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

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

Issue	Primary Theme/Committee	Article Deadline
Fall 2014	Corporate Laws Committee	July 31, 2014
Spring 2015	Debtor/Creditors Rights Committee	November 30, 2014
Summer 2015	Nonprofits Corporations Committee	March 31, 2015
Fall 2015	Uniform Commercial Code Committee	July 31, 2015

ADVERTISING

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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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Volume XXII, Issue 1, and subsequent issues of the *Journal* are also available online by accessing http://www.michbar.org/business/bizlawjournal.cfm

From the Desk of the Chairperson

By Jeffrey J. Van Winkle

During the past several months, many of us have been discussing the merits of a mandatory state bar association. Senate Bill 743, introduced on January 23, 2014, by Senator Arlan Meekhof, prompted this discussion. On its surface, the bill is an attempt to reconcile the right to work provisions in Michigan with mandatory state bar membership. Essentially, I surmise that Senator Meekhof concluded that a mandatory bar association membership is equivalent to a mandatory union membership, which is now prohibited under the right to work provisions. Following the introduction of SB 743, several sections of the state bar, as well as the board of commissioners for the state bar, have opposed the enactment of SB 743. No matter the outcome of any vote on SB 743, the conversation about a mandatory bar association is interesting.

The bar commissioners offered answers to frequent questions that communicate how and why a mandatory bar delivers value to its members that a voluntary bar cannot. However, I do not believe that their responses fundamentally get at the issues raised by this discussion. Even if the mandatory bar association is eliminated, the state would continue to regulate admission of individuals to the practice of law in the same way it continues to regulate admission of other professionals and trades. The state has an important interest in ensuring law practitioners satisfy minimum qualifications. So that the core question is whether individuals practicing law have a different reason for requiring the mandatory association in a trade association than the other licensed trades and professions.

I assert that there is a distinctive reason that lawyers should be required to maintain a mandatory association, and one of the answers provided by the bar commissioners to the frequently asked questions is on the same path. The commissioners identify that the mandatory bar assumes responsibility for programs that are designed to protect the public and to provide access to justice. While many of us who practice business law on a daily basis do not routinely consider these issues, we know that fundamentally a society governed by the rule of law and that permits all participants to have access to the system is a sturdy place for business and for encouraging proper social welfare. But the commissioner's answer does not go far enough to say that the mandatory bar creates a community that specifically enhances these efforts.

This is what I mean: In today's world of e-mail and texting, we often think that actions by individuals are most important, and that impersonal electronic interactions are fully effective. However, bar commissioners, association sections, and committees act in groups. The most productive activity a section of the state bar may conduct is the bringing together of key leaders to discuss, debate, and ultimately take action on a particular issue. Individual actions on the same topic do not have nearly the strength of the community assessing and acting. In fact, a community that discusses a particular matter may identify better solutions than any individual might have developed.

I don't believe that that benefit of a mandatory bar association is simply that the bar association members have a nice community—if that is true then there may be little basis to justify distinctive treatment for the state bar association. Instead, I believe that by requiring lawyers to act in community through a mandatory association, lawyers are more effective in discharging their duties to the broader community. As a result, the mandatory bar association benefits the community to which we, as lawyers, have a duty.

We know that there are other states without mandatory bar associations, and the practice of law is not collapsing in those states. In fact justice continues to be delivered in those states as well. However, in this instance, there is no good reason to terminate the existing mandatory association. In fact, doing so would likely start to erode the community that so many lawyers work hard to maintain for the benefit of our state-wide community. We do not need to create one more barrier to healthy communities.

No matter what the outcome has been or will be with respect to SB 743, business lawyers today should reflect on how they can act in community to provide a better framework for the delivery of justice and service to our state community. If you have thoughts on this topic, please do not hesitate to email me at jvanwinkle@clarkhill.com. I encourage you to keep seeking out community in all aspects of your practice.

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Electronic Seals and Architects, Professional Engineers, and Professional Surveyors

HB 4585 amended sections 2007 and 2008 of the Occupational Code[1] to specifically provide for the use of electronic seals and electronic signatures by architects, professional engineers, and professional surveyors. Signed by Governor Snyder on November 26, 2013, the bill became Public Act 178 of 2013 and will take effect 90 days after it was signed.

The Uniform Electronic Transactions Act ("UETA"), 2000 PA 305, applies to any electronic record or electronic signature created, generated, sent, communicated, received, or stored on or after the effective date of the act, October 15, 2000. The terms electronic, electronic record, electronic signature, transaction, and record are defined in section 2 of UETA as follows:

> (e) "Electronic" means relating to technology having electrical, digital, magnetic, wireless, optical, electromagnetic, or similar capabilities.
>
> (g) "Electronic record" means a record created, generated, sent, communicated, received, or stored by electronic means.
>
> (h) "Electronic signature" means an electronic sound, symbol, or process attached to or logically associated with a record and executed or adopted by a person with the intent to sign the record.
>
> …
>
> (m) "Record" means information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.
>
> …
>
> (p) "Transaction" means an action or set of actions occurring between 2 or more persons relating to the conduct of business, commercial, or governmental affairs.

The MCL chapter on statutes provides in MCL 8.3, "In the construction of the statutes of this state, the rules stated in sections 3a to 3w shall be observed, unless such construction would be inconsistent with the manifest intent of the legislature." MCL 8.3a provides, "All words and phrases shall be construed and understood according to the common and approved usage of the language; but technical words and phrases, and such as may have acquired a peculiar and appropriate meaning in the law, shall be construed and understood according to such peculiar and appropriate meaning."

MCL 8.3n, as amended by PA 57 of 2010, defines "seal" as follows:

> In all cases in which the seal of any court or public office is required to be affixed to any paper or electronic document issuing from the court or office, the word "seal" shall be construed to include any of the following:
>
> (a) The impression of the seal on the paper alone.
>
> (b) The impression of the seal affixed to the paper by means of a wafer or wax.
>
> (c) The seal affixed electronically on the paper or affixed to an electronic document.

Regarding the sealing of deeds and other instruments Public Act 198 of 1895, as amended by 2010 PA 56, in MCL 565.232 provides:

> (1) A seal of a court, public officer, or corporation may be affixed in any of the following ways:
>
> (a) Impressed directly upon the instrument or writing to be sealed.
>
> (b) Impressed upon wafer, wax, or other adhesive substance affixed to the instrument or writing or upon paper or other similar substance affixed to the instrument or writing by an adhesive substance.
>
> (c) Affixed electronically upon the instrument or writing to be sealed, or affixed electronically upon an electronic document.
>
> (2) An instrument or writing duly executed in the corporate name of a corporation that has not adopted a corporate seal, if executed by the proper officers of the corporation under any seal, shall be considered to have been executed under the corporate seal.

Effective February 25, 2014, Public Act 178 of 2013 defines "electronic signature," "electronic seal," "seal," and "signature" as used in sections 2007 and 2008 of Occupational Code. "Electronic signature" is "a signature created by electronic or optical means and affixed electronically to a document or electronic document with intent to sign the document."[2] "Electronic seal" is "a seal created by electronic or optical means and affixed electronically to a document or electronic document."[3] Thus, the definition of "seal" includes an electronic seal and the definition of "signature" includes an electronic signature. Public Act 178 of 2013 does not define "electronic" or "electronic record." The definition for "electronic signature is different than in UETA, and the definition for "seal" is different than in MCL 8.3n and MCL 565.232.

The Uniform Real Property Electronic Recording Act, 2010 PA 123, uses the same definitions for "electronic" and "electronic signature" as UETA and makes specific reference to UETA in section 4, MCL 565.844. Regarding the use of electronic documents, section 3 of the Uniform Real Property Electronic Recording Act, MCL 565.843, provides:

> (1) If a law requires as a condition for recording that a document be an original, be on paper or another tangible medium, or be in writing, the requirement is satisfied by an electronic document.
>
> (2) If a law requires as a condition for recording that a document be signed, the requirement is satisfied by an electronic signature.
>
> (3) A requirement that a document or a signature associated with a document be notarized,

acknowledged, verified, witnessed, or made under oath is satisfied if the electronic signature of the person authorized to perform that act, and all other information required to be included, is attached to or logically associated with the document or signature. A physical or electronic image of a stamp, impression, or seal need not accompany an electronic signature.

(4) This section does not require that a register of deeds accept electronic documents for recording.

Section 2007 requires a licensee to apply both seal and signature to a plan, specification, plat, or report issued by the licensee and filed with a public authority. A signature was not previously required by the act, but was required by the rules.[4]

Both UETA and Public Act 178 of 2013 address the use of electronic documents and electronic signatures. Statutes that relate to the same subject or share a common purpose are *in pari materia* and should be read together. To the extent that statutes are in conflict, the more specific statute controls. If a conflict arises due to the differences between the definitions, or lack of definitions, in Public Act 178 of 2013 and other statutes addressing the use of electronic documents and electronic seals it may be necessary to determine which statute should prevail.

Crowdfunding

In general all securities offered in the United States must be registered with the Securities and Exchange Commission (SEC) or must qualify for an exemption from the federal registration requirements. Offerings that are exempt from federal registration requirements may still be subject to Michigan law.

Section 301 of the Uniform Securities Act (2002), MCL 451.2301, provides:

A person shall not offer or sell a security in this state unless 1 or more of the following are met:

a) The security is a federal covered security.

b) The security, transaction, or offer is exempted from registration under section 201 to 203.

c) The security is registered under the act.

In 2012, Congress enacted the Jumpstart Our Business Startups Act ("JOBS Act"),[5] which included a federal securities registration exemption to permit issuers to raise money through the internet, commonly referred to as crowdfunding. Crowdfunding has not previously been used to offer or sell securities because doing so could require the offer or sale of the securities to be registered with the SEC, unless an exemption is available. One of the investor protections provided for in the JOBS Act is the requirement that the transactions take place through an SEC registered intermediary, either a broker-dealer or a funding portal.

The JOBS Act crowdfunding exemption allows small businesses to raise capital via a registered portal to which the public has direct access. However, the federal exemption is not available until the SEC promulgates crowdfunding regulations. On October 23, 2013, the SEC released proposed rules to permit companies to offer and sell securities through crowdfunding and establishes requirements and prohibitions for intermediaries.[6] There is a 90-day public comment period, and comments on the proposed rule are available on the SEC website.[7]

HB 4996 signed by Governor Snyder is Public Act 264 and effective on December 26, 2013. HB 4996 amends sections 102a, 202, 504, and 520 of the Uniform Securities Act (2002) and adds new section 202a to the act. The amendment creates an exemption from sections 301-306 and 504 of the act if the issuer is a Michigan entity that meets the requirements for the federal intrastate offering exemption under section 3(a)(11) of the Securities Act of 1933, 15 USC 77C(A)(11) and SEC Rule 147, 17 CFR 230, and complies with other criteria in section 202a.

The federal intrastate exemption is a prerequisite for the Michigan crowdfunding exemption.

If a transaction does not meet the federal intrastate exemption requirements, the offering would have to be registered with the SEC or must qualify for another exemption from federal registration. In addition, if the transaction does not meet the federal intrastate exemption and Rule 147, the Michigan crowdfunding exemption is not available, and the offering must be registered or qualify for another exemption from Michigan law.

Section 202a(8) provides a website through which an offer or sale of securities "is not subject to the broker-dealer, investment adviser, or investment adviser representative registration requirement under article 4" if the website meets all the requirements in section 202a(8). A person operating a website under section 202a(8) may be required, however, to register with the SEC as a broker dealer or a funding portal. Under federal law, to operate as an intermediary, a person must be registered with the SEC as a broker dealer or funding portal.[8]

Crowdfunding provides another option for small businesses to raise capital. Due to the complex nature of both federal and state securities laws and regulations, small businesses should seek the advice of securities experts to determine the most appropriate manner in which to raise capital. In many instances, use of existing exemptions, such as Reg D, may provide more flexibility and predictability.

NOTES

1. MCL 339.2007 and 339.2008.
2. MCL 339.2007(3)(b).
3. MCL 339.2007(3)(a).
4. AC, R 339.15301, AC, R 339,16024, and AC, R 339.17301.
5. Public L 112-106, 126 Stat. 306 (2012).
6. http://www.sec.gov/rules/proposed/2013/33-9470.pdf.
7. http://www.sec.gov/comments/s7-09-13/s70913.shtml.

8. http://www.sec.gov/divisions/marketreg/tmjobsact-crowdfundingintermediariesfaq.htm.

G. Ann Baker is Deputy Director of the Corporations, Securities and Commercial Licensing Bureau, Department of Licensing and Regulatory Affairs. Ms. Baker routinely works with the department, legislature, and State Bar of Michigan's Business Law Section to review legislation. She is a past chair of the Business Law Section and is the 2008 recipient of the Stephen H. Schulman Outstanding Business Lawyer Award.

 By Eric M. Nemeth

Internal Revenue Service/Department of Justice (Tax Division) Enforcement Priorities

I recently attended the 30th Annual National Institute on Criminal Tax Fraud and the Third Annual National Institute on Tax Controversy sponsored by the American Bar Association. What makes this seminar particularly important and informative to business lawyers is that the key speakers are the leading tax enforcement officials from the U.S. Department of Justice—Tax Division ("Justice"), the U.S. Department of the Treasury ("Treasury"), and the Internal Revenue Service (IRS). In other words, what these people say matters.

This column will be the first of two outlining government enforcement priorities and, as such, practice tips that may benefit your clients. Forewarned is forearmed. Before I delve into particulars, my general take-away is that the government has done a remarkable job of leveraging technology and marshalling resources with the same or even less personnel than several years ago. The Treasury and Justice departments know where information about businesses and individuals is located, and they know how to access that information. The coordination between the two departments is at historic dimensions. Taxpayers and their representatives would be wise to take note.

International tax enforcement remains the top enforcement priority. International is not as exotic as it may seem. Clients may have a foreign financial account or assets through a variety of methods or reasons. There could be family in the "old country," foreign rental property (yes, Canada is a foreign country), and foreign business interests. Do you have a client that travels overseas regularly for business? There may also be dual citizenship (including spouse), asset protection (a popular sales pitch), or just the "excitement" of having a foreign financial account. Perhaps like the structuring column I wrote last quarter, the income could have all been reported, including payment of tax in the host country; nevertheless, problems still result from improper informational reporting.

The Tax Division's top litigation priority is the concerted civil and criminal effort to combat "the serious problem of non-compliance with our tax laws by U.S. taxpayers using secret offshore bank accounts." A problem that a 2008 Senate report concluded costs the U.S. Treasury at least $100 billion annually.[1]

IRS Commissioner, Douglas H. Shulman, stated, "Our focus on offshore tax evasion continues to produce strong, substantial results for the nation's taxpayers.… As we've said all along, people need to come in and get right with us before we find you.…We are following more leads and the risk for people who do not come in continues to increase."[2]

The government has successfully used the "John Doe" summons to gather information about unknown taxpayer(s). A summons is issued under IRC 7609(f) and requires the IRS to demonstrate in an *ex parte* court proceeding that the summons relates to an ascertainable group or class, a reasonable basis exists that there is a failure to comply with the revenue laws, and that the information sought is not readily available from other sources. Generally, the burden on the IRS has been viewed as minimal.

The John Doe procedure has been used in the past to gather offshore credit card information drawn on foreign banks (tax-havens) and, over the years, various domestic banks. In 2008, banking secrecy (Switzerland) had the lid blown off when the IRS was allowed to issue a John Doe summons to UBS for information about U.S. taxpayers using Swiss bank accounts. That venture by the IRS led to thousands of U.S. taxpayers (43,000 by last count) fighting for their proverbial freedom, and USB paying a $780 million penalty. Besides Switzerland, other countries in play are the Cayman Islands, Israel, and Singapore, to name but a few.

Historically, the targeted banks had a U.S. presence. Now, the IRS has been approved to use a John Doe summons to gather information about correspondent banks and their accounts. A correspondent account is simply a foreign bank with no direct U.S. banking presence that has a bank account with a U.S. bank. The reason that a foreign bank would have such an account is access to U.S. financial markets, and any global transaction denominated in U.S. dollars must go through a U.S. bank.

Example: Client has a bank account with a small bank in country "X" with no U.S. banking presence (branches). They tell your client that they do not file "anything" with the IRS. Client opens an account. Client needs to access funds to pay for college tuition. Acting upon instructions from client to pay the college tuition, foreign bank writes a check or wire to the U.S. bank payable to the university for tuition. The domestic bank honors the request of its account holder (foreign bank) that it uses to wire or write a check to university "Y." The IRS summonses U.S. bank for correspondent account detail. The IRS gets the check or wire for university "Y." The IRS contacts the university to find out what account the tuition paid. A little legwork later, the IRS can cross-check to see if the appropriate taxpayer disclosed the existence of the offshore account (FBAR forms) and if the income was disclosed (audit or investigation).

On the home front, the IRS has begun utilizing some rather basic investigative tools *before* the taxpayer is even contacted. The IRS agent pulls a credit report for your client. Credit reports have an immense amount of detail including credit cards, mortgages, secured loans, and payment

history. A basic Internet search will also provide a remarkable amount of information such as business interests, memberships, litigation, property records, etc. A quick Internet search can uncover a Facebook or LinkedIn account. What are your privacy settings? Are there pictures of exotic travel, luxury goods purchased, and perhaps even e-mails with friends and business associates (perhaps your foreign banker "likes" your new luxury watch that you bought in the Cayman Islands)? Isn't technology grand? As I said earlier, the government has leveraged technology. What can be uncovered in a few minutes with a simple laptop computer could literally take months (if at all) not many years ago. Does your client's tax return match his or her public footprint?

The Tax Matters column for the Summer issue will cover more detail from the conference. At this point, though, the first and most important take-away from the Institute is that if your client is not compliant, strongly consider a voluntary disclosure with the IRS. The avoidance of criminal prosecution (if your client otherwise qualifies) is the gift that keeps on giving. The parameters of a voluntary disclosure are multi-faceted and should be the subject of an in-depth client meeting, but, be advised, if the IRS contacts you first, there is no eligibility for this program. Given the current enforcement atmosphere, a client might wish he or she had the opportunity for a disclosure.

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NOTES

1. http://www.justice.gov/tax/offshore_compliance_intiative.htm.

2. http://www.irs.gov/uac/IRS-Offshore-Programs-Produce-$4.4-Billion-To-Date-for-Nation%E2%80%99s-Taxpayers;-Offshore-Voluntary-Disclosure-Program-Reopens.

By Michael S. Khoury and Joshua M. Borson

Cybersecurity: We Are From the Government – We Want to Help

Global dependence on the Internet has transformed this essential business and personal resource into a fertile breeding ground for identity theft, compromised data, and numerous other cybercrimes.[1] In 2012, the state of Michigan's governmental computer networks alone detected approximately 187,000 cyber anomalies per day (hacks, attempted intrusions, and other criminal or economic espionage activities).[2] The National Institute of Science and Technology ("NIST") estimates that up to 75 percent of companies' information technology ("IT") databases nationwide are vulnerable to attack.[3] The technology sector has had information assurance and security on its radar for a while; industry has been dragged along. But where has government been? How are agencies securing the technology infrastructure necessary for the operation of government, and are they supporting our nation's critical infrastructure? Is regulation the right path? Are mandates required such as the rules promulgated by the Securities Exchange Commission?[4]

The growing concern over cybersecurity has prompted a nationwide effort, both at the federal and state level, to develop policies and take action to defend public and private critical infrastructures. Proposed standards to prevent or minimize cyber attacks have generally fallen short in effectively counteracting a dynamic and rapidly evolving adversary challenging our IT environments.[5] But there is some basis to believe that progress is possible. Two developments in 2013 seemed to be leading the way toward an effective government support for a strategy that will establish some basic standards for cybersecurity.

The Cybersecurity Framework

In early 2013, the White House issued an executive order that recognized the national and economic reliance on a properly functioning critical infrastructure and directed that a collaborative initiative be undertaken between the public and private sectors to develop an approach to cybersecurity protocols.[6] In the fall of 2013, the NIST released a framework document for comments that is intended to establish a minimum baseline for protecting critical infrastructure in cyberspace.[7] The overarching goal of the framework is to provide some structure by which organizations can individually craft cybersecurity measures in a manner that reflects an entity's unique risk tolerance and IT acumen.

The Cybersecurity Framework (the "Framework") includes a three-part approach: the Framework Core, the Framework Profile, and the Framework Implementation Tiers (the "Framework Tiers"). As its name implies, the Framework Core describes various cybersecurity activities that an organization can implement in performing five basic categories: to identify, protect, detect, respond, and recover cybersecurity risks.[8] At a minimum, the Framework Core informs an organization whether it has a system in place at each level of vulnerability.

The Framework Profile compares an organization's actual performance and expected achievement based on industry standards and best practices.[9] This metric is likely intended to establish an objective standard such that an organization has the ability to assess and prioritize its core areas of cybersecurity.

The Framework Tiers rank an organization's effectiveness at implementing risk-management programs given its business, role in critical infrastructure, and vulnerability.[10] The Framework Tiers also describe the depth and involvement of an organization's cybersecurity management.

The Cybersecurity Framework may appear to be a weak attempt at insuring the protection of the national infrastructure and the systems supporting business and government. On the positive side, however, this is the first step at a comprehensive approach to raise the awareness of business and government about this serious and growing threat.

The Michigan Cyber Disruption Response Strategy

Governor Rick Snyder and key members of his administration have taken a leadership role in developing governmental cybersecurity programs to maintain vital public services and critical infrastructure in the event of a catastrophic event. In addition to serving as the co-chair of the National Governors Association's State Cybersecurity Resource Center, Governor Snyder introduced the Michigan Cyber Initiative to manage the impact of cyber disruption in Michigan.[11] In pursuit of this initiative, state and local agencies have teamed up with select private sector critical infrastructure owners and operators to develop the Michigan Cyber Disruption Response Strategy (the "Response Strategy").[12] Formally launched at the Michigan Cyber Summit in the fall of 2013, the Response Strategy strives to identify and improve awareness of critical infrastructure vulnerabilities, create template plans to respond to cyber disruption events, train key personnel, and conduct exercises to test response plans annually.[13]

The key components of the Response Strategy are the Communication Annex, Response Plans Annex, Training & Exercise Annex, and Risk Assessment Annex. The Communication Annex acts as a threshold that must be triggered to activate the Response Strategy to limit the unnecessary deployment of public resources.[14] The two scenarios envisioned by the Response Strategy include situations when a participating member either (1) experiences a harmful cyber disruption; or (2) is compelled to share emerging cyber anomalies or threats.[15]

The Response Plan Annex mirrors the five functions of the Federal Cybersecurity Framework Core, discussed above, and is intended to identify the key aspects of the response plans for business or government in the event of a cyber attack.

As the name implies, the Training and Exercise Annex provides a platform that assumes the participant will both train key personnel in the actions necessary for a response to such an event, and the testing to ensure that a participating member has effective training based on its respective domain and technical expertise.[16]

The Risk Assessment Annex leverages the resources of all participating members to maximize risk elimination.[17] The Response Strategy conforms to the National Infrastructure Protection Plan ("NIPP") adopted by the U.S. Department of Homeland Security[18] and complements the cybersecurity framework released by the White House at approximately the same time. NIPP locates concentrated groups of network assets to divert resources to areas where attacks are highly likely to occur or cause the greatest damage.[19]

What Should Business Do?

The key point from both the federal Cybersecurity Framework and the Michigan Cyber Disruption Response Strategy is that cyber risks can no longer be ignored. Each participant needs to consider these risks as part of their risk management strategies. Qualified professionals need to be hired or consulted to ensure that the business or government has adequate protection against threats. This determination requires an analysis by each participant of the potential for risks, the risk tolerance of the organization, and the likely impact of an event on operations.

Whether your organization needs to establish a complete cybersecurity protocol or merely requires fine-tuning an existing program, the Framework and Response Strategies offer an invaluable resource to protecting critical infrastructure.

NOTES

1. See "SEC Issues Guidance on Cybersecurity Risks and Disclosure," MI Bus LJ (Summer 2012).
2. Statistics provided by the Mich Dep't of Tech, Mgmt & Budget, Cyber Sec & Infrastructure Protection Admin, and Mich Cyber Sec Office.
3. Chris Dimarco, *NIST Releases Proposed Cybersecurity Framework*, InsideCounsel (Oct 24, 2013), which can be found at http://www.insidecounsel.com/2013/10/24/nist-releases-proposed-cybersecurity-framework.
4. See "SEC Issues Guidance on Cybersecurity Risks and Disclosure," MI Bus LJ (Summer 2012).
5. *Id.*
6. Executive Order 13636; 78 Fed. Reg. 11,737 (Feb 19, 2013).
7. Jennifer Buergo, *NIST Releases Preliminary Cybersecurity Framework, Will Seek Comments*, NIST (Oct 22, 2013), which can be found at http://www.nist.gov/itl/cybersecurity-102213.cfm.
8. 78 Fed Reg 11,737, at § 1.1.
9. *Id.*
10. *Id.*
11. *Michigan Cyber Initiative: Defense and Development for Michigan Citizens, Businesses and Industry*, which can be found at http://www.michigan.gov/documents/cybersecurity/MichiganCyberInitiative2011_365631_7.pdf.
12. Mich Dep't of Tech, Mgmt and Budget, Mich State Police and Mich Nat'l Guard, Mich Cyber Disruption Response Strategy (Sept 16, 2013) which can be found at https://www.michigan.gov/documents/cybersecurity/Michigan_Cyber_Disruption_Response_Strategy_1.0_438703_7.pdf.
13. *Id.* at pp. 2-3.
14. *Id.* at pp. 10-13.
15. *Id.*
16. *Id.*
17. *Id.* at pp. 28-31.
18. U.S. Dep't of Homeland Sec., Nat'l Infrastructure Protection Plan, which can be found at https://www.dhs.gov/national-infrastructure-protection-plan.
19. Mich Cyber Disruption Response Strategy, at pp. 28-31.

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 By Kim Yapchai

Michigan In-House Counsel: Over 4000 Strong

Did you know that there are over 4000 attorneys belonging to the State Bar of Michigan who designate themselves as in-house counsel? Did you know that many of them are in small legal departments? I have spent over 20 years as an in-house attorney but did not know this until recently.

The Business Law Section is the home of the In-House Counsel Committee. Unlike other bar sections that focus on specific legal topics, the In-House Counsel Committee is devoted to the unique needs of in-house counsel. The State Bar provides generous funding and support for the Committee. I do not know of any in-house counsel who would say "no" to a legitimate funding source. Bharat Gandhi, Lead Counsel, IP-Legal-Technology Licensing at the Dow Chemical Company, is the current chair of the Committee. Recent past chairs include Theresa Orr, Assistant General Counsel at NSK Americas, Inc., Florence Affatato, Compliance Manager and Legal Counsel at Portfolio Solutions, and myself.

The In-House Counsel Committee focuses on two premier events each year: the Crain's In-House Counsel Awards and the annual Champions' Dinner. By working with Crain's, we are able to recognize the unsung heroes and heroines in legal departments. The event consists of a daytime conference focused on hot legal topics and an evening awards program. It is one of the largest gatherings of in-house counsel in Michigan. My favorite part of the event is the roundtable discussions exclusive to in-house only. It gives me the chance to sit with other attorneys who specialize in my practice area and discuss whatever is on our minds—legal trends, benchmarking, and even brainstorming on issues. The opportunity to find out what has worked (and more importantly, what hasn't worked) for other companies is invaluable to me. Average attendance has been around 350 people. This year's event will be held on Tuesday, May 13, 2014, at the Westin Book Cadillac in Detroit, Michigan. For more information, you can visit crainsdetroit.com/events. Information about last year's winners is available at http://www.crainsdetroit.com/section/general_and_in_house_counsel_awards_2013.

The Champions' Dinner, on the other hand, provides a more intimate setting. In-House Counsel Committee members have the unique opportunity to sit at a dinner table with a Crain's award winner. Over dinner, members then have the opportunity to ask about the secrets of success and share best practices. This event is typically held in the late summer and is free, but registration is limited. Last year, the event sold out quickly, so I highly recommend reserving your spot once reservations are open. It is a relaxed evening that has received rave reviews. Hope to see you there this year.

The In-House Counsel Committee also has an exclusive LinkedIn group for its members—the "Michigan In-House Network." You can find it at www.linkedin.com/groups/Michigan-InHouse-Counsel-Network-4342523. LinkedIn is a great networking tool. Last year, we even held a webinar about how easy it is to set up your profile and get started. LinkedIn can also help you to find out about job opportunities, keep up to date on events, and get referrals for law firms. Research shows that in-house counsel frequently use LinkedIn to vet outside counsel since it is so easy to see how many people in your network also have a connection to that attorney or law firm.

Being part of the Business Law Section has a lot of benefits. In addition to the generous funding it provides to the Committee, the Business Law Section is one of the largest and most active sections in the State Bar of Michigan. A network like the Business Law Section is invaluable, especially if you are in a small legal department. The Section also provides many leadership opportunities for its members, ranging from committee participation to chairing the section. Your in-house counsel perspective is highly valued and easy to share at the many speaking opportunities as well. I have enjoyed my participation and made many new friends and connections.

This column is the first in a series that I will be writing for the In-House Counsel Committee this year, so please look for more information in the next edition. If you have a particular topic that you would like us to address, or if you would like to sign up for the Committee, you can send an email to businesslaw@mi.rr.com. We look forward to connecting with you at our next event and online.

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The SEC Whistleblower Program – What Employers Need to Know

By Matthew P. Allen

Introduction

After Lehman Brothers, Bernie Madoff, and the mortgage-backed securities meltdown of 2008, the Dodd-Frank Wall Street Reform and Consumer Protection Act and the public have charged the U.S. Securities & Exchange Commission ("SEC" or "Commission") with doing its part to help prevent another financial and economic catastrophe by regulating with more authority various securities products and industries. From money market funds to private equity funds to foreign private issuers, the SEC has stepped up its efforts to effectively examine, investigate, and charge securities violations that it views as endangering investors. However, it appears the Commission's budget has not kept up with the increased scope of its duties.[1] So the Commission must be effective and judicious with its resources, which has resulted in a reorganization of the SEC's divisions and reporting structure, enactment and implementation of new examination and investigation procedures and protocols, and increased cooperation with settling defendants and other state, federal, and international regulators and authorities.[2]

One of the primary tools developed for the SEC to carry out the increased scope of its duties, with the relatively modest budget provided to do so, is the creation by Congress of the "Securities Whistleblower Incentives and Protection" section in the Dodd Frank Act ("Section 21F" or "the Whistleblower Act").[3] Section 21F directs the SEC to provide monetary awards to individuals who provide "voluntary," "original" information that leads to a successful enforcement action that results in a sanction over $1 million. Congress established the Investor Protection Fund to ensure enough money to pay whistleblowers without diminishing the amount of recovery for victims of securities fraud. The Commission established the Office of the Whistleblower to administer the whistleblower program. "It is [the Office of the Whistleblower's] mission to administer a vigorous whistleblower program that will help the Commission identify and halt frauds early and quickly to minimize investor losses."[4]

Equally important to Congress and the SEC is protecting whistleblowers from retaliation by their employers. Section 21F provides whistleblowers with a statutory cause of action and significant remedies for retaliation, which can include reinstatement, two times the back pay owed, and payment of their attorney fees. Moreover, Section 21F and its implementing regulations do not permit companies to use confidentiality or severance provisions in employment agreements to prevent whistleblowers from providing tips or information to the SEC, and permits whistleblower employees to secretly communicate with the SEC even if the employee is represented by corporate counsel. These laws and rules create new challenges for corporate counsel managing an internal or other investigation involving a whistleblower.

This article provides an overview of the SEC's whistleblower rule, provides some whistleblower compliance tips for employers, and an overview of how courts are interpreting and enforcing the whistleblower provisions.

The SEC Whistleblower Program

Overview

The Whistleblower provisions of the 2010 Dodd-Frank legislation were enacted to empower the SEC to financially reward, and protect from retaliation, securities fraud whistleblowers. Congress legislated the parameters for the SEC whistleblower program, created an Office of the Whistleblower, and directed the SEC to issue final regulations implementing the whistleblower legislation no later than mid-2011.[5] In May 2011, the SEC issued its final whistleblower program and rules, which became effective on August 12, 2011 and are embodied in SEC Rule 21F.[6]

Former SEC Chairman Mary Shapiro remarked that the SEC's whistleblower program has already "proven to be a valuable tool in helping us ferret out financial fraud…. When insiders provide us with high-quality

road maps of fraudulent wrongdoing, it reduces the length of time we spend investigating and saves the agency substantial resources."[7] The SEC interim Commissioner after Chairman Shapiro left, Elisse Walter, commented in December 2012 that she was "bothered" by two issues with the whistleblower rules: (1) the impact of the program on internal corporate compliance processes, and (2) that culpable whistleblowers may receive an award as long as they are not criminally convicted.[8] In 2013, President Obama nominated as SEC Chairman the former U.S. Attorney for the Southern District of New York, Mary Jo White, who has implemented an aggressive SEC enforcement agenda.[9] Unlike her predecessor, Chairman White sees the whistleblower rules augmenting, not inhibiting, corporate internal compliance programs:

> When our whistleblower program was being set up, many in the securities bar…worried that the program would undermine internal compliance efforts. It seems, however, that the program may be having the opposite effect. Today, we hear that companies are beefing up their internal compliance function and making it clear to their own employees that internal reporting will be treated seriously and fairly. And most in-house whistleblowers that come to us went the internal route first.[10]

[T]he SEC has stepped up its efforts to effectively examine, investigate, and charge securities violations that it views as endangering investors.

Chairman White's comments indicate that more whistleblower awards will be made, and that the whistleblower program will be used to "dramatically broaden [the Commission's] presence."[11]

This section provides the following information about the SEC's whistleblower program: (A) summary of some of the more relevant provisions of Rule 21F; (B) statistics from the SEC's whistleblower reports for 2012 and 2013, the first two full operational years of the whistleblower program; (C) whistleblower compliance suggestions and issues for companies and counsel to consider; and (D) an analysis of important court decisions interpreting the Whistleblower Act provisions and SEC implementing rules.

Summary of Salient Provisions of Rule 21F[12]

Rule 21F-3: SEC will pay an award to one or more whistleblowers who:

1. "Voluntarily provide" the SEC
2. "original information"
3. "that leads to the successful enforcement" by the SEC in court or admin action
4. where SEC "obtains monetary sanctions totaling *more than*" *$1million ("1M")*

Whistleblowers can also receive award in a "related action" (such as parallel proceedings by the United States Department of Justice (DOJ), U.S. Commodity Futures Trading Commission (CFTC), Financial Industry Regulatory Authority (FINRA), Internal Revenue Service (IRS)) if the whistleblower satisfies Rule 21F.

Rule 21F-4: definitions of key terms

- **Voluntary submission of information**: provide information "before a request, inquiry, or demand that relates to the subject matter of your submission is directed to you or anyone representing you" by the SEC, PCAOB or any other SRO, or any federal government branch or agency. It will not be voluntary "even if your response is not compelled by a subpoena;" any inquiry counts. But it will be voluntary if original information was provided to another agency prior to the SEC request or inquiry. It will not be voluntary if the submission is required as part of a pre-existing duty.
- **Original information**: information that is "derived from your *independent knowledge* or *independent analysis*," not already known to the SEC from another source ("unless you are the original source of that information"), not derived from a public allegation, report, news story, etc., and provided after the 7/21/10 date of the Dodd Frank enactment. "*Independent analysis*" can mean an evaluation of public information that reveals information not generally known or available to the public. Company officers, directors, compliance officers, accountants, auditors, and lawyers cannot be whistleblowers unless 120 days elapses after they report a violation to the responsible person or committee and nothing happens or no action is taken.
- **When internal reporting still**

counts as original information: If provided original information is through the company's internal compliance reporting procedures, the person can submit the same information to the SEC *within 120 days of the internal report* and still receive credit as the source of the original information, with the date internally reported counting as the date reported to the SEC, even if the company voluntary discloses the information to the SEC before the person within that 120-day period.

- **"Leads to successful enforcement:"** when the person provides "sufficiently specific, credible, and timely" original information that "significantly contributes" to a "successful judicial or administrative action"
- **Monetary sanctions of more than $1M**: SEC will count two or more administrative or judicial proceedings together towards the $1M number, even if their individual penalties are less than $1M, if the proceedings "arise out of the same nucleus of operative facts"

Rule 21F-5: Amount of Award

- SEC has discretion to award an amount "at least 10% and no more than 30% of the monetary sanctions" the SEC "and other authorities are able to collect"
- Amounts paid to multiple whistleblowers in the same action will not in the aggregate be less than 10% or more than 30% of the amount the SEC or other authorities "collect"

Rule 21F-6: Criteria for determining amount of award

Factors that increase the amount of the award

- Significance of the information
- Assistance provided by the whistleblower
- Law enforcement interest in case
- Participation in internal compliance systems

Factors that decrease the amount of the award

- Culpability of whistleblower in infraction
- Unreasonable reporting delays
- Interference with internal compliance and reporting systems

Rule 21F-8: Eligibility

The person is ineligible if "*convicted* of a criminal violation that is related to the commission action…for which [he or she] otherwise could receive an award."

Rule 21F-14: Procedures applicable to payment of awards

- Only entitled to award amount "to the extent that a monetary sanction is collected in the commission action or in a related action upon which the award is based."

Rule 21F-15: No Amnesty

- A person's status as a whistleblower does not preclude enforcement action against him or her by the SEC for conduct in connection with the securities violations.
- But if the SEC brings such an action against you, it will "take your cooperation into consideration" in accordance with its Statement Concerning Cooperation by Individuals
- Only a criminal conviction will make the whistleblower ineligible for an award

Rule 21F-16: Awards to Whistleblowers Who Engage in Culpable Conduct

- SEC will not count towards the $1M penalty threshold amount any sanctions for violations that are "based substantially on conduct that the whistleblower directed, planned, or initiated."
- If the whistleblower is entitled to an award, the amount of the sanction upon which the award is calculated will be reduced by any amount the whistleblower is required to pay for his or its own culpable conduct

Rule 21F-17: Staff Communications with Individuals Employed by Companies

- "No person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement…with respect to such communications."
- The SEC staff is authorized to communicate directly with an entity's

A person's status as a whistleblower does not preclude enforcement action against him or her by the SEC for conduct in connection with the securities violations.

director, officer, member, agent, or employee that has initiated communication with the SEC, even if that entity has counsel, without the SEC seeking the consent of the entity's counsel.

Section 78u-6(h):[13] Protections and Remedies for Whistleblowers and Their Lawyers

- "No employer may *discharge, demote, suspend, threaten, harass*, *directly or indirectly*, or in *any other manner discriminate against*, a whistleblower in the terms and conditions of employment because of any lawful act done by whistleblower…"
- Retaliation plaintiffs are entitled to nationwide service of process in prosecuting whistleblower retaliation claims
- Remedies available to whistleblowers include:
  1. "reinstatement with the same seniority status that the individual would have had, but for the discrimination"
  2. "2 times the amount of back pay otherwise owed to the individual; *and*"
  3. "compensation for litigation costs, expert witness fees, and reasonable attorneys' fees"

The 2013 Annual Report indicates that the Whistleblower Program is gaining momentum in its second full year of operation.

2012 and 2013 Statistics From the SEC Office of the Whistleblower

2012 was the first full year for which data was available to begin to assess the SEC's whistleblower program. On November 15, 2012, the SEC released its Annual Report on the Dodd-Frank Whistleblower Program ("2012 Annual Report"), a requirement of the Dodd-Frank legislation. Some of the data revealed in the 2012 Annual Report included:

- 3,050 hotline calls from members of the public
- the SEC Office of the Whistleblower received 3,001 formal whistleblower tips via submission of Form-TCR (tips, complaints, and referrals)
- The most frequent tips concerned corporate disclosures (547 tips, 18.2%), offering fraud (465 tips, 15.5%), and manipulation (457 tips, 15.2%)
- The state from which the largest number of tips emanated was California (435 tips, 17.4%), followed by New York (246 tips, 9.8%) and Florida (202 tips, 8.1%)
- The Office of the Whistleblower received tips from whistleblowers from 49 countries outside the United States, including 74 tips from the United Kingdom, 46 tips from Canada, 33 tips from India, and 27 tips from China.

The SEC posted notices of 143 "covered actions" in 2012—SEC enforcement actions in which a final judgment or order resulted in monetary sanctions exceeding $1 million. In 2012, the SEC issued only one award under the Whistleblower program—a $50,000 award to an anonymous tipster who revealed a multi-million dollar fraud.[14]

The 2013 Annual Report indicates that the Whistleblower Program is gaining momentum in its second full year of operation. In 2013, the SEC:

- paid over $14 million to whistleblowers as a result of tips
- has over $439 million available in the Investor Protection Fund for whistleblower awards
- has received 3,238 formal tips (8% increase from 2012)
- received the most common tip relating to "Corporate Disclosures and Financials"
- received the most tips from outside the U.S. from the United Kingdom, followed closely by China and Canada
- received 18% more international tips in 2013 compared to last year and a 12% increase in countries that submitted tips
- returned over 2,810 phone calls from members of the public to its whistleblower hotline
- created an on-line portal for submission of formal tips to the SEC at www.sec.gov/whistleblower.[15]

The Chief of the SEC Office of the Whistleblower, Sean McKessy, noted in the 2013 Annual Report that the Commission will focus on protecting whistleblowers from retaliation by employers, noting that the "protection of whistleblowers from retaliation by their employers is important to the success of the whistleblower program," and that retaliating employers will face SEC enforcement for such conduct:

> [The Office of the Whistleblower] is coordinating actively with Enforcement Division staff to identify matters where employers may have taken retaliatory measures against individuals who reported potential securities law violations or have utilized confidentiality, severance, or other agreements in an effort to prohibit their employees from voicing concerns about potential wrongdoing.[16]

McKessy and his Office have said "'[w]e're keeping our eyes open for the right fact pattern' with which to bring an action" under the anti-retaliation provisions.[17] In light of this focus by the Commission, employers may want to develop whistleblower compliance guidelines. The next section below provides tips for companies to get started.

Whistleblower Compliance Tips For Companies

The following are general tips and considerations for companies and compliance personnel considering Rule 21F, the SEC Annual Reports, and relevant caselaw and regulatory reports and notices:

- Craft a compliance investigation plan that can be immediately customized as needed.
- Publicize remediation and resultant disciplinary action when appropriate to demonstrate that the company is serious about compliance and expects no less from its employees.
- Establish a formal whistleblower hotline that is well-known within the company.
- Publicize in the compliance program that internal compliance reporting first can still qualify the whistleblower for an award under the whistleblower law, and that internal reporting first is an element that may increase the award paid by the SEC.
- Incentivize internal whistleblowing by making it the easiest course with flexible reporting mechanisms, prompt investigations, regular briefings to whistleblowers, and internal recognition for bringing compliance issues to management.
- To incentivize internal reporting, consider setting up an internal award scheme but perhaps with less hurdles than Rule 21F (to support perhaps less generous company awards).
- Consider making valid whistleblower reports part of the company's compensation or bonus scheme.
- Multi-national companies with potential non-U.S. whistleblowers must be mindful that any whistleblower compliance program should account for potential civil or criminal liability under privacy and secrecy laws of some non-U.S. countries for sharing certain information with the SEC. It is relevant to note that the SEC may share the information from a whistleblower with foreign law enforcement or regulators.
- Multi-national compliance programs should also account for the cultural stigmas or biases that may attach to whistleblowers in certain cultures, countries, or regions.
- Be mindful of Rule 21F-17 and the right it provides the SEC to speak directly with company employee whistleblowers, even if the company has counsel, and without the SEC seeking the consent of the company's counsel.
- Be mindful of the harsh whistleblower retaliation laws and procedures and that sub-par or non-performing employees may use this law to try and protect themselves from termination.

What the Courts Are Saying about the Whistleblower Act

Handling Conflicts Between Congressional Statutory Provisions of the Whistleblower Act and The SEC's Implementing Rules

In *Asadi v GE Energy United States, LLC*,[18] the U.S. Court of Appeals for the Fifth Circuit held that an employee must report potential securities law violations to the SEC, not just to his or her employer, to have standing to bring a lawsuit under the anti-retaliation provisions of the Whistleblower Act. In so ruling, the court invalidated an SEC administration definition of "whistleblower" that impermissibly broadened the definition by Congress to include employees who do not report securities law violations to the SEC.

In light of this focus by the Commission, employers may want to develop whistleblower compliance guidelines. The next section below provides tips for companies to get started.

Asadi was employed by GE Energy and sent to Amman, Jordan to serve as the Iraq Country Executive. Asadi informed his supervisor about concerns raised by an Iraqi official about the company's potential violations of the Foreign Corrupt Practices Act (FCPA). Asadi did not report this tip to the SEC. Asadi was terminated one year later and sued his employer under the anti-retaliation provisions of the Whistleblower Act, arguing he was fired in retaliation for reporting his concerns about the FCPA. In Section 78u-6(a) of the Whistleblower Act, Congress defines "whistleblower" as someone who "provides…information relating to a violation of the securities laws *to the Commission*."[19] However, the anti-retaliation provision, Section 78u-6(h), contains a subsection—78u-6(h)(1)(A)(iii)—that prohibits retaliation for an employee making disclosures required by the Sarbanes Oxley Act ("SOX"), which do not require disclosure of information to the SEC.[20] Asadi argued that persons who take action that fall within this category of the anti-retaliation Section 78u-6(h)(1)(A)(iii)—which does not require reporting to the SEC—are protected even if they do not fall within the Section 78u-6(a) definition of "whistleblower"—which requires reporting to the SEC as part of the definition. Asadi interpreted a conflict between 78u-6(a) and 78u-6(h), which he said created an ambiguity that should be cured in his favor. The court cited several U.S. District Court opinions that accepted Asadi's analysis and permitted retaliation claims by employees who did not report alleged securities violations to the SEC.[21]

The Fifth Circuit in *Asadi* found no conflict or ambiguity with Sections 78u-6(a) and 78u-6(h). To the court, Section 78u-6(a) unambiguously defines "whistleblower" as an individual who provides "information relating to a securities law violation to the SEC."[22] Section 78u-6(h)(1)(A) represents protected activity in a whistleblower retaliation claim, but it does "not define which individuals qualify as whistleblowers."[23] Indeed, the anti-retaliation Section 78u-6(h) unambiguously provides protection to "whistleblowers," which is unambiguously defined in Section 78u-6(a) as someone who reports a securities law violation to the SEC. Congress did not provide anti-retaliation protection to any "employee" or "individual," it provided protection for a "whistleblower" previously defined as someone who reports violations to the SEC.[24] Merely because someone may take protected activity under 78u-6(h)(1)(A)(iii) yet not qualify as a "whistleblower" "does not render [Section] 78u-6(h)(1)(A)(iii) conflicting or superfluous."[25] The court provided an example of an employee who reports a securities law violation to his CEO and the SEC and is fired by the CEO when the CEO was not aware the employee also reported to the SEC. Because the employee was not fired for reporting a violation to the SEC, the employee could not pursue a retaliation claim under 78u-6(h)(1)(A)(i) or (ii). But the disclosure to the CEO is protected under SOX, which is protected under 78u-6(h)(1)(A)(iii). And because the employee also reported the violation to the SEC, he qualifies as a whistleblower under Section 78u-6(a) and is eligible for the more generous remedies and limitations period provided in the Whistleblower Act as compared to the SOX whistleblower provisions.[26] Asadi's interpretation of Section 78u-6(h)(1)(A)(iii) would render the SOX whistleblower provisions moot because both could be used without reporting violations to the SEC.[27]

The court rejected Asadi's reliance on Rule 21F-2(b)(1),[28] wherein the SEC redefined "whistleblower" to include individuals who engage in protected activity under Section 78u-6(h) but do not report the securities law violation to the SEC. Because the court found Congress's definition of "whistleblower" in Section 78u-6(a) unambiguous, the court rejected "the SEC's expansive interpretation of the term 'whistleblower' [in Rule 21-F(b)(1)] for purposes of the whistleblower protection provision" under the *Chevron* doctrine.[29]

U.S. District Courts in other circuits since *Asadi* was decided have declined to follow *Asadi* and have found a conflict between Section 78u-6(a) and 78u-6(h)(1)(A)(iii), which they resolved by deferring to the SEC's broadened definition of "whistleblower" in Rule 21-F(b)(1).[30] Stay tuned for further caselaw developments.

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Extraterritorial Application of the Whistleblower Act Provisions

In *Liu v Siemens AG*,[31] the U.S. District Court for the Southern District of New York held that the Whistleblower Act's anti-retaliation provisions did not apply to acts of retaliation occurring outside of the United States. Liu was a resident of Taiwan, working for a Chinese subsidiary (Siemens China) of a German company (Siemens). Liu made an internal

report that Siemens China was involved in a kickback scheme in violation of the FCPA in its sales of equipment to public hospitals in North Korea and China. Liu was terminated after his persistent internal reports and presentations about the issue. Citing the Supreme Court of the United States' decision in *Morrison v National Australia Bank Ltd*,[32] the court held that the anti-retaliation provisions did not apply extraterritorially because Congress gave no clear indication that they had extraterritorial application: "'When a statute gives no clear indication of an extraterritorial application, it has none.'"[33] The court found this was so even though Siemens AG securities traded on the New York Stock Exchange, noting that this was no replacement for the required express congressional intent for extraterritorial application, and that the supreme court did not require total disconnect with the U.S. for the ban on extraterritorial application of U.S. laws to apply:

> The [Supreme] Court acknowledged that "it is a rare case of prohibited extraterritorial application that lacks all contact with the territory of the United States. But the presumption against extraterritorial application would be a craven watchdog indeed if it retreated to its kennel whenever some domestic activity is involved in the case." This is a case brought by a Taiwanese resident against a German corporation for acts concerning its Chinese subsidiary relating to alleged corruption in China and North Korea. The only connection to the United States is the fact that Siemens has [securities] that are traded on an American exchange, just as in *Morrison*. There is simply no indication that Congress intended the Anti–Retaliation Provision to apply extraterritorially.[34]

Liu appealed this ruling to the Second Circuit Court of Appeals.[35]

Conclusion

The SEC's whistleblower program is gaining steam, and SEC Chairman Mary Jo White views it as an indispensable part of enforcing the nation's securities laws. Companies may want to become familiar with the SEC whistleblower rules and incentives, and how courts are interpreting them, to understand their effect on various issues that arise in any internal or other investigation of securities fraud: parallel criminal proceedings, the witness's Fifth Amendment privilege (a company does not have one), and how the program affects attorney-client privileges of the company, the employee, and other witnesses. Hopefully this article helps identify some of the issues you or your client may need to consider in these circumstances.

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NOTES

1. *See, e.g.*, Sarah N. Lynch, SEC Chairman to Request Budget Boost As Sequestration Looms, Reuters, Feb 13, 2013.
2. *See* Matthew P. Allen, *The SEC Cooperation Initiative and Its Criminal Roots*, ABA Section of Litigation Annual Meeting (2013) (www.millercanfield.com/assets/attachments/The%20New%20SEC%20Cooperation%20Program%20And%20Its%20Criminal%20Roots.pdf).
3. 15 USC 78u-6 ("Section 21F").
4. SEC 2013 Annual Report to Congress on the Dodd-Frank Whistleblower Program (Nov. 2013), at 2 (http://www.sec.gov/about/offices/owb/annual-report-2013.pdf).
5. *See* 15 USC 78u-6, 78u-7.
6. *See* SEC Release No. 34-64545 (May 25, 2011). The whistleblower rules are published in 17 CFR 240.21F-1 – 21F-17.
7. *SEC's Whistleblower Office Received 3,001 Tips in Fiscal Year 2012, Report Says*, Secs Reg & Law Rpt, (BNA) Vol 44, No 46 at 2109 (Nov 19, 2012).
8. *See* Yin Wilczek, *SEC Seeing Poor Controls Over Fees During Exams of Private Fund Advisers*, Secs Reg & Law Rpt (BNA) at 2227-28 (Dec 10, 2012).
9. *See SEC Nominee Signals Shift: Obama Taps Ex. Prosecutor Mary Jo White, Portending Increased Policing of Wall Street*, Wall St J, Jan 25, 2013 at A1.
10. SEC Chair Mary Jo White Remarks at the Securities Enforcement Forum, Washington DC (Oct 9, 2013).
11. *Id.*
12. 17 CFR 240.21F-1 – 21F-17.
13. 15 USC 78u-6(h).
14. *See generally* SEC Annual Report on the Dodd Frank Whistleblower Program, Fiscal Year 2012 (Nov. 2012); *SEC's Whistleblower Office Received 3,001 Tips in Fiscal Year 2012, Report Says*, Secs Reg & Law Rpt (BNA) Vol 44, No 46 at 2109; *Lessons From the Whistleblower Report*, Law 360 (Nov. 12, 2012); *$104M Whistleblower Award — A Sign of Things to Come*, Law360 (Dec. 6, 2012); *Cross-Border Implications of the SEC Whistleblower Report*, Law 360 (Nov. 15, 2012).
15. *See generally*, SEC Annual Report on the Dodd Frank Whistleblower Program, Fiscal Year 2013 (Nov. 2013) ("2013 Annual Report"); Walter Pavlo, *What the SEC Whistleblower Report Means for Companies*, Forbes (Nov. 18, 2013).
16. 2013 Annual Report at 2.
17. *See* Yin Wilczek, *SEC Received More Than 3,200 Tips in FY2013, Whistle-Blower Official Says*, Secs Reg & Law Report (BNA) (Nov 18, 2013).
18. 720 F3d 620 (5th Cir 2013).
19. 15 USC 78u-6(a)(6) (emphasis added).
20. 15 USC 78u-6(h)(1)(A)(iii).

21. *See Asadi*, 720 F3d at 625 n6.

22. *Id.* at 625.

23. *Id.*

24. *See id.* at 626.

25. *Id.*

26. *Id.* at 627-28 & n11, 629.

27. *See id.* at 628.

28. 27 CFR 240.21F-2(b)(1).

29. *See Asadi*, 720 F3d at 629-30 (citing *Chevron USA, Inc v Natural Res Def Council, Inc*, 467 US 837, 842-44 (1984) (finding that an administrative agency like the SEC must give effect to the unambiguous intent of Congress and not make rules that contradict that intent)). *See also* Rachel Louise Ensign, *The Whistleblower Debate: Companies Say Protections Apply Only When Tipsters Raise Concerns With the SEC*, Wall St. J., Aug 12, 2013 at B4.

30. *See, e.g., Rosenblum v Thomson Reuters, LLC*, No 13 Civ 2219 (SAS), 2013 US Dist LEXIS 153635 (SDNY Oct 25, 2013).

31. No 13 Civ 317 (WHP), 2013 US Dist LEXIS 151005 (SDNY Oct 21, 2013).

32. __US__, 130 S Ct 2869 (2010).

33. *Liu*, *supra* at *2 (quoting *Morrison*, 130 S Ct at 2878).

34. *Id.* at *3-4 (quoting *Morrison*, 130 S Ct at 2884) (internal citation omitted).

35. *See Whistle-Blower Appeals Dismissal of Retaliation Suit*, Secs. Reg. & Law. Report (BNA) (Nov 18, 2013).

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Simplifying Securities Regulation of M&A Brokers

By Shane B. Hansen

Introduction

Business brokerage services are critically important to the liquidity of small business ownership, business growth, and related jobs preservation and creation. Baby boomers are faced with the prospects of either selling or closing their businesses to retire. Small business owners need and rely on the professional services of merger and acquisition intermediaries, advisors, and business brokers (together, "*M&A brokers*") to advise about and assist with the sale of privately owned businesses. However, today's "one-size fits all" system of federal broker-dealer regulation applies "Wall Street" investment banking regulation to "Main Street" M&A brokers. Pending bipartisan federal legislation and new guidance from the Securities and Exchange Commission ("*SEC*") staff will simplify and lower the regulatory costs associated with M&A brokerage services for small business owners in privately negotiated transactions.

M&A Brokerage Services

When a small business owner starts thinking about selling, an M&A broker may be engaged to advise about the prospects, anticipated range of purchase prices, and possible legal structures for a transaction. An M&A broker's engagement commonly includes a broad range of business transition and related consulting services, often lasting many months, sometimes lasting more than a year, and sometimes ending without a successful closing. Services may include helping a seller prepare its business for sale, valuing the business and its assets, screening and introducing prospective buyers, and assisting with the pre-purchase due diligence process. Consulting advice may address financial accounting, operations, risk management, human resources, taxes, and related business considerations. As a transaction moves forward, an M&A broker may become involved in negotiating terms, though typically not in drafting legal documents or in handling the cash or securities to be exchanged by the parties at closing. An acquisitive buyer may engage an M&A broker to locate potential business sellers. The scope and depth of an engagement often depends on the value and complexity of the business. Typically, an M&A broker's compensation is a "success fee" based on the value of the consideration exchanged by the parties and contingent upon the closing regardless of its legal structure. Often, if no closing occurs, an M&A broker is not compensated for its services.

M&A brokers come from a broad range of business backgrounds, many with prior experience and skills as a corporate executive, accountant, banker, lawyer, or commercial real estate broker. Many have completed financial, accounting, and business courses in college and graduate school programs. Many have participated in advanced post-graduate education programs offered by national and regional professional associations.[1] Most have commercial real estate brokerage licenses. Some states such as Illinois require business broker licensing.[2]

M&A Securities Regulation

Whether or not an M&A broker's services are regulated under federal and state securities laws is usually not known when a client engagement begins because it depends on each transaction's legal structure—which is beyond the control of the M&A broker—and sometimes cannot readily be determined without a legal analysis of the facts and circumstances. Regardless of the legal structure, however, the economic objective of an M&A broker's engagement remains the same—to convey ownership and control of the business from the seller, who runs the business now, to the buyer who will run the business after closing. Neither the seller nor the buyer are passive investors.

The legal structure of a business sale is negotiated by the parties, commonly with the advice of legal counsel and tax advisors. Small transactions are often structured as the sale of business assets for cash and as such are generally not subject to securities regulation. However, for a variety of reasons a seller and buyer may choose to transfer ownership

through the purchase and sale, merger, consolidation, recapitalization, repurchase, issuance, or other business combination involving the seller's stock or other securities, and sometimes involving the buyer's issuance or exchange of its own stock or other securities (an "*M&A transaction*"). Stock is expressly included in the broad definition of a "security" in the Securities Act of 1933 ("*Securities Act*"), and the Securities Exchange Act of 1934 ("*Exchange Act*"), and state securities laws.[3] Other types of ownership, such as limited liability company membership interests,[4] may or may not be a "security" depending on the facts and circumstances. Small business transactions often involve the issuance of a promissory note from the buyer to the seller—commonly called a "seller's note." A note is presumed to be a "security" and its terms, conditions, and related circumstances must be closely examined to determine if it has a "family resemblance" to court-created exceptions from the "security" definition.[5] If a transaction involves an offer or sale of a security, regardless of its structure, then federal and one or more state securities laws apply to the parties,[6] the M&A transaction,[7] and the M&A broker.[8]

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"Broker" Status and Regulation

When compensated for business brokerage services in an M&A transaction involving securities, an M&A broker comes within the broad definition of a "broker" under the Exchange Act. Section 3(a)(4)(A) of the Exchange Act defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others."[9] Courts, the SEC, and state securities regulators have found this definition triggered when a person is regularly involved in soliciting, introducing, advising about, negotiating, or closing a securities transaction.[10] Handling the funds or securities to be exchanged at closing poses potential risk of theft, so even temporary possession or custody, whether actual or constructive, is a significant consideration in this analysis.[11] Various forms of fixed or variable compensation can satisfy the "engaged in the business" element in the "broker" definition, particularly contingent transaction-related compensation that creates a "salesman's stake" in the transaction's outcome with related conflicts of interest.[12]

Section 15(a) of the Exchange Act requires a broker's registration as a "broker-dealer" with the SEC, as well as membership in a self-regulatory organization such as the Financial Industry Regulatory Authority ("*FINRA*"), unless an exclusion or exemption from registration is available.[13] There is no statutory exclusion or exemption applicable to M&A brokerage services except for a purely intrastate transaction.[14] However, in view of newspaper, internet, and e-mail marketing of businesses to prospective buyers, it is virtually impossible to build a sustainable business brokerage practice around the statutory intrastate exclusion. Offering-related securities registration exemptions[15] are not broker-dealer registration exemptions. In addition, at least one and perhaps more state securities laws impose similar registration and regulatory requirements on brokers, dealers, or broker-dealers as those or comparable terms are defined.

The time and cost of initial broker-dealer registration and on-going compliance with current SEC and FINRA requirements are very substantial. Initial regulatory applications and compliance-related costs typically exceed $150,000. On-going compliance costs often exceed $75,000 per year. Applying for and obtaining FINRA membership typically takes six to nine months, and frequently longer. There are competency exams testing on regulations that are almost totally irrelevant to the professional knowledge required to advise about M&A transactions. Accrual-based GAAP accounting is required and minimum net capital must be maintained at all times regardless of the ebbs and flows of transaction-related income and expenses. Monthly or quarterly financial reporting must be prepared by specially qualified financial and operations principals. Annually audited balance sheets and related schedules and attestations must be filed with the SEC and FINRA. Anti-money laundering programs, procedures, and independent third-party testing are required, even though M&A brokers would rarely, if ever, touch the parties' funds or securities. Membership in the Securities Investors Protection Corporation is required and membership fees are assessed, even though M&A brokers do not trade or handle stock certificates. The SEC, FINRA, and states charge annual firm and individual registration fees; FINRA imposes membership assessments based on the firm's gross revenues.

Existing SEC and FINRA rules impose significant requirements affecting every as-

pect of a broker-dealer's business ownership, staffing, marketing, operations, and record-keeping. These rules have become highly complex over the years in response to, among other things, evolving financial markets, major securities frauds, national financial crises, and perceived regulatory gaps. This "one size fits all" body of regulation has been written largely to address investor protection in the context of retail brokerage services and investment banking services for publicly traded companies. Most of the SEC's and FINRA's rules and related guidance require "translation" when applied in the M&A brokerage context. For example, FINRA's "know your customer" and "suitability" rules must be applied to "customers" in the context of transactions between business buyers and sellers—i.e., the "investors." Newly released regulatory guidance is published by the SEC and FINRA at least weekly and should be monitored for generally applicable changes.

All of this complexity and cost disproportionately impacts small and mid-sized businesses and the M&A brokers who serve them. The commitment of management and staff time, as well as largely fixed compliance-related costs, are annually required to maintain registered status regardless of the number of securities-regulated business sale transactions closed by the M&A broker in any given year. Substantially all of these costs are necessarily passed on to the business owners who use the registered broker-dealer's services. Smaller transactions generate smaller success fees, incenting registered brokerage firms to have little or no interest in advising smaller business owners, leaving smaller businesses and communities poorly served by registered broker-dealers. High engagement fees drive many small business owners to engage unregistered M&A brokers if they want professional assistance with their transactions.

SEC No-action Relief

The SEC staff has recognized that federal broker-dealer regulation designed to protect passive investors in public companies trading securities on public markets unduly burdens smaller business owners in their privately negotiated transactions. The staff has granted limited relief from the broker-dealer registration requirements through several no-action letters.[16] Facing mounting pressure from Congress to reduce federal regulatory burdens on small business,[17] as well as related legislation discussed below, the SEC issued a new "M&A Broker" no-action letter on January 31, 2014,[18] significantly expanding its previous no-action relief. The in-coming letter submitted by six securities lawyers provides an extensive discussion of why this relief is important to small businesses and the M&A brokers who serve them. In responding, the SEC's no-action letter defines several operative terms, including "M&A Broker," "privately held company," and "M&A transaction." Without acknowledging the background or reasoning in the request letter, but relying upon its predicate facts, the SEC's no-action response emphasizes ten specific conditions to its no-action relief:

1. The M&A broker (as defined in the no-action letter) must not have the ability to bind a party to an M&A transaction (as defined in the no-action letter).
2. Neither the M&A broker nor its affiliate may provide transaction-related financing; if it assists a buyer obtain financing from an unaffiliated lender, it must disclose its compensation and, as applicable, comply with the Federal Reserve Board's Regulation T (12 CFR 220 *et seq.*) (credit by securities broker-dealers).
3. The M&A broker must not have custody, control, or possession of, or otherwise handle funds or securities issued or exchanged in the M&A transaction.
4. The M&A transaction must not involve a public offering of securities; the offer and sale must comply with a private offering exemption from securities registration. No party may be a public "shell company."
5. If an M&A broker represents both a buyer and seller, it must disclose its joint representation and obtain the parties' written consent.
6. If an M&A transaction involves a group of buyers, the M&A broker may have no involvement with the group's formation.
7. Upon completion of the M&A transaction, the buyer or buyers group must "control" and actively operate the acquired company. "Control" includes the power, directly or indirectly, to direct the

The SEC staff has recognized that federal broker-dealer regulation designed to protect passive investors in public companies trading securities on public markets unduly burdens smaller business owners in their privately negotiated transactions.

management or policies of the company, such as through ownership of securities by contract or otherwise. Control is presumed if the buyer or buyers group will have the right to vote 25 percent or more of a class of voting securities, the power to sell or direct the sale of 25 percent or more of a class of voting securities, or has contributed or upon dissolution will have the right to receive 25 percent or more of the capital of the acquired company or its successor.

8. The M&A transaction cannot transfer ownership interests to a passive buyer or passive buyers group.
9. Any securities received by the buyer or the M&A broker will be "restricted securities" within the meaning of SEC Rule 144(a)(3) because those securities are not SEC-registered in the offering.
10. The M&A broker and its officers, directors, employees, or other associated persons (e.g., independent contractors) must not be suspended or subject to a statutory disqualification from association with a broker-dealer.

It is important to note that no-action letters only provide relief with respect to registration requirements. As explained above, an M&A broker still comes within the meaning of "broker" and remains subject to SEC jurisdiction and generally applicable securities antifraud prohibitions. Like all no-action letters,[19] the SEC staff's relief is predicated on the stated facts and conditions described in the underlying request letter. SEC no-action letters do not provide any legal analysis, only reflect the SEC staff's position on bringing a regulatory enforcement action, may be withdrawn or limited by subsequent no-action letters, do not have the legal force of an SEC rule or order, are not legally binding on any court, and leave many unanswered questions about its application to new facts and circumstances. That said, the new M&A broker no-action letter significantly expands the scope of permissible activities and types of compensation beyond the SEC's older no-action letters. While not stated in the no-action letter, it would be prudent for an M&A broker to preserve books and records demonstrating that the no-action letter's factual predicates have been satisfied in each transaction.

Bipartisan federal legislation to amend section 15 of the Exchange Act to create a simplified system of notice-filing registration and tailored regulation for M&A brokers was introduced on June 6, 2013.

Registration Violations

Coming within the definition of a "broker" but failing to come within the scope of the SEC's no-action relief may subject an M&A broker to regulatory enforcement and civil consequences for violating broker-dealer registration requirements.[20] Fraud is not a prerequisite to an SEC enforcement action.[21] Several recent enforcement cases have not involved fraudulent conduct at all but merely asserted broker-dealer registration violations.[22] Sanctions for violations may include regulatory cease and desist orders, fines, penalties, and disgorgement of unlawful compensation, all of which will significantly complicate later becoming properly registered with the SEC, FINRA, and states. Regulatory enforcement actions must be disclosed in regulatory applications and become publicly available on FINRA's BrokerCheck website.[23] Civil consequences may include liability for damages, voiding the M&A broker's engagement agreement, loss of compensation,[24] and under some circumstances rescission rights to unwind the transaction.[25]

Pending Legislative Reform

Building on the recommendations of two well-regarded independent sources,[26] in 2006 the Alliance of Merger and Acquisition Advisors ("*AM&AA*"), with the support of the International Business Brokers Association, the M&A Source, and 15 regional professional associations of M&A brokers, began working cooperatively with the SEC staff and with representatives of the North American Securities Administrators Association ("*NASAA*") to reform regulation through proposed rulemaking. The SEC staff and NASAA representatives have been supportive, but, in 2012, the SEC staff suggested that the professional associations approach Congress to seek a legislative solution because its regulatory agenda was driven by congressionally mandated rulemaking in the Dodd–Frank Wall Street Reform and Consumer Protection Act[27] and the Jumpstart Our Business Startups Act or JOBS Act.[28]

Bipartisan federal legislation to amend section 15 of the Exchange Act to create a simplified system of notice-filing registration and tailored regulation for M&A brokers was introduced on June 6, 2013, by Congressman Bill Huizenga (R-MI) and co-sponsored by Congressmen Brian Higgins (D-NY) and Bill Posey (R-FL). As introduced, H.R. 2274, the Small Business Mergers, Acquisitions,

and Sales Brokerage Simplification Act of 2013, was supported in testimony by NASAA and the U.S. Chamber of Commerce.[29] After two hearings before the Committee on Financial Services of the U.S. House of Representatives,[30] the SEC requested that the bill be amended to instead create an exemption from broker-dealer registration for M&A brokers; no other changes were requested. The exemption would be self-effecting following enactment and no SEC rulemaking would be required. As amended, H.R. 2274 unanimously passed (57-0) the Committee on November 14, 2013.[31] On January 14, 2014, the amended H.R. 2274 unanimously passed (422-0) the full U.S. House of Representatives and was referred to the U.S. Senate.[32] Concurrently, an identical bipartisan companion bill, S. 1923, was introduced by Senators Joe Manchin III (D-WV) and David Vitter (R-LA) and is presently pending before the U.S. Senate Committee on Banking, Housing, and Urban Affairs.[33] To date, six additional senators have joined in co-sponsoring S. 1923.

The legislation defines the parameters of the exemption using several key terms, "M&A broker," "eligible privately held company," and "control." An "M&A broker" means "a broker, and any person associated with a broker, engaged in the business of effecting securities transactions solely in connection with the transfer of ownership of an eligible privately held company, regardless of whether the broker acts on behalf of a seller or buyer, through the purchase, sale, exchange, issuance, repurchase, or redemption of, or a business combination involving, securities or assets of the eligible privately held company." To qualify the broker must reasonably believe[34] that, "upon consummation of the transaction, any person acquiring securities or assets of the eligible privately held company, acting alone or in concert, will control and, directly or indirectly, will be active in the management of the eligible privately held company or the business conducted with the assets of the eligible privately held company." The term "control" means "the power, directly or indirectly, to direct the management or policies of a company, whether through ownership of securities, by contract, or otherwise." The legislation creates a presumption of control for any person who is a director, general partner, member, or manager of a limited liability company, or officer exercising executive responsibility; or who has the right to vote 20 percent or more of a class of voting securities or the power to sell or direct the sale of 20 percent or more of a class of voting securities; or has the right to receive upon dissolution, or has contributed, 20 percent or more of the capital. While not referenced in the legislation, a 20 percent threshold was chosen because the Small Business Administration ("SBA") requires under its loan programs personal guarantees from each of a company's owners having an interest of 20 percent or more.[35]

In addition, if the buyer's securities will be issued to the seller in the transaction, the broker must reasonably believe that the seller "will, prior to becoming legally bound to consummate the transaction, receive or have reasonable access to the most recent year-end balance sheet, income statement, statement of changes in financial position, and statement of owner's equity of the issuer of the securities offered in exchange," as well as any independent audit report, a balance sheet dated within 120 days before the date of the offer, and "information pertaining to the management, business, results of operations for the period covered by the foregoing financial statements, and material loss contingencies of the issuer." This provision is intended to assure that the buyer provides appropriate disclosures to the seller, while recognizing that the M&A broker has no ability to mandate a buyer's conduct.

To be an "eligible privately held company" it must meet two conditions. First, it must not have any class of SEC-registered securities or file with the SEC periodic information, documents, and reports regarding those securities. This prevents an M&A broker from being involved in the sale of a public company but would still allow the sale of a subsidiary or division of a public company if those securities are neither registered nor the subject of SEC reporting. Second, the company must come within a size cap based on its historical financial accounting records. It must have earnings before interest, taxes, depreciation, and amortization (EBITDA) of less than $25 million and/or gross revenues of less than $250 million. These thresholds are subject to periodic inflation adjustments. Notably, the SEC's new M&A broker no-action letter, discussed above, does not contain any size cap, indicating the SEC staff's belief that a cap is not necessary to preserve investor protections.

Important existing "investor" protections would be preserved by the legislation. An

The legislation defines the parameters of the exemption using several key terms, "M&A broker," "eligible privately held company," and "control."

M&A broker could not, directly or indirectly, receive, hold, transmit, or have custody of the funds or securities to be exchanged by the parties to the transaction. An M&A broker could not be engaged on behalf of an issuer in a public offering of SEC-registered securities or securities subject to the company's periodic SEC filings. An M&A broker would remain subject to antifraud prohibitions and SEC jurisdiction to investigate and bring enforcement actions. State regulation of securities, real estate, and business brokerage services are unaffected.

Looking Ahead

The SEC's latest no-action letter will allow M&A brokers to lawfully and cost-effectively assist baby boomers and other small business owners to sell, rather than close, the businesses they have built and enable entrepreneurs and growing companies to sustain and create new jobs by buying and operating those businesses. Moreover, the SEC staff's no-action relief—issued eight months after H.R. 2274's introduction—tangibly evidences the SEC's recognition of the need for regulatory reform and draws many of its concepts from the legislation.

If enacted, the legislation will permanently clarify and simplify M&A broker regulation at the federal level. With unanimous passage of H.R. 2274 in the U.S. House of Representatives, the prospects for senate passage of its companion bill, S. 1923, appear to be good. Rarely does legislation receive such broad-based bipartisan support. Moreover, both the SEC and state securities regulators have reviewed and expressed their views on the legislation, as well as the U.S. Chamber of Commerce. If passed by the U.S. Senate, it must, of course, be signed by President Obama. Those prospects also appear favorable because the administration has on several occasions expressed its strong interest in supporting bipartisan small business legislation.[36] State level efforts will still be required to bring greater uniformity to M&A broker regulation, primarily working through NASAA, but these federal developments do remove a major obstacle to moving forward with state securities regulators. Stay tuned.

NOTES

1. See, e.g., professional education programs offered by the Alliance of Merger & Acquisition Advisors (AM&AA) at http://www.amaaonline.com/education; the International Business Brokers Association (IBBA) at http://www.ibba.org/education; and the M&A Source at http://masource.org/education.

2. See the Illinois Department of Securities web site at http://www.cyberdriveillinois.com/departments/securities/busbroker.html.

3. Section 2(a)(1) of the Securities Act, 15 USC 77b(a)(1), and Section 3(a)(10) of the Exchange Act, 15 USC 78c(a)(10); see also *Landreth Timber Co v Landreth*, 471 US 681 (1985).

4. See, e.g., Welle, *Limited Liability Company Interests as Securities: An Analysis of Federal and State Actions Against Limited Liability Companies Under the Securities Laws*, 73 Denv UL Rev 425 (1996).

5. *Reves v Ernst & Young*, 494 US 56 (1990).

6. See, Sections 4, 5, and 10 of the Securities Act, 15 USC 77d, 77e, 77j, and related SEC rules.

7. See SEC Rule 145, Reclassification of Securities, Mergers, Consolidations and Acquisitions of Assets.

8. See the SEC's *Guide to Broker-Dealer Registration* for guidance and various examples of "broker" status at http://www.sec.gov/divisions/marketreg/bdguide.htm#II.

9. 15 USC 78c(a)(4)(A).

10. See, e.g., *SEC v Kramer*, 778 F Supp 2d 1320 (MD Fla 2011). See also *SEC v Bravata*, No 09-12950, 2009 US Dist. LEXIS 64609 (ED Mich July 27, 2009), identifying "[t]he most important factor in determining whether an individual or entity is a broker" as the "regularity of participation in securities transactions at key points in the chain of distribution." *See also Cornhusker Energy Lexington, LLC v Prospect St. Ventures*, No 8:04CV586, 2006 US Dist. LEXIS 68959, (D Neb Sept 12, 2006), identifying as evidence of broker activity a person's "analyzing the financial needs of an issuer," "recommending or designing financing methods," discussing "details of securities transactions," and recommending an investment.

11. See the SEC's Guide to Broker-Dealer Registration, supra.

12. The SEC and some federal courts have placed considerable weight on the presence of transaction-based compensation. *Cornhusker,* supra, describes "transaction-based compensation" as "one of the hallmarks of being a broker-dealer." 2006 US Dist LEXIS 68959 at *6 stating that "[t]he underlying concern has been that transaction-based compensation represents a potential incentive for abusive sales practices that registration is intended to regulate and prevent."

13. 15 USC 78o(a). This provision also makes it unlawful for a person to induce, offer, or effect the purchase or sale of a security, regardless of how a transaction is structured, unless registered with the SEC as a "broker".

14. See Section 15(a) of the Exchange Act, 15 USC 78o; for a discussion of what constitutes "intrastate" activity, see Section 3(a)(11) of the Securities Act of 1933, 15 USC 77c(a)(11), the related definitions and safe harbor created by SEC Rule 147, 17 CFR 230.147, adopted in Release No. 33-5450, *Conditions for Intrastate*

Offering Exemption, January 7, 1974.

15. See, e.g., Section 4 of the Securities Act, 15 USC 78d, and SEC Regulation D, Rule 506, 17 CFR 230.506.

16. *Country Business, Inc*, 2006 SEC No-Act LEXIS 669 (Nov 6, 2006); *Victoria Bancroft*, 1987 SEC No-Act LEXIS 2517 (Aug 9, 1987); and *International Business Exchange Corp*, 1986 SEC No-Act LEXIS 3065 (Dec 12, 1986).

17. See, e.g., questions posed to incoming SEC Chairman Mary Jo White by Congressman Bill Huizenga at the hearing entitled, "Oversight of the SEC's Agenda, Operations, and FY 2014 Budget Request", May 16, 2013 before the Committee on Financial Services of the U.S. House of Representatives archived on the Committee's web site at http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=333327.

18. *M&A Brokers*, January 31, 2014, available on the SEC's web site at http://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf.

19. The SEC explains the legal effect of a no-action letter on its website at: http://www.sec.gov/answers/noaction.htm. See also SEC Rule 202.1, *General*, paragraph (d), Part 202, *Informal and Other Procedures*. 17 CFR Part 202.

20. See Section 15 (registration), Section 20 (control person liability), Section 21 (investigations; injunctions and prosecution), Section 21B (civil remedies in administrative proceedings), Section 21C (cease-and-desist proceedings), Section 29 (validity of contracts), and Section 32 (penalties) of the Exchange Act and comparable provisions in state securities laws.

21. See the speech by David W. Blass, Chief Counsel, SEC Division of Trading and Markets, *A Few Observations in the Private Fund Space* (April 5, 2013) at http://www.sec.gov/news/speech/2013/spch040513dwg.htm.

22. See, e.g., *In the Matter of William M Stephens*, File No 3-15233, 2013 SEC LEXIS 970 (Mar 8, 2013), and *In the Matter of Ranieri Partners LLC and Donald W Phillips*, File No. 3-15234, 2013 SEC LEXIS 971 (Mar 8, 2013), at http://www.sec.gov/news/press/2013/2013-36.htm; and *In the Matter of Ram Capital Resources, LLC, et al.*, File No 3-13524, 2009 SEC LEXIS 2035 (June 19, 2009).

23. FINRA's BrokerCheck web site can be used to look-up the regulatory status, history, and disciplinary actions involving brokerage firms and associated individuals at http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/index.htm.

24. See, e.g., *Torsiello Capital Partners LLC v Sunshine State Holding Corp*, No 600397/06, 2008 NY Misc LEXIS 2879 (NYS Ct Apr 1, 2008).

25. See, e.g., Section 410, *Civil liabilities*, of the Uniform Securities Act of 1956 and Section 509, *Civil liability*, subparagraph (d), *Liability of unregistered broker-dealer and agent*, of the Uniform Securities Act of 2002.

26. American Bar Association, Business Law Section, *Report and Recommendations of the Private Placement Broker-Dealer Task Force* (2005), available on the SEC's web site at http://sec.gov/info/smallbus/2009gbforum/abareport062005.pdf; and *Final Report of the Advisory Committee on Smaller Public Companies* (2006) available on the SEC's web site at http://sec.gov/info/smallbus/acspc/acspc-finalreport.pdf. "Right-sizing" federal regulation of M&A brokers and finders was among the top recommendations in the 2006, 2007, 2008, 2009, 2010, and 2011 Government-Business Forum on Small Business Capital Formation hosted by the SEC available on the SEC's web site at http://sec.gov/info/smallbus/sbforum.shtml.

27. 111 Pub L No 203, 124 Stat 1376 (2010).

28. 112 Pub L No 106, 126 Stat 306 (2012).

29. Hearing entitled "Legislation to Further Reduce Impediments to Capital Formation", October 23, 2013, available at http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=355850.

30. Hearing entitled "Reducing Barriers to Capital Formation" before the Capital Markets and Government Sponsored Enterprises, June 12, 2013, available at http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=336906; and hearing held on October 23, 2013, supra.

31. The Committee's mark-up and recorded vote on H.R. 2274, as amended, is available at http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=360865.

32. The House's recorded vote is available at https://www.govtrack.us/congress/votes/113-2014/h14. More legislative information about H.R. 2274 is available at http://thomas.loc.gov/cgi-bin/bdquery/z?d113:hr2274.

33. Legislative information about S. 1923 is available at http://thomas.loc.gov/cgi-bin/bdquery/z?d113:s1923.

34. The "reasonably believe" language was used because an M&A broker has no control over a seller or buyer in an M&A transaction.

35. See the SBA's loan repayment terms at http://www.sba.gov/content/7a-loan-repayment-terms.

36. See, e.g., statements made by Press Secretary Jay Carney on January 16, 2014 at http://www.whitehouse.gov/the-press-office/2014/01/16/press-briefing-press-secretary-jay-carney-1162014.

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Going Public Is Not Merely the S-1 Registration Statement

By Stuart Sinai

Introduction

The S-1 registration statement is only half the battle when preparing for an initial public offering ("IPO"). So much more goes into the whole process, and it may be difficult to explain to clients why they will be engaged in an endeavor that will cost at least several hundred thousand dollars and likely in excess of 600 to 1,000 hours of lawyer time. Aside from a restatement of the articles (in Delaware a "certificate") of incorporation[1] and bylaws to support a publicly traded entity that is to have many new voices and opinions ("stockholders"), many other committee charters, codes, and internal policy statements must also be drafted as well as other documents noted below.

Much drafting, discussions, and endless meetings must occur to comply with the NYSE Euronext ("NYSE"), or the NASDAQ Stock Markets ("NASDAQ"), or the Securities and Exchange Commission ("SEC") requirements or to meet your investment banker's expectations of what a sophisticated company is to have in place before the company is offered to the public.

Certificate of Incorporation and Bylaws

The first issue is what to include in the certificate of incorporation and/or bylaws. Considerable time can be spent determining whether to include in the certificate of incorporation, in addition of course to common stock provisions:

- Dual-class voting rights (giving founders and corporate officers greater "say").
- Blank-check preferred (allowing innumerable permeations and special rights).
- Size of the board (limitations).
- Staggered board (three classes).
- Limiting stockholder action by written consent.
- Allowing removal of directors between meetings only for "cause."
- Limiting the right to call stockholder meetings.
- Filling director vacancies between meetings.
- Changing the annual meeting calendar.
- Prohibitions on calling special meetings (permitted only by board of directors or chairman).
- Setting record date for who may vote.
- Adoption of a "poison pill."[2]
- Supermajority voting requirements (for future amendments to certificate of incorporation, to bylaws, and to approve any business combinations).
- Director nominations—make only within certain time periods.
- Pre-emptive rights (to subscribe to additional stock issuances).
- Cumulative voting rights—prohibited.
- Extent of director or officer indemnification, reimbursement and payment of attorney fees.

Decisions relating to the items above typically require thorough research and discussion with the company describing the pro's and con's of the numerous choices.

Charter, Codes, and Policies

Both major exchanges, the NYSE and NASDAQ, have their own rules that require the formation of certain committees and the adoption of required charters that define members duties and responsibilities. Each exchange and the SEC require that a company wishing to become publicly traded and listed must establish an audit committee and adopt an audit committee charter that must contain a number of procedures and rules. Each exchange also requires that the company establish a compensation committee and the NYSE also requires a nominating committee. NASDAQ requires that a company either establish a nominating committee, or, in lieu thereof, that all nominating issues must be decided by a majority of the independent directors.[3] Typically because of the many procedures that must be followed,

it becomes more convenient to form committees and to define in their charters the various duties and responsibilities that must be fulfilled. As a practical matter, most, if not all, companies wishing to be listed on NASDAQ create not only an audit committee and a compensation committee but also a nominating committee and adopt charters specifying the many duties of their members.

The following is a typical list of charters, codes, policies and procedure manuals adopted before or expected to be in existence immediately on the day the company issues its shares. Most of these documents are very detailed and also walk the constituency for whom they are intended through their duties or responsibilities. They mostly commonly include the following:

- Audit Committee Charter
- Compensation Committee Charter
- Nominating and Corporate Governance Committee Charter
- Code of Business Conduct and Ethics for all Employees
- Supplemental Conflict of Interest Policy for Directors and Senior Officers
- Transactions with Related Parties Policy
- Corporate Governance Guidelines
- Anti-Corruption Policy
- Insider Trading Policy
- Insider Trading and Section 16 Compliance and Procedures Manual
- Whistleblower Policy
- Anonymous Complaints Policy—Reporting Procedures Pertaining to Accounting and Auditing Matters
- Policy regarding Compliance with SEC Attorney—Conflict Rules
- Document Retention Policy
- Memorandum to Board—"Now that you are the Public" (what are your duties)
- Memorandum—"Insider Trading—How to Avoid—Overview"

Each one of these charters, codes, manuals, memoranda, and policies are often near-treatise-like documents (e.g., the Anti-Corruption Policy and its discussion of the Foreign Corrupt Practices Act; the Insider Trading and Section 16 Compliance and Procedure Manual). The time necessary to draft and to present them in a fashion that will hold the attention of the company's officer and director audience can near-equal that required to draft the S-1.

Independent or Not

The company also needs to analyze whether existing and proposed nominees for director meet the "independent" requirements of the SEC, the IRS, and each exchange. Aside from certain rules that provide some leeway concerning the early composition of committees, all directors of the three front-line committees must be independent.

Under the NASDAQ definition, an "independent director" means a person other than an officer or employee of the company or its subsidiaries or any other individuals having a relationship that, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of the director. The board's discretion in determining director independence is not completely unfettered. Under the NASDAQ definition, an independent director is one who (1) is not currently (or whose immediate family members are not currently), and who has not been over the past three years (or whose immediate family members have not been over the past three years), employed by the company; (2) has not (or whose immediate family members have not) been paid more than $120,000 during the current or past three fiscal years; (3) has not (or whose immediate family members have not) been a partner in, or controlling shareholder or executive officer of, an organization that the company made, or from which the company, received, payments in excess of the greater of $200,000 or 5 percent of that organizations consolidated gross revenues in any of the most recent three fiscal years; (4) has not (or whose immediate family members have not), over the past three years, been employed as an executive officer of another entity in which an executive officer of the company has served on that other entity's compensation committee; or (5) is not currently (or whose immediate family members are not currently), and has not been over the past three years (or whose immediate family members have not been over the past three years), a partner of the company's outside auditor.[4]

Additionally, to be able to serve on the company's audit committee, the individual must meet the "super independent" rules of the SEC,[5] namely that such person may not, other than fees for service on the board

Both major exchanges, the NYSE and NASDAQ, have their own rules that require the formation of certain committees and the adoption of required charters that define members duties and responsibilities.

or any committee of the board, "accept, directly or indirectly, *any* consulting, advisory, or other compensatory fees from issuer" or be an affiliate (e.g., more than 10 percent stockholder) of the issuer (emphasis added). The "accept, directly or indirectly" language also excludes any partner in a law firm that receives any payments from the issuer from serving on the audit committee, although he or she still might be "independent" merely to serve on the board (e.g., within last three years that person has not received from the issuer $120,000 per year, and the law firm has not received more than $200,000 in any such year).

NASDAQ rules also require that the three (minimum number of) independent directors who comprise the audit committee must "be able to read and understand fundamental financial statements," and that the company must be able to certify to NASDAQ that it has at least one member who is a bona fide "financial expert" with experience in finance or accounting, professional certification in accounting, or is or has been a CEO, CFO, or other senior officer with financial oversight responsibilities (but excluding anyone who was involved in preparing financial statements for the company within the past three years).[6]

The NASDAQ compensation committee independence rules also provide that, in addition to the existing director independence general requirements, a board of directors must affirmatively consider all factors specifically relevant to determining whether a director who will serve on the compensation committee has a relationship to the listed company that is material to that director's ability to be independent from management in connection with the duties of a compensation committee member. These factors should include, but are not limited to: (1) the source of compensation of the director, including any consulting, advisory, or other compensatory fee paid by the company to that director; and (2) whether the director is affiliated with the listed company, a subsidiary of the listed company, or an affiliate of a subsidiary of the listed company.[7]

Needless to say, to reach a conclusion that all these criteria are satisfied also can take a good deal of lawyer time.

Stock Option Plans

No IPO is complete without a stock option or equity plan. A good deal of the excitement of an IPO revolves around the opportunity of employees (especially non-founder officers) to be awarded stock options, restricted stock, or other equity awards that vest over time.

Accordingly, as part of the IPO process, and in consultation with the client to determine its specific needs and wishes, lawyers commonly draft a stock option, stock appreciation rights, and a restricted stock incentive plan. Pursuant to the plan, "eligible individuals" include directors, officers, employees, and independent consultants. The typical plan provides for incentive stock options (so-called "qualified" options—qualifying for deferment of taxes), non-statutory (non-qualifying) options, restricted stock (shares providing for actual issuance of shares but not saleable until vesting and restrictions lapse), stock appreciation rights, and other stock-based awards.

Developing and explaining to the client various alternatives, and then drafting such a plan can also consume substantial time.

Nominee Directors—Indemnity Agreements

Many IPO candidates want to supplement their board of directors by adding not only those who are independent, but also persons with recognized experience, reputation, and a curriculum vitae that is impressive. Director candidates may grant use of their names and allow themselves to be described as "nominee directors," but frequently they will not agree to actually join the board until the IPO is completed. The reason for this is to avoid liability for both pre-IPO actions of the company and especially issues and litigation that may arise from the IPO itself.

Many IPO candidates want to supplement their board of directors by adding not only those who are independent, but also persons with recognized experience, reputation, and a curriculum vitae that is impressive.

However, whether at the start-up stage or at any point in the company's life, any knowledgeable nominee is likely to demand a contractual indemnity agreement for protection from exposure to litigation and especially attorney expenses, which often occur with publicly traded companies, and even more so following IPOs.

Even though corporate laws such as those that exist in Delaware and Michigan are very broad, and notwithstanding that extensive indemnity and reimbursement provisions are commonly already in place in the IPO company's certificate of incorporation, experienced nominees want a contractual, direct obligation from the company.

To fulfill this demand, attorneys are called on to draft an indemnity agreement

that creates a direct obligation of the company to indemnify, defend, and reimburse the directors from financial losses due to actions brought by private complainants or governmental/regulatory agencies (except to the extent public policy may limit or prevent findings of intentional wrongdoing or criminal conviction).

Conclusion

The purpose of this article is to outline some of the many tasks and documents, in addition to the S-1 registration statement, that require an inordinate amount of attorney time. Although clients find it difficult to comprehend why the process take so long, why it takes so many lawyers and accountants, and why it is so expensive, this article highlights the key reasons why the process must be so detailed.

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NOTES

1. Since Delaware re-incorporation frequently is the choice for companies wishing to go public, the "certificate of incorporation" and legal provisions referred to will also reflect Delaware law. However, Michigan corporate laws were drafted to be modeled on Delaware's and with several variations many of Delaware's "corporate friendly" features were adopted.

2. "Poison pill" refers to a Shareholder Rights Plan adopted by the Board. The Plan allows for the issuance at a small fractional price of new shares to existing shareholders if a hostile bidder surpasses certain 'red lines" of ownership. The potential issuance of new shares makes it prohibitively expensive for the hostile bidder to acquire control.

3. See NYSE Listed Company Manual §§303A to 303A.10; NASDAQ OMX Exchange Rules 5600 et seq.; SEC Rule §240.10A-3 pursuant to Securities Exchange Act of 1934.

4. NASDAQ. Rules 5605(a)(2). The NYSE Rules, §303A.02 of the NYSE Listed Company Manual are fairly similar except for some helpful "commentary" as to potential conflicts of interest and materiality of certain relationships.

5. Exchange Act, Rule 10A-3 (implemented §301 of Sarbanes-Oxley Act of 2003).

6. SOX, Section 407, 15 USC 7265; NASDAQ 5605(c)(2)(A).

7. NASDAQ Rule 5605(d)(2)(A).

Changes to Michigan Tax Law Regarding Tax Clearance Procedure, Responsible Officer Liability, Audit Procedures, and Claims for Refund

By Edward J. Castellani

On January 30, 2014, Governor Snyder signed into law Senate Bill No. 337 (the "Act"). The Act, recorded as Public Act 3 of 2014, amends sections MCL 205.201, 205.27a, and 205.30 relating to tax clearance procedure, responsible officer liability for unpaid Michigan taxes, successor liability for purchasers of a business, audit procedure, and claims for refund. The primary changes to Michigan law contained in the Act are summarized below.

Changes to Tax Clearance Procedure

Prior to the Act, a seller and buyer of a business had to estimate and agree on an amount to hold in escrow to protect the buyer from any unpaid Michigan taxes of the seller. This involved negotiations between the parties and uncertainty as to whether the estimated amount was sufficient to pay the seller's unpaid Michigan taxes. After the sale of the business was closed, the seller would request the Tax Clearance Division of the Michigan Department of Treasury ("Treasury Department") to provide a tax clearance. There were no time requirements to provide the tax clearance, and it generally took three to twelve months to receive it.

The Act provides that within sixty days of a request from the purchaser, the Treasury Department must provide the business's known or estimated tax liability to the purchaser for the purpose of establishing an escrow account for the payment of taxes.[1] Prior law did not contain a requirement that the Treasury Department provide an amount to be placed in escrow.

If the purchaser of a business complies with the escrow requirements contained in the Act, the purchaser will not be held liable for more than the known or estimated tax liability disclosed by the Treasury Department and held in escrow.[2]

If the Treasury Department does not provide the required tax liability within the sixty-day period, the purchaser will not be liable for any unpaid taxes of the seller.[3]

Changes to Responsible Person Liability for State of Michigan Taxes

The responsible officer law in Michigan prior to amendment by the Act was brief and vague about who was or was not a responsible officer. It also sometimes led to unfair results for certain employees who signed tax returns or corporate checks without any authority to control payments to creditors. It did not contain notice requirements, a statute of limitations, or a requirement that the failure to file or pay was willful.

The Act provides that a responsible person means any officer, member, manager, or a manager-managed limited liability company, or partner for the business who controlled, supervised, or was responsible for the filing of returns or payment of taxes administered under this Act during the time period of default and who, during the time period of default, willfully failed to file a return or pay the tax due or any of the taxes described in the Act.[4] The signature, including electronic signature, of any officer, member, manager or a manager-managed limited liability company, or partner on returns or negotiable instruments submitted in payment of taxes of the business during the time period of default is *prima facie* evidence that the person is a responsible person, except that a signature, including electronic signature, on a return or negotiable instrument submitted in payment of the taxes after the time record of default is not *prima facie* evidence that the person is a responsible officer.[5] This is an important change since it introduces the concept of a "willful" failure to file or pay similar to the

Internal Revenue Code, and it limits liability to the time period of default.

The time period of default means the tax period for which the business failed to file the returns or pay the tax due and through the later of the date set for the filing of the tax return or making the required payment.[6]

Willful or willfully means the person knew or had reason to know of the obligation to file a return or pay the tax but intentionally or recklessly failed to file the return or pay the tax.[7]

Treasury Department must provide a responsible person assessed under the Act with notice of any amount collected by the department from any other responsible person determined to be liable under the Act, or purchaser of the business determined to be liable under the Act, that is attributable to the assessment.[8] The Act does not contain a time requirement for this notice.

The Treasury Department may not assess a responsible person under the Act more than four years after the date of the assessment issued to the business, subject to certain exceptions for fraud.[9]

A responsible person may challenge the validity of an assessment to the same extent that the business could have challenged that assessment when originally issued.[10]

The Treasury Department has the burden to first produce *prima facie* evidence or establish a *prima facie* case that the person is a responsible person under the Act.[11]

In a separate proceeding before the circuit court, a responsible person found to be liable for the assessment under the Act may recover from other persons an amount equal to the assessment or a portion of the assessment based on that person's proportionate liability for the assessment as determined in that circuit court proceeding.[12]

Before assessing a responsible person as liable under the Act for the tax assessed to the business, the Treasury Department must first assess a purchaser or succeeding purchaser of the business personally liable under the Act: (1) if the Treasury Department has information that clearly identifies a purchaser or succeeding purchaser, and (2) it establishes that the assessment of the purchaser or succeeding purchaser would permit the Treasury Department to collect the entire amount of the tax assessment of the business.[13] The Treasury Department may assess a responsible person under the Act notwithstanding the liability of a purchaser or succeeding purchaser if the purchaser or succeeding purchaser fails to pay the assessment.[14]

Assessments issued to responsible persons before January 1, 2014, will apply to all taxes administered under the Revenue Act.[15] Assessments issued to responsible persons after January 1, 2014, will apply to taxes levied under the general sales tax, the use tax act for taxes that were taxes collected from, or on behalf of, a third person, the tobacco products tax act, the motor fuel tax act, the motor carrier fuel tax act, the withholding of income tax, and any other tax administered under the Act that a person is required to collect from, or on behalf of, a third person to pay to the state.[16]

On request of a responsible person who was issued an Intent to Assess by the Treasury Department, the department must disclose any documents considered in the Treasury Department's audit or investigation in determining that the responsible person is personally liable for the assessment and any other documents that the Michigan Tax Tribunal or court determines are necessary for fair adjudication of a person's liability.[17]

Changes to Audit Procedure

Michigan law prior to the Act did not contain restrictions on how long an audit would take or when an assessment had to be issued after completion of the audit.

The statute of limitations for audit purposes is extended by the Act for the period pending a final determination of tax through audit conference, hearing, and litigation of liability for federal income tax and for one year after that period.[18]

For audits commenced after September 30, 2014, the Treasury Department must complete field work and provide a written preliminary audit determination no later than one year after the statute of limitations described in MCL 205.27(a)(2), without regard to the extension provided for in MCL 205.27(a)(3).[19]

For audits commenced after September 30, 2014, unless agreed otherwise by the Treasury Department and the taxpayer, the final assessment must be issued within nine months of the date that the department provided the taxpayer with a written preliminary audit determination, unless the taxpayer for any reason requests reconsideration of the preliminary audit determination or the taxpayer requested an informal conference.[20] A request for reconsideration by a taxpayer

Michigan law prior to the Act did not contain restrictions on how long an audit would take or when an assessment had to be issued after completion of the audit.

permits, but does not require, the Treasury Department to delay the issuance of a final assessment.[21]

Changes to Claim for Refunds

Prior to the Act there was no time requirement for the Treasury Department to reply to a request for a tax refund.

Under the Act, if a claim for refund, other than one made on an individual income tax, is not acted on by the Treasury Department (approved, denied, or adjusted) within one year from the date the claim was received, the claim may be treated as denied at the election of the taxpayer and may be appealed by the taxpayer in accordance with section 22.[22]

This article is a summary of a complex and lengthy new law. Practitioners should review the new law carefully as certain sections of the new law are not included in this summary.

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NOTES

1. MCL 205.27(a)(1).
2. *Id.*
3. *Id.*
4. MCL 205.27(a)(15)(b).
5. *Id.*
6. MCL 205.27(a)(15)(c).
7. MCL 205.27(a)(15)(d).
8. MCL 205.27(a)(5).
9. MCL 205.27(a)(2).
10. MCL 205.27(a)(5).
11. *Id.*
12. *Id.*
13. *Id.*
14. *Id.*
15. MCL 205.27(a)(14)(a).
16. MCL 205.27(a)(14)(b).
17. MCL 205.27(a)(6).
18. MCL 205.27(a)(4).
19. MCL 205.21(6).
20. MCL 205.21(7).
21. I*d.*
22. MCL 205.30(2).

Case Digests

Use Tax—Lease of Aircraft

NACG Leasing v Department of Treasury, No 146234, 2014 Mich LEXIS 410 (Mar 21, 2014). A Michigan corporation purchased an aircraft from one company and immediately executed a five-year lease to another company that already had possession of the aircraft. The Michigan Supreme Court concluded that this constituted a "use" for purposes of the Use Tax Act, regardless of whether the corporation ever had actual possession of the aircraft. The supreme court reversed and remanded the case to the court of appeals to consider the corporation's alternative claim challenging the calculation of the assessment amount.

Income Tax—Apportionment of S Corporations Income

Winget v Department of Treasury (On Remand), No 302190, 2014 Mich App LEXIS 424 (Mar 14, 2014). Where one petitioner was the sole shareholder of several S corporations, some of which had multistate operations, and determined Michigan income tax liability by combining the property, payroll, and sales figures for all of the S corporations to calculate a single apportionment percentage, the Department of Treasury properly concluded that the petitioners should have calculated and applied separate apportionment percentages for each of the S corporations. Since the petitioners failed to establish that the S corporations comprised a unitary business, they were not entitled to use combined reporting.

The petitioners argued that as resident individual taxpayers, MCL 206.110 and 206.115 required allocation of all taxable business income in accord with the apportionment formula, regardless of whether their businesses were unitary. However, *Malpass v Department of Treasury,* 494 Mich 237, 833 NW2d 272 (2013) foreclosed this possibility since that case recognized that combined reporting could only occur if the businesses were unitary.

Use Tax—Industrial Processing Exemption

Detroit Edison Co v Department of Treasury, No 309732, 2014 Mich App LEXIS 59 (Jan 9, 2014). Although the Department of Treasury contended that an electric utility's machinery and equipment located outside of its generation plants and used to transmit and distribute electricity were subject to taxation under the Use Tax Act, the utility was entitled to the act's "industrial processing" exemption pursuant to MCL 205.94o because the machinery and equipment was used not only to transmit and distribute electricity but to also continue the "processing" of electricity.

Unemployment Insurance—Voluntary Quit without Good Cause

Logan v Manpower of Lansing, No 311167, 2014 Mich App LEXIS 450 (Mar 13, 2014). Claimant began working for a temporary employment agency and was assigned to a part-time position. After going on medical leave, she was directly hired by that employer but had a medical restriction that limited her to working no more than four hours per day for no more than three days per week. After the medical restrictions were removed, the claimant never worked anything close to full-time employment before she was laid off and applied for unemployment benefits. The Unemployment Insurance Agency initially granted benefits to claimant, finding that she was not disqualified under MCL 421.29(1)(a). The temporary employment agency contested this determination, and, after holding a hearing, an administrative law judge found that claimant was disqualified for benefits under MCL 421.29(1)(a) because she did not leave the temporary employment agency to accept permanent full-time work but instead had abandoned her job and took a part-time job with the client company.

The court of appeals held that the circuit court properly ruled that, pursuant to MCL 421.29(1)(a), one who voluntarily leaves work without good cause attributable to her prior employer is disqualified from receiving unemployment benefits. The circuit court also properly noted that one who voluntarily leaves work to accept part-time employment cannot invoke the statutory exception provided in MCL 421.29(5).

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Council Meetings

DATE	TIME	LOCATION
June 7, 2014	10:00 a.m.	J.W. Marriott Hotel, Grand Rapids
September 11, 2014*	4:00 p.m.	Sheraton Detroit, Novi
December 6, 2014	10:00 a.m.	Clark Hill, Birmingham

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