysler Corp v Skyline Indus Servs, Inc*, 448 Mich 113, 528 NW2d 698 (1995).
16. *In re Dow Corning Corp*, 419 F3d 543, 548 (6th Cir 2005) (citation omitted).
17. *Mill's Pride, Inc v Continental Ins Co*, 300 F3d 701, 705 (6th Cir 2002) (citations omitted).
18. See *In re Vision Dev Grp of Broward Cty, LLC*, 411 BR 768 (Bankr SD Fla 2009) (applying New York law pursuant to the parties' choice of law, stating that Florida courts will enforce a choice of law provision even when the intent and effect is to evade Florida's usury laws).
19. *Johnson v Ventra Grp, Inc*, 191 F3d 732, 740 (6th Cir 1999) (citation omitted).
20. See *MoneyForLawsuits V LP v Rowe*, No 10-CV-11537 at *1 (ED Mich Mar. 29, 2012), aff'd sub nom. *Money for Lawsuits V LP v Rowe*, 570 F App'x 442 (6th Cir 2014).
21. *Soaring Pine*, op. at 8, 25 (citation omitted).
22. NY Code Sec 5-1401.
23. Some other states have similar laws. See, e.g., 6 Del. C. Sec 2708 (threshold is \$100,000).
24. MCL 450.4212.
25. MCL 450.1275.

Another question raised by *Soaring Pine* is whether the holding of the court with respect to usury savings clauses would similarly apply in a case where the borrower is a corporation[.]



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Case Digests

Prepared by *Tala Dahbour

MSSC, Inc v Airboss Flexible Prods Co, No 163523, ___ Mich ___, ___ NW2d ___ (July 11, 2023)

MSSC, Inc., a Tier-1 automotive supplier, alleged anticipatory breach of contract against its supplier Airboss Flexible Products Co, a Tier-2 automotive supplier. Airboss moved for summary disposition and argued that the purchase order (PO) failed to satisfy the Uniform Commercial Codes' statute of frauds, MCL 440.2201(1), and therefore, was not an enforceable contract under the statute. The trial court granted summary disposition in favor of MSSC, holding that the PO was a "blanket" order containing a "quantity term," satisfying MCL 440.2201(1). The court of appeals affirmed. On appeal to the Michigan Supreme Court, the court reversed and remanded the court of appeals decision, holding that a "blanket" order alone does not satisfy MCL 440.2201(1) and that *Great Northern Packaging, Inc v General Tire & Rubber Co*, 154 Mich App 777, 399 NW2d 408 (1987) is overruled to the extent that it held to the contrary.

MCL 440.2201(1) provides for the enforcement of contracts for the sale of goods worth \$1,000 or more where the contract is in writing and a quantity of goods is also included in the writing. A requirements contract between a supplier and manufacturer outlines that the seller agrees to supply all of the goods purchaser requires. However, a requirements contracts must include a quantity term which is set in good faith and is not disproportionate to any provided estimate. MCL 440.2306(1). Alternatively, a release-by-release contract provides the seller with the opportunity to reject orders when releases are issued and not accepted. In other words, the contract expires with the refusal of a new release.

The contract at issue did not include a quantity term and instead stated that MSSC would issue releases. Because the PO did not include any specifics as to the quantity term, parol evidence could not be used to discern one. Therefore, the trial court erroneously relied on *Cadillac Rubber & Plastics, Inc v Tubular Metal Sys, LLC*, 331 Mich App 416, 952 NW2d 576 (2020). Further, the requirement of "good faith and fair dealing," and the 2015 "value add provision" did not create a requirements contract where there was no specified quantity term. The case is vacated and remanded to the Court of Appeals and *Great Northern Packaging, Inc* is overruled to the extent that it holds that "blanket" qualifies as a quantity term.

Davis v BetMGM, LLC, No 363116, ___ Mich App ___, ___ NW2d ___ (Sept 28, 2023)

Plaintiff won approximately three million dollars playing defendant's online game, Luck O' the Roulette. After Plaintiff withdrew \$100,000 of her winnings, defendant

determined that plaintiff's win was caused by an error in the game and refused to issue plaintiff further winnings. Plaintiff then filed suit, alleging claims of fraud, conversion, and breach of contract. One month after filing suit, plaintiff filed a patron dispute with the Michigan Gaming Control Board (MGCB). Subsequently, defendant filed a motion for summary disposition under MCR 2.116(C) (4), arguing that the MGCB had primary jurisdiction over plaintiff's claims, and that plaintiff had failed to exhaust her administrative remedies as outlined under the Lawful Internet Gaming Act (LIGA), MCL 432.301 et seq. The MGCB issued a letter to plaintiff's attorney stating that an investigation would be conducted by the board and, if necessary, an appropriate remedy under the Administrative Procedures Act would apply. The note also clarified that, "MGCB investigations are not intended to determine the merits of any outstanding dispute or litigation," prompting plaintiff to argue that the letter indicated that the MGCB lacked jurisdiction over her claims. The circuit court disagreed, granting defendant's motion for summary disposition and holding that LIGA preempted plaintiff's claims. Plaintiff then filed a motion for reconsideration and provided the court with a letter from the MGCB addressed to the defendant, finding violations of MGCB rules, but stopping short of enforcing any disciplinary action against the defendant. The circuit court denied the motion for reconsideration and the plaintiff appealed.

The Court of Appeals set out to determine whether the legislature intended that LIGA provide the exclusive remedy for plaintiff's claims. With a lack of case law interpreting LIGA, the court looked to cases interpreting the Michigan Gaming Control and Revenue Act (MGCRA) for guidance. In *Kraft v Detroit Entm't, LLC*, 261 Mich App 534, 540, 683 NW2d 200 (2004), the court found that language under MGCRA stating, "[a]ny other law that is inconsistent with this act does not apply to casino gaming as provided for by this act," precluded inconsistent common-law actions. *Kraft*, 261 Mich App at 546. LIGA contains a similar provision under MCL 432.304(3), "[a] law that is inconsistent with this act does not apply to internet gaming as provided for this act." Further, like MGCRA, LIGA "prescribes in detail a course of conduct to pursue and the parties and things affected, and designates specific limitations and exceptions." *Kraft*, 261 Mich App at 545. Therefore, applying the reasoning in *Kraft*, the court of appeals held that, despite the unfavorable outcome for plaintiff, plaintiff's claims contradicted MGCB's authority under LIGA to regulate all aspects of internet gaming. The decision of the circuit court is affirmed.

Department of Agric & Rural Dev v Zante, Inc, No 363515, ___ Mich App ___, ___ NW2d ___ (Sept 21, 2023)

Despite a November 2020 Michigan Department of Health and Human Services (MDHHS) order prohibiting indoor dining, defendant continued operating her restaurant in the midst of the COVID-19 pandemic. After a warning, the Michigan Department of Agriculture and Rural Develop-

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ment (MDARD) suspended defendant's food license pursuant to MCL 289.4125(4). The suspension was continued in a February 2021 order by an administrative law judge. MDARD then filed for injunctive action in circuit court to stop defendant from continuing to operate her business without a license. The circuit court, after issuing a temporary restraining order, proceeded to issue a preliminary injunction, both of which did not stop defendant from operating her business. As a result, the circuit court had entered two contempt judgements against defendant and issued a permanent injunction against defendant.

Defendant filed an action to set aside the contempt judgements and request for a refund of damages, costs, and fees incurred as a result. The circuit court denied defendant's motion and the court of appeals affirmed. MDARD then sought summary disposition in circuit court and defendant moved for declaratory judgement to dismiss, vacate, void, and set aside the case and award damages. The circuit court entered judgment for MDARD and denied defendant's motion.

Defendant appealed, citing the unconstitutionality of the November 2020 MDHHS order. The court of appeals reasoned that because defendant did not appeal the administrative order suspending her food license, the court lacked subject matter jurisdiction. Consistent with *Johnson v White*, 261 Mich App 332, 346, 682 NW2d 505 (2004), the court held that when a constitutional issue is intermingled with issues properly before an administrative agency, all administrative remedies must be exhausted. However, defendant failed to challenge the validity of the order during administrative proceedings, thereby foreclosing on the circuit court's review of constitutionality of an agency's actions. The decision of the circuit court is affirmed.

***Vectren Infrastructure Servs Corp v
Department of Treasury, No 163742, ___
Mich ___, ___ NW2d ___ (July 31, 2023)***

Minnesota Limited, Inc (ML), a company retained to assist in a Kalamazoo oil spill in 2010, sold its assets to Vectren Infrastructure Services Corporation in March 2011, treating the sale as a sale of its assets under the federal tax code. Pursuant to an audit, the Department of Treasury (DoT) found that ML had improperly included its gain from the sale of its assets in the sales-factor denominator under MCL 208.1303, thereby overstating the company's total sales and limiting tax liability under the Michigan Business Tax Act (MBTA). DoT's audit resulted in a sales factor increase from 14.9860% to 69.9761%, denying ML's request for an alternative apportionment for the short year. Vectren sued the DoT, alleging that the DoT improperly assessed a tax deficiency against the company and raising claims under the Equal Protection, Due Process, and Commerce Clauses of the Constitution.

The Court of Claims granted summary disposition in favor of the DoT, holding that the sale constituted "business income" as defined under the MBTA. The Court of Appeals reversed, finding that ML was entitled to an al-

ternative apportionment. The Supreme Court vacated the Court of Appeals decision and remanded the case to the Court of Appeals on the question of whether the DoT properly calculated and applied the apportionment formula. The case was remanded to the Court of Claims as to whether Vectren's inclusion of the sale of the business's tangible and intangible assets in the denominator of the sales factor was proper. The Court of Claims found it to be improper. Vectren, once again, appealed to the Court of Appeals, which once again held that Vectren was entitled to an alternative apportionment formula, citing an abuse of Michigan's taxing powers.

On appeal, the Supreme Court held that the DoT properly included income from an asset sale in the tax base apportionment formula under MCL 208.1201(2). It was inappropriate to include the asset sale in either the sales-factor numerator or denominator as the income does not qualify as "sales" pursuant to the definition under MCL 208.1115(1). Furthermore, the company's intangible income was properly taxed because the record showed adequate connections between Michigan and the company both before and after the sale. Therefore, absent clear and cogent evidence to the contrary, the DoT properly applied the tax base apportionment formula under the MBTA. Further, the DoT's determination did not offend the state's taxing power, the due process clause, or the commerce clause of the constitution because the MBTA apportionment formula is both internally and externally consistent and ML failed to show that the business activity attributed to Michigan was out of proportion to the business transacted in the state. The judgement of the Court of Appeals is vacated and the case is remanded to the Court of Claims.

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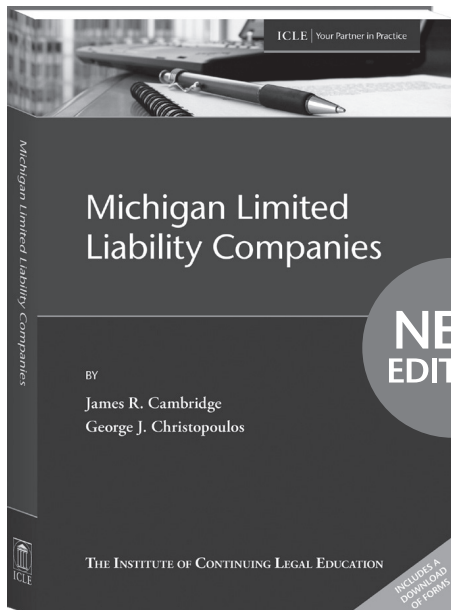
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