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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, Brendan J. Cahill, *The Michigan Business Law Journal*, 39577 Woodward Ave., Ste. 300, Bloomfield Hills, Michigan 48304, (248) 203-0721, bcahill@dykema.com, or through Kanika S. Ferency, ICLE, 1020 Greene Street, Ann Arbor, Michigan, 48109-1444, (734) 936-3432, ferencyk@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://connect.michbar.org/businesslaw/newsletter.

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 2019	Financial Institutions Committee	July 31, 2019
Spring 2020	Regulations of Securities Committee	November 30, 2020
Summer 2020	In-House Counsel Committee	March 31, 2020
Fall 2020	Corporate Laws Committee	July 31, 2020

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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://connect.michbar.org/businesslaw/newsletter

From the Desk of the Chairperson

By Kevin T. Block

Around the time I was elevated to the Chair of the Business Law Section, a few of the past Chairpersons mentioned to me that my one-year term as Chair will go faster than one could imagine. Roughly halfway through my one-year term, this certainly seems to be the case. The Business Law Section continues to by a very active Section, and I will be highlighting a number of those activities in this article, including the activities of the Section's Ad Hoc Committee on Diversity and Inclusion, the Section's Commercial Litigation Committee's work with respect to proposed legislation that would have abandoned the American Rule for a "loser pays" rule in litigation, and the continued development of our Section's law school outreach program.

At the BLS' Council's Quarterly Meeting held in March of this year, the Ad Hoc Committee on Diversity and Inclusion submitted a report and recommendation regarding the Business Law Section's diversity and inclusion activities. After discussion and review of the report and recommendations, the Council acted on two matters recommended by the Ad Hoc Committee. First, the Section became a signatory to the State Bar of Michigan's *Pledge to Achieve Diversity and Inclusion in the Legal Profession in Michigan*. Second, the Council established a Directorship on Diversity and Inclusion. The purpose of this Directorship will be to promote diversity and inclusion in the Section's programs and activities. I look forward to the development of this Directorship and the important work it will being doing to strengthen our Section.

The Section's Commercial Litigation Committee's activities were front and center at the BLS' Council's Quarterly Meeting held in December 2018. In advance of the meeting, and on short notice, the Commercial Litigation Committee reviewed legislation (SB 1182 and SB 1183) on behalf of the Section that was introduced late in the "lame duck" 2018 legislative session. These bills, if passed, would have altered the traditional American Rule under which each party in litigation is generally responsible to pay its own attorneys' fees. After discussions at the meeting and based on the recommendations of the Commercial Litigation Committee, the Section submitted a report to the State Bar of Michigan in opposition of the senate bills. The Commercial and Litigation Committee Chair (and past Section Chair), Douglas L. Toering, was prepared to address the Senate Judiciary Committee regarding the Section's opposition to such legislation. Prior to appearing, however, we were informed that the bills had been removed from the docket. To date, it appears that no further action has been taken with respect to these bills.

As part of the Section's law school outreach program, the Section had opportunities earlier this year to speak to students at both the University of Detroit Mercy Law School and Wayne State University Law School. In January of this year, I spoke to the University of Detroit Mercy Business Law Society on various aspects of a transactional practice and the life cycle of a typical business transaction.

In March of this year, Marguerite Donahue, Celeste Arduino, Mark Kellogg, and I participated on behalf of the Section in a panel discussion moderated by Anne Choike, Assistant Professor and Director of Business and Community Law Clinic at Wayne State University. This panel discussion was coordinated by the Entrepreneurial and Business Law Society of Wayne State University Law School. The varied practices of the panel participants gave the students an opportunity to see the many and different opportunities available to a business lawyer in Michigan.

The Business Law Section's educational opportunities, as well as opportunities to become involved in the Business Law Section's various committees, were also emphasized to the law students at both law school events. I am happy to report that both of these events were well attended and well received.

I would like to thank the Commercial Litigation Committee for coordinating the publication of the articles appearing in this edition of the Business Law Journal. As usual, I am sure you will find the articles to be well written, very informative, and useful to any business law practitioner.

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When I originally wrote this column, we entered the end of the first month of the partial government shut-down. The vast majority of IRS employees had been furloughed, and most of the rest were working without contemporaneous pay. The employees that were working were part of the criminal investigation branch, including a core cadre for field operations such as a revenue officer to process payments and some basic supervisory staff. Most operations at National Office and processing centers were shuttered including technical advice, PLRs, Regulations and Appeals operations. The United States Tax Court had cancelled dozens of calendars around the country.

The long-term impact will manifest itself over time. In the near-term, examinations and other administrative operations have been impacted. The results from the 2019 filing season will not be known for some time, but as of April 15, 2019, a record number of tax returns remain unfiled.

Tax Court Update

The tax court fills an important space in tax advocacy practice. The tax courts provide streamlined litigation procedures, and there is a modest cost of entry by a petition. Cases are litigated in all major cities around the country. Timely petitioning of the tax court is a critical jurisdictional prerequisite. Limited to civil controversies, the tax court provides the only judicial forum where tax payers can challenge various actions of the IRS without first paying the tax. Some of the major areas of the court's jurisdiction include: notices of deficiency (audit disputes), worker classification, determination of innocent spouse matters, passport revocation challenges, whistleblower matters in certain circumstances, and various collection actions.

The IRS is represented by lawyers from IRS Chief Counsel rather than the U.S. Department of Justice. Qualifying tax payers may receive free legal assistance from various low-income taxpayer clinics partially funded by the government.

Recent Updates In Tax Court Practice

There were various amendments to the United States Tax Court's procedural rules on November 30, 2018 and December 19, 2018. Some of the new rules allow for electronic payment of filing fees and the electronic filing through the court's system. This change essentially gives taxpayers and practitioners the entire day to submit a timely filing rather than looking for a post office to postmark filings at the established deadline. A companion change to Rule 23 allows for electronic signatures. Rule 34 was also amended to start the procedural ball ruling. This amendment may be the most important because petitions that are not filed within the 90-day deadline are dismissed by the tax court due to their limited jurisdiction. This means that the asserted taxes by the IRS are assessed and will become liabilities subject to collection. Payment is then required for a judicial determination to become available to a taxpayer.

Other changes allow for challenges for interest abatement if the IRS fails to issue a determination and certain passport revocation actions. I previously discussed the ability of the IRS to request that the U.S. State Department revoke the passport for those with seriously delinquent taxes in the Spring 2016 Tax Matters column. The IRS has begun issuing Notice CP 508C, which informs the State Department that an individual taxpayer has serious delinquent tax debt. Failure to address the situation can result in the denial of a passport or a potential suspension of a current passport.

Case Updates

In a recent case, *Kimble v United States*, 141 Fed Cl 373 (2018), the U.S. Court of Federal Claims upheld the full amount of civil penalties connected to an undisclosed offshore account. The taxpayer made the strategic decision to withdraw from the Offshore Voluntary Disclosure Program. Her penalty went to 50 percent of the highest account balance. The court found a "'reckless disregard' of the legal duty to report" foreign bank accounts. Taxpayers still out of compliance should take note that the courts may not provide relief from the determinations of the agency. The general view is that after years of pronouncements and litigation, there are very few taxpayers that will have credible narratives that will warrant significant relief from penalties.

In a recent case out of the 9th Circuit, the court found that a 2011 treasury regulation, specifically section 301.7502-1(e) provides the exclusive means to prove delivery and renders the common-law mailbox rule unavailable. Therefore, testimonial or circumstantial evidence is not available to prove timely mailing. To comply with the regulation, registered mail is required.

As many practitioners know, tax law is mostly administered through regulations. Regulations provide guidance, direction, and clarity when navigating legislative meaning and intent or certainly the IRS's view of such matters. The IRS's guidance has been held to have the highest level of deference. Generally, if the statute is ambiguous and the IRS interpretation is reasonable, the courts will apply the IRS's interpretation even if the court thinks another interpretation might be better or more reasonable.

Given the wide-ranging changes to the tax law from the Tax Cuts and Jobs Act "TCJA," there has been much anticipation for new regulations. Currently, the courts look to a reasonable standard when reviewing deference to the various agencies' regulations. However, recently the United States Supreme Court granted *certiorari* in the case of *Kisor v O'Rourke*, No 18-15 (US Aug 1, 2018). The issue is whether deference is appropriate and what weight should be given to an agency's, at times, ambiguous regulations. If the U.S. Supreme Court should pare back or eliminate this deference, the issue could have a cascading effect on IRS guidance. This impact is significant because courts would no

longer look to a reasonable standard but perhaps a higher standard.

Voluntary Disclosure—Still Viable

Lastly, the IRS updated the voluntary disclosure provision. The program is an invaluable opportunity for taxpayers that have potential criminal tax exposure (unfiled returns, questionable tax filings) to eliminate criminal exposure. Details are important and, as always, consult IRS Form 14457 for an overview and an experienced tax controversy specialist for specific guidance. Remember, once the taxpayer is contacted by the IRS, or the IRS learns about the taxpayer, voluntary disclosure is not available.

Michigan AG Ups the Pressure

The Michigan Attorney General's office has announced the formation of the Payroll Fraud Enforcement Unit. The stated mission is targeting employers that misclassify workers as independent contractors rather than employees, thus evading various employment taxes and overtime rules.

The current enforcement effort will use existing laws and can include civil and criminal penalties. There are some legislative proposals expected that offer further sanctions for noncompliance.

Lastly, the IRS has reported a significant increase in the whistleblower payouts. Last year, more than $300 million was awarded. The whistleblower program requires more than a phone call or grievance. Interested taxpayers and their professionals should seek informed guidance.

Eric M. Nemeth of Varnum LLP in Novi, Michigan practices in the areas of civil and criminal tax controversies, litigating matters in the various federal courts and administratively. Before joining Varnum, he served as a senior trial attorney for the Office of Chief Counsel of the Internal Revenue Service and as a special assistant U.S. attorney for the U.S. Department of Justice, as well as a judge advocate general for the U.S. Army Reserve.

Who are You? – The Growing Importance of Identity Management

We live in an increasingly (electronically) connected world. An individual's public persona and social media profile, however, may be completely fake. How can the real identity of a person be verified? When you log on to see your credit card or bank account, the financial institution is often using tools to authenticate that you are the person you say you are. These practices involve what is commonly called multi-factor authentication.[1] While it seems, at times, that the steps you have to go through to access information on the Internet are cumbersome, those requirements are truly for your own good.

In the context of business, validating a person's identity in order to ensure security of systems for the purposes of limiting access to information is critically important. The role of identity management (IdM) has been growing in importance albeit behind the scenes. Identity management is typically a set of policies implemented by an organization coupled with technologies which work in tandem to ensure that the person seeking to access systems has been authenticated as the correct person and is authorized to access a particular system. IdM is part of a group of computer security technologies that has been used primarily in regulated industries but is becoming more important across businesses.

What is IdM?

IdM can generally be considered to be a set of tools and technologies which authenticate an individual or entity, authorize access, define roles and access rights within an organization and provide for a means by which a system or application can ensure identity and access integrity. A "federated" IdM allows the use of these tools across different systems. For example, a large organization may use a federated IdM in order to authenticate and control user access across many different systems and applications. Only specific people need to have access to financial or human resources data, and a single sign-on giving everyone access would be unworkable. These systems provide a level of governance by which an organization can administer its environment, often using role–based categories to define access.

The essence of IdM is that an organization can use the tools to securely grant users access to systems and privileges within the system. The implementation of IdM may not be particularly easy, and it will certainly be expensive and time-consuming. The ability to manage the authentication and access of different types of users (employees, contractors, customers, business partners, suppliers, etc.) can improve productivity and simplify the process of access to multiple systems.

The immediate thought, of course, of everyone who has gotten this far in the article is that they can dispense with the myriad of usernames and passwords of which they have to keep track. While that may be something for the future, the current tools really do not provide a realistic way to do that. Biometric data (your fingerprint or your retina for example) may provide that mechanism, but it is not an IdM system.

Legal Developments Related to IdM

One of the most active organizations analyzing how IdM can assist in global interactions is the United Nations Commission on International Trade Law (UNCITRAL). An UNCITRAL Working Group has been studying the problems in the use of IdM for cross-border transactions. In a recent report,[2] it summarized the problem as the following:

> *Several obstacles to the broader use of IdM and trust services exist. Some obstacles are of a legal nature and include: (1) a lack of legislation giving legal effect to IdM and trust services; (2) divergent laws and approaches to IdM, including laws that are based on technology-specific requirements; (3) legislation requiring paper-based identification documents for entering into online commercial transactions; and (4) the absence of mechanisms for cross-border legal recognition of IdM and trust services.*

The progress of the Working Group may assist in making IdM more globally accessible and useful.

The Commonwealth of Virginia has actually taken the lead in state legislative initiatives with the passage of the Electronic Identity Management Act,[3] which establishes a framework by which IdM systems are legally recognized. Biometric identity management has gotten the attention of Congress with draft legislation in the last legislative session[4] to establish an office within the Department of Homeland Security to address IdM.

Conclusions

While there is a lot of activity dealing with IdM across the world, the benefits are primarily being seen in organizations that invest in technologies to assist with authentication and access. How the rollout of IdM will affect most businesses and customers will be seen in the future.

NOTES

1. This is often referred to as a system that requires verification from the person of something they know (such as a password), something they have (such as a smartphone where access numbers can be sent) or something you are (facial recognition or fingerprints).

2. See "Explanatory Remarks on the Draft Provisions on the Cross-border Recognition of Identity Management and Trust Services," dated February 1, 2019 and prepared in advance of a meeting of the Working Group in April 2019. The full report can be found at https://undocs.org/en/A/CN.9/WG.IV/WP.157 Other UNCITRAL reports and documents can be found at https://uncitral.un.org/en/working_groups/4/electronic_commerce.

3. See Virginia Code § 59.1-550, et seq.

4. H.R. 5206, Office of Biometric Identity Management Authorization Act of 2018

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Judge James M. Alexander and recently retired Judge Wendy L. Potts (succeeded by Judge Martha D. Anderson on January 1, 2019) have presided over the Oakland County Business Court since it officially began on June 3, 2013. This article introduces the court and its inaugural judges, who have shared their views on case management and discovery and impart wisdom for both transactional attorneys and litigators.

The Docket

There are two judges presiding over the Oakland County Business Court. The business court judges in Oakland County (and statewide) serve for a term of six years. (The term for each business court judge in Michigan officially expired April 1, 2019, although judges may seek reappointment by the Michigan Supreme Court.) Each business court judge in Oakland County has roughly 250 open business cases at any given time, as well as a criminal docket with 40-60 criminal cases at any given time. The State Court Administrative Office (SCAO) has recently completed a study of case weight times, which will be the basis for the upcoming Judicial Resource Recommendations (JRR) report (typically issued in July of every odd year). The JRR will be issuing a report this July, which may have an impact on the dockets of Oakland County and other courts.

Case Management Protocol

The Oakland County Circuit Court has a specific Case Management Protocol[1] for its business court cases.[2] Judge Alexander believes that the business courts work only "if there is early, intense judicial involvement." According to Judge Alexander, Oakland County's Case Management Protocol is one of the ways the business judges achieve such involvement. He considers case management "a triage – it allows us to find problems… understand what the issues are, and the lawyers can understand how we manage."

The Joint Case Management Plan

The Joint Case Management Plan is one of the main features of Oakland County Business Court's Case Management Protocol. According to Judge Potts, "the Case Management Plan makes case management more useful" because it "gives the attorneys an opportunity to discuss the case with each other prior to positions becoming entrenched." Judge Alexander emphasized this point: The Case Management Plan "requires lawyers to know the case when they come in and it allows [the judges] to get involved early on."

The Case Management Protocol directs counsel for the parties to confer in advance of the Case Management Conference (more on that later) to identify areas of agreement and disagreement on various issues, which will be incorporated in the Joint Case Management Plan. The plan must be filed by plaintiff's counsel at least one week in advance of the Case Management Conference. Judge Potts emphasized the submission ahead of the conference, calling it "critical" that the judges receive the plan in advance of the conference: "I'd like to know something about the case" before counsel come in.

The plan must set forth, among other things, the parties' positions on a variety of issues, including a good faith estimate of the amount of damages; any intention to file initial dispositive or injunctive motions and the proposed impact such motions will have on discovery; the timetable for the case including initial disclosures, date for discovery cutoff, and a mutually acceptable neutral mediator; and consent to the Court's Model Protective Order.[3] The Joint Case Management Plan will then be incorporated into an order.

The Case Management Conference

The Oakland County Business Court's protocol includes a Case Management Conference, which is the first opportunity for the judge to talk with the lawyers. Lead counsel for the parties must attend the conference and be prepared to discuss the case. The parties, however, are not required to attend.

Discovery and Facilitation

The Standard Discovery Protocol

Another key aspect of the Case Management Protocol is the standard discovery protocol. The discovery protocol requires discovery be "proportional to the complexity and amount of damages sought." It includes a number of provisions "suggested to the parties as a starting point in order to streamline discovery, reduce costs, and engage in meaningful ADR processes as early in the litigation as practicable." The protocol (and the court) are serious about proportionality: "The court will consider principles of proportionality with regard to all discovery disputes."

The standard discovery protocol requires counsel to file initial disclosures within 30 days of the Case Management Conference. The concept behind the initial disclosure requirements is "know your case." According to Judge Alexander, there is "nothing worse than to look at a lawyer and ask them what their case is about and receive a blank stare in return." He added, "we have many cases and we don't want lawyers to waste time." The initial disclosures require the lawyers to know their case; this, in turn, enables the lawyers to help the judges get involved in their case.

Discovery Facilitation

Like the general civil cases, the Oakland County Business Court uses voluntary discovery facilitators. For the business court, the discovery facilitators are also a part of the Business Court Advisory Committee. Typically, before a discovery motion is heard, the discovery facilitator meets with counsel before the Wednesday morning motion call to attempt to resolve the dispute. The business court has had a positive experience with the discovery facilitation program. Judge Potts called the program

"very successful" and essential to their caseload: Given the heavy caseload, managing the business docket "would be nearly impossible without the facilitators." Judge Alexander emphasized the need for the lawyers to communicate in advance of motion calls, as "90 percent of discovery disputes can be resolved if the attorney will pick up the phone."

Early ADR

The Oakland County Business Court typically emphasizes early ADR. Generally, the court will order mediation early in the case and allow sufficient discovery before the mediation to allow the mediation to be meaningful. That said, as Judge Alexander pointed out, little if any discovery is usually needed for low-dollar cases.

Early mediation is particularly helpful in cases where there is an ongoing business relationship that the parties would like to preserve, Judge Alexander noted. Also, Judge Potts observed that even if a mediation does not settle the case, it can narrow the issues. Case evaluation has not played a significant role in the business cases in Oakland County.

Proposed Discovery Rule Changes

The Michigan Supreme Court is considering 23 amendments to the discovery rules contained in the Michigan Court Rules. Some of these are patterned after the Oakland County Business Court's standard discovery protocol. Judge Alexander and Judge Potts are hopeful that the proposed rules will help reign in discovery so that it is not overly burdensome; they believe that the proportionality requirement will help to manage discovery. Judge Alexander added that "nobody tries cases anymore. Litigation has become a discovery fight… . It's hard to distill [11 million pages of ESI] to a judge or jury."

Words of Wisdom

Transactional Lawyers

Judge Alexander would like to see more thoughtfulness in drafting documents: "Keep in mind the 'what if.' When you're writing things, if it's ambiguous, we will hold this against you. Six people who are lay people will be deciding [these things]."

Litigators

Judge Potts cautioned lawyers to read the Case Management Plan carefully before agreeing to it. "Too many lawyers say it's fine and don't get involved. If they're agreeing to things it could come back to haunt them." Judge Alexander's advice to litigators is "know your case" and to pick up the phone and communicate with the other side. Judge Potts echoed Judge Alexander's sentiment to pick up the phone and try to work things out, adding that lawyers should pick their battles.

Respect

The Golden Rule is important to Judge Alexander and Judge Potts. Business court cases often involve family businesses and ongoing business relationships. Judge Alexander would like to remind lawyers that "it's not personal – people try to make these cases personal and they're not. It's business." Judge Potts advised that "it's up to the lawyers to restrain their clients – tell them about the cost of [litigating on] principle and educate them so they can make a good business decision."

Respect and civility are two guiding principles that will go far for lawyers who appear in Oakland County Business Court. Indeed, both judges identified incivility as a pet peeve. Judge Potts admonished that "Incivility should not be tolerated. You're not doing your client any favors. You need preparation as opposed to drama and grandstanding." Judge Alexander added: "Civility and courtesy is going to be what I talk about most. That goes lawyer-to-lawyer and lawyer-to-staff."

The Business Court's Development

Judge Alexander and Judge Potts have served as the Oakland County Business Court's first judges. Asked what her greatest satisfaction has been in the business court, Judge Potts quickly answered, "bringing parties together and creating resolution." Judge Alexander has enjoyed watching the court develop and putting policies and procedures in place that other courts now use as a model. He added that the court has achieved exactly what it set out to do: "Look at what the statute says – the business courts were created to get consistency and expertise. The consistency is there, the community knows what to expect when they come in here."

The Future of the Business Court

Judge Wendy Potts retired in 2018 and was replaced by Judge Martha Anderson as of January 1, 2019. Both Judge Alexander's and Judge Anderson's terms expired on April 1, 2019, but they have been reappointed to another term.

NOTES

1. For an in-depth discussion of Oakland County Business Court's Case Management Protocol, see *Touring the Business Courts*, 38 Bus. L. J. No. 1, Spring 2018, p. 12.
2. https://www.oakgov.com/courts/businesscourt/Documents/ocbc-pro-case-management.pdf.
3. https://www.oakgov.com/courts/businesscourt/Documents/mod-bc-pro_ord.pdf.

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The Risk of Silence: Allocating the Risks of Buyers and Sellers Through the Use of Pro- and Anti-Sandbagging Provisions

By Daniel D. Quick and Ariana D. Pellegrino

Introduction

Commentators attribute varied historical meanings to the term "sandbagging." One commentator described it as originating "from the 19th century where gang members would fill socks full of sand to use as weapons against unsuspecting opponents."[1] In that vein, another commentator suggested the term might derive from the use of a sand bag as a weapon in a surprise attack.[2] Others have attributed a less sinister meaning, describing "sandbagging" as "a 'check-raise' gambit—in which a player (usually with a strong [poker] hand) would check early in a round of betting in order to lure another into making the opening bet, and then proceed to raise that bet."[3]

"Sandbagging" is not all that different in the mergers and acquisitions context, where it refers to "the practice of asserting a claim based on a representation despite having had reason to suspect it was inaccurate."[4] In other words, the buyer slow-plays its suspicions—or perhaps even actual knowledge—and then ups the ante, often to the tune of millions in post-closing indemnification claims. While some courts foreclose indemnity claims where the claimant suspected or had knowledge of the inaccuracy of the representation or warranty before closing, many jurisdictions permit such claims.

The consequences cannot be ignored. Approximately one-quarter of all deals with an indemnification escrow result in at least one claim,[5] and, in 2017, indemnitors paid, on average, 70 percent of escrow holdbacks as a result of indemnification claims.[6] In the absence of specific pro- or anti-sandbagging provisions in a purchase and sale agreement, courts apply default rules, leaving clients at the mercy of an uncertain and evolving area of law. Thus, it is important as counsel for both buyers and sellers to know the governing default rules and consider whether risk-allocation provisions are appropriate, ensuring your client's fate is not left to a game of chance.

Default Rules: New York, Delaware, and California

The Reliance Problem

While courts take different approaches to whether so-called "sandbagging" claims are permissible, that determination ultimately turns on whether courts treat claims for breach of representations and warranties as sounding in contract or tort.[7] The determination of whether such a claim sounds in contract or tort implicates whether a claimant must show that it relied on the representation or warranty,[8] a showing a claimant will be hard-pressed to make if it had knowledge of the inaccuracy prior to closing.

The majority of jurisdictions take a pro-sandbagging approach, meaning that they do not require proof of reliance in a breach of warranty claim.[9] Delaware and New York, the two jurisdictions most likely to supply the governing law in a purchase and sale agreement,[10] are viewed as sandbagging friendly.[11] Conversely, the other prominent governing jurisdiction, California,[12] is considered anti-sandbagging, requiring proof of reliance for such claims.[13]

The reality is more nuanced and fact-intensive. For example, while authorities view Delaware as pro-sandbagging, caselaw is less than clear, and as recently as 2018, in *Eagle Force Holdings, LLC v Campbell*, the Delaware Supreme Court called the viability of sandbagging claims into question.[14] Accordingly, this article addresses current caselaw in three prominent jurisdictions—California, Delaware, and New York—and the approach Michigan might follow.

New York

New York permits litigants, with little limitation, to bring claims for breach of a warranty, even where the litigant suspected or knew that the warranty was false pre-closing.

In the seminal case of *CBS Inc v Ziff-Davis Pub Co*[15] ("*Ziff-Davis*"), the New York Court of Appeals addressed whether reliance is an element for a claim for breach of an express warranty where, prior to closing, the buyer suggested to the seller that there were "material misrepresentations in the financial statements provided [to CBS]… ."[16] Notably, while the buyer suggested that certain warranties were inaccurate, the seller disputed that fact.[17] In holding that reliance is not an element of a claim for breach of warranty, the court of appeals held:

> The critical question is not whether the buyer believed in the truth of the warranted information, … but whether it believed it was purchasing the seller's promise as to its truth. This view of "reliance"—i.e., as requiring no more than reliance on the express warranty as being a part of the bargain between the parties—reflects the prevailing perception of an action for breach of express warranty as one that is no longer grounded in tort, but essentially in contract. The express warranty is as much a part of the contract as any other term. Once the express warranty is shown to have been relied on as part of the contract, the right to be indemnified in damages for its breach does not depend on proof that the buyer thereafter believed that the assurances of fact made in the warranty would be fulfilled. The right to indemnification depends only on establishing that the warranty was breached.[18]

The New York Court of Appeals determined that this held true even if the buyer, "after agreeing to make the purchase, forms doubts as to the existence of those facts[.]"[19] To hold otherwise "would have the effect of depriving the express warranties of their only value to [the buyer]—i.e., as continuing promises by [the seller] to indemnify [the buyer] if the facts warranted proved to be untrue."[20]

Two years after *Ziff-Davis*, in *Galli v Metz*,[21] the United States Court of Appeals for the Second Circuit clarified the *Ziff-Davis* holding. In *Galli*, the buyer asserted a counterclaim for breach of warranty arising out of a purchase and sale agreement.[22] Among other warranties, the sellers warranted that they did not "know or have reason to be aware of any facts which might result in any … claim … which might adversely affect the business or condition … of [the company] or its properties."[23] However, the sellers conceded that they knew about contamination at one of the company's properties, which later resulted in environmental litigation post-closing.[24] Even so, the contamination "was … disclosed to [the buyer] prior to the [closing]."[25] Notwithstanding, the buyer argued that, under *Ziff-Davis*, his claim for breach of the warranty did not require proof of reasonable reliance.[26]

The district court and Second Circuit disagreed. The Second Circuit stated that "*Ziff-Davis* has far less force where the parties agree at closing that certain warranties are not accurate."[27] In other words, the Second Circuit distinguished the facts of *Ziff-Davis*—where the parties disputed pre-closing whether certain warranties were inaccurate—from the facts of *Galli*, where, prior to closing, the parties did not dispute that they were aware of the property contamination. Accordingly, the court held that "[w]here a buyer closes on a contract in the full knowledge and acceptance of facts disclosed by the seller which would constitute a breach of warranty under the terms of the contract, the buyer should be foreclosed from later asserting the breach."[28] The court did not deem this an exception to the *Ziff-Davis* rule, but a waiver of the claimed breach.[29] However, the court limited waiver to circumstances where the *seller* disclosed to the *buyer* the inaccuracy of a warranty, and where the buyer did not reserve its rights.[30] Accordingly, the court remanded the case for findings consistent with its ruling.[31]

In their wake, New York courts have stridently followed the *Ziff-Davis* rule and (what came to be known as) the limited "*Galli* waiver."[32] Indeed, courts have stressed exactly how limited a *Galli* waiver is. One court noted that "[a] *Galli* waiver is not lightly inferred," arising only where, "notwithstanding warranties and representations by a seller, it is proved that the seller (*no one else*) disclosed to the buyer (*no one else*) circumstances that contradicted its own representations and warranties, and the buyer closed nonetheless without reserving its rights."[33]

Thus, New York is decidedly pro-sandbagging, with limited exception.

The majority of jurisdictions take a pro-sandbagging approach, meaning that they do not require proof of reliance in a breach of warranty claim.

Delaware

Before 2003, Delaware courts recognized that "in order for a defendant to be responsible for a breach of warranty, plaintiff must have known about the warranty and relied upon it."[34] However, in 2003, the Delaware Court of Chancery did an about-face, holding,[35] without citation to any authority, that "[r]eliance is not an element of a claim for indemnification."[36] Accordingly, the buyer was not required to prove that it justifiably relied on the seller's representations in order to seek indemnification.[37]

After *Gloucester*, Delaware lower courts adopted the theory that a claim for indemnification for breach of a warranty is effectively a claim for breach of contract, for which reliance is not an element.[38] Similarly, because the courts recognized that "reasonable reliance is [not] required to make a *prima facie* case for breach[,]" the Delaware Superior Court held that "[i]t follow[ed], then, that the extent or quality of plaintiffs' due diligence is not relevant to the determination of whether [the defendant] breached its representations and warranties… ."[39] In so holding, the superior court determined that the defendant's warranty of certain facts or circumstances represented an allocation of the risk of loss to the defendant, "irregardless [sic] of what [plaintiff's] due diligence may have or should have revealed."[40]

Notwithstanding *Gloucester* and its progeny, some Delaware courts cling to pre-*Gloucester* caselaw, reiterating, as recently as 2010, that reliance is "a prerequisite for a breach of warranty claim."[41] Moreover, in May 2018, the Delaware Supreme Court explicitly noted that, to date, it has not decided the "interesting issue" of "whether a party can recover on a breach of warranty claim where the parties know that, at signing, certain of them were not true."[42] While the *Eagle Force* Court declined to decide the issue, it nonetheless observed that "a majority of states have followed the New York Court of Appeals' decision [*Ziff-Davis*]…"[43] Still, the dissent argued that "[v]enerable Delaware law casts doubt" on a party's ability to sustain a claim for breach of a warranty when the party knew the warranty was false.[44]

Thus, while commentators often deem Delaware "pro-sandbagging" or "sandbagging friendly," the state of Delaware law is unclear and, potentially, in flux.

California

In contrast to New York and Delaware law, which commentators typically view as pro-sandbagging, California courts have long held that reliance is an "essential ingredient" of a claim for breach of warranty.[45]

Notwithstanding, at least one California federal court has distinguished *Kazerouni*.[46] In *Telephia, Inc v Cuppy*, the buyer and seller did not dispute that they were both aware that the seller was in "technical breach" of certain warranties before closing.[47] Accordingly, the seller argued that, because "[the buyer] knew that the warranties were false, [it] could not have relied on them," a critical element of its claim for breach of warranty.[48] The buyer, in turn, argued that "it need not prove reliance" because the purchase agreement provided that "[n]o information or knowledge obtained in any investigation … shall affect or be deemed to modify any representation or warranty contained in this Agreement."[49] The purchase agreement further provided that "[n]o investigation made by or on behalf of the Company … shall be deemed to affect … reliance on the representations, warranties, covenants, and agreements made by [seller]."[50]

Under those circumstances, the court determined that "defendants may be held accountable to the warranties in the [purchase agreement] regardless of plaintiff's reliance on those warranties."[51] And while defendants argued that such a result would be "condoning a fraud"—*i.e.*, allowing the buyer to enforce warranties that it knew to be false—the court stated that it found it "no stranger a result than to interpret [the purchase agreement] in a manner that results in [the buyer] having insisted on toothless provisions."[52] Thus, the court distinguished *Kazerouni* on the grounds that it "did not consider whether a bargained-for, risk-shifting provision such as the one at issue in this case should be enforced," nor did it "involve contractual language explicitly addressing reliance such as that found in [the purchase agreement]."[53]

Accordingly, while California courts historically require reliance to state a claim for breach of warranty, parties may still contractually alter that default rule.

Michigan: Edging Toward New York?

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and there is a dearth of caselaw on the topic. Notwithstanding, limited relevant decisions suggest that Michigan might adopt the New York approach.

In *Grupo Condumex SA v SPX Corp*, the United States District Court for the Northern District of Ohio addressed whether, in the context of an asset purchase agreement, Michigan law would require reliance as a necessary element of a claim for breach of warranty.[54] While not specifically referencing any Michigan authority rejecting the tort or reliance approach, the court noted that "[m]odern courts in Michigan adjudicating claims for breach of warranty have not required reliance on the victim's part."[55] The court found such an approach "logical," as, "under Michigan law, 'a breach of warranty is essentially a breach of contract.'"[56] The court further found that "[d]eclining to impose an obligation on a party claiming damages for breach of warranty to prove reliance on the warranty conforms to the current view of a majority of other jurisdictions."[57] Thus, the court believed that Michigan would apply a pro-sandbagging approach, but it did not describe the extent or limitations of its holding.

One year later, in an unpublished decision, the Michigan Court of Appeals addressed a situation where it ultimately found that a warranty was *not* included in the contract.[58] While that factual scenario largely differs from those cases described herein, the *Gallagher* court did briefly address whether a claim for breach of warranty requires reliance, and answered in the negative. As the court explained:

> Defendants assert, and we agree, that a contractual warranty term is essentially a bargained-for purchase by the buyer of insurance from the seller that some fact is as represented. It is therefore not defeated by the buyer's mere suspicion that those facts are actually untrue, so long as the buyer genuinely relied on the warranty being—in the abstract—a part of the contract. See [*Galli*], which is not binding on this Court, but we find persuasive. It is therefore true that the buyer's "reasonable reliance" on the facts stated in a *contractual* warranty term is not the standard for evaluating whether the seller is liable for breaching that term. However, a buyer cannot genuinely rely on a warranty term if it should be *patently obvious* to the buyer that those facts are blatantly false.[59]

The Michigan Court of Appeals did not describe in what circumstances the inaccuracy of a warranty would be "patently obvious." Nonetheless, when coupled with its statement that "mere suspicion" does not defeat a claim for breach of warranty, with citation to *Galli*, it appears that the court endorsed New York's approach to sandbagging—*i.e.,* that only limited circumstances, such as actual disclosure by the seller to the buyer or a "patently obvious" inaccuracy could defeat a claim for breach of warranty in the face of bargained-for risk allocation.

Drafting a Purchase and Sale Agreement with your Client in Mind

In reviewing the varied and sometimes inconsistent approaches to the sandbagging problem, what is clear is that the safest way to ensure protection for your client – whether buyer or seller—is by contractually allocating your client's risk. Despite the potential for costly consequences and the application of inconsistent law, in 2017, more than half of publicly available acquisition agreements were silent with respect to sandbagging provisions.[60] What is worse, only six percent of publicly available acquisition agreements contained anti-sandbagging provisions, leaving sellers exposed to potential liability under state default rules.[61]

While you should always consider the specific facts and circumstances of a particular transaction, the American Bar Association offers model pro- and anti-sandbagging provisions:

> Pro-Sandbagging Provision:
>
> > The right to indemnification, payment, reimbursement, or other remedy based upon any such representation, warrant, covenant, or obligation will not be affected by … any investigation conducted or any Knowledge acquired at any time, whether before or after the execution and delivery of this Agreement or the Closing Date, with respect to the accuracy or inaccuracy of, or compliance with, such representation, warranty, covenant, or obligation.[62]
>
> Anti-Sandbagging Provision:
>
> > No party shall be liable under this Article for any Losses resulting from or relating to any inaccuracy in or breach of any representation

To ensure that your client's post-closing rights or potential liabilities are not left to the courts, it is important to negotiate for pro- and anti-sandbagging provisions, depending upon the status of your client as buyer or seller.

> or warranty in this Agreement if the party seeking indemnification for such Losses had Knowledge of such Breach before Closing.[63]

For Michigan practitioners, and while the law on this subject is not conclusive, it is also important for a buyer to reserve its rights "by expressly stating that disputes regarding the accuracy of the seller's warranties are unresolved, and that by signing the agreement the buyer does not waive any rights to enforce the terms of the agreement."[64] Such a reservation minimizes the risk of a potential *Galli* waiver.[65]

Conclusion

Post-closing indemnification claims are common, and often result in significant payouts post-closing. While courts take different and often inconsistent approaches, the majority of jurisdictions hold that reliance is not a required element of a claim for breach of warranty—and thus, even if a buyer has actual knowledge that a representation or warranty is inaccurate, the buyer could bring a claim for breach thereof. To ensure that your client's post-closing rights or potential liabilities are not left to the courts, it is important to negotiate for pro- and anti-sandbagging provisions, depending upon the status of your client as buyer or seller.

NOTES

1. Shadden, *How to Sandbag Your Opponent in the Unsuspecting World of High Stakes Acquisitions*, 47 Creighton L Rev 459, 459 (2014).

2. Whitehead, *Sandbagging: Default Rules and Acquisition Agreements*, 36 Del J Corp L 1081, 1083 n 4 (2011).

3. *Id.*

4. *Akorn, Inc v Fresenius Kabi AG*, unpublished opinion of the Court of Chancery of Delaware, issued October 1, 2018 (C.A. No. 2018-0300-JTL), at n 756, citing Whitehead, *supra*, at 1087, 1092-1093.

5. JP Morgan 2018 M&A Holdback Escrow Study, p 16 (finding that, based on over 1,100 J.P. Morgan terminated escrow deals, 27 percent of transactions had an indemnity, adjustment, or expense claim, and 25 percent of escrows specifically for indemnity purposes had a claim).

6. *Id.* at p 19.

7. *See* Whitehead, *supra* note 2, at Appendix A (collecting caselaw).

8. *Id.*

9. *Id.* (comparing jurisdictions that take a contract approach to those that take a tort approach).

10. *See* T. Eisenberg and G. Miller, *Ex Ante Choices of Law and Forum: An Empirical Analysis of Corporate Merger Agreements*, 59 Vand L Rev 1975, 1987 (2006).

11. *See* Whitehead, *supra* note 2, at Appendix A.

12. *See* Eisenberg, *supra* note 10, at 1987.

13. Whitehead, *supra* note 2, at Appendix A, p 1114.

14. *Eagle Force Holdings, LLC v Campbell*, 187 A3d 1209, 1236 n 185 (Del 2018).

15. 75 NY2d 496; 553 NE2d 997 (1990).

16. *Id.* at 999.

17. *Id.*

18. *Id.* at 1000-1001 (internal citations and punctuation omitted).

19. *Id.* at 1001 (citation omitted).

20. *Id.* at 1002 (citation omitted).

21. 973 F2d 145 (CA 2 1992).

22. *Id.* at 147.

23. *Id.* at 150.

24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.* at 151.

28. *Id.*

29. *Id.* Nonetheless, courts have noted that a "buyer may preserve his rights by expressly stating that disputes regarding the accuracy of the seller's warranties are unresolved, and that by signing the agreement the buyer does not waive any rights to enforce the terms of the agreement." *Rogath v Siebenmann*, 129 F3d 261, 264-265 (CA 2 1997), citing *Galli*, 973 F2d at 150.

30. *Galli*, 973 F2d at 151.

31. *Id.* The *Galli* court also noted that:

> [W]hether Metz' knowledge of the [property] contamination vitiates his warranty breach claim depends on the circumstances in which Metz learned of the problem… . [T]he possibility lingers that the district court found only that the [property] problem was common knowledge. In that event, it is possible that a third person disclosed the problems to Metz and that Metz purchases the sellers' warranty as insurance against any future claims. Thus, under *Ziff-Davis*, Metz would have a strong argument.

32. *See ASM Capital v First Nat'l Bank of Waverly*, 146 App Div 3d 741, 743; l45 NYS3d 504 (2017); *Bank of New York Mellon Trust Co, NA v Morgan Stanley Mortg Capital, Inc*, unpublished decision of the United States District Court for the Southern District of New York, issued Feb 10, 2017 (No. 11 Civ 505 (CM) (GWG)), at *2 (noting that "the New York Court of Appeals carved out no exception to [the *Ziff-Davis* rule] and neither in 1990 nor at any time since did it place any limitation on it."); *Powers v Stanley Black & Decker, Inc*, 137 F Supp 3d 358, 374-375 (SDNY 2015).

33. *Bank of New York Mellon*, at *2 (emphasis added).

34. *Bleacher v Bristol-Myers Co*, 53 Del 1; 163 A2d 526, 528 (Del Super 1960), citing *Loper v Lingo*, 97 A 585 (Del 1916). *See also Kelly v McKesson HOB, Inc*, unpublished opinion of the Superior Court of Delaware, issued Jan 17, 2002 (No. CIV.A. 99C-09-265WCC), at *8 ("According to sound Delaware law, a plaintiff must establish reliance as a prerequisite for a breach of warranty claim."); *Middleby Corp v Hussmann Corp*, unpublished opinion of the United States District Court for the Northern District of Illinois, issued Aug 27, 1992 (No. 90C 2744), at *6 ("Although Delaware caselaw is not replete with discussions of whether reliance is an essential element of a breach of warranty claim, several old—but apparently still viable—decisions answer the question in the affirmative.").

35. *Gloucester Holding Corp v US Tape and Sticky Prods, LLC*, 832 A2d 116 (Del Ch 2003).

36. *Id.* at 127.

37. *Id.*

38. *Interim Healthcare, Inc v Spherion Corp*, 884 A2d 513, 548 (Del Super 2005).

39. *Id.*

40. *Id.*

41. *MicroStrategy Inc v Acacia Research Corp*, unpublished opinion of the Court of Chancery of Delaware, issued Dec 30, 2010 (Civil Action No. 5735-VCP), at *10, citing *Kelly*, *supra*, at *8.

42. *Eagle Force Holdings*, 187 A3d at 1236 n 185..

43. *Id.*

44. *Id.* at 1247 n 39, citing *Clough v Cook*, 87 A 1017, 1018 (Del Ch 1913) (holding that "a party who signs a contract with knowledge that a representation is false may not later claim reliance on it.").

45. *Grinnell v Charles Pfizer & Co*, 274 Cal App 2d 424, 440 (1969). *See also Kazerouni v De Satnick*, 228 Cal App 3d 871, 873-874 (1991) (holding that a claimant must prove reliance for claim of breach of warranty in the context of the sale of a business).

46. *Telephia, Inc v Cuppy*, 411 F Supp 2d 1178, 1188 (ND Cal 2006).

47. *Id.*

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.* at 1188 n 5.

54. Unpublished opinion of the United States District Court for the Northern District of Ohio, issued Sept 19, 2008 (No. 3:99CV7316), at *2.

55. *Id.*, citing *Borman's Inc v Lake State Devel Co*, 60 Mich App 175, 180; 230 NW2d 363 (1975) ("[P]laintiff has alleged a breach of specific provisions of that agreement and damages flowing therefrom. Plaintiff, at the very minimum, states a cause of action for breach of the … service warranty); *Knight v Rhoades Aviation, Inc*, unpublished per curiam opinion of the Court of Appeals, issued January 12, 2006 (No. 255952), at *4 ("To state a claim for breach of warranties, plaintiff must allege the existence of warranties, their breach, and damages as a proximate result of the breach.").

56. *Grupo Condumex*, *supra*, at *2, quoting *Plymouth Condo Ass'n v Delcor Homes-Plymouth*, unpublished per curiam opinion of the Court of Appeals, issued October 28, 2003 (No. 233847), at *5.

57. *Grupo Condumex*, *supra*, at *4 (collecting cases).

58. *Gallagher v Richfield Equities, LLC*, unpublished per curiam opinion of the Court of Appeals, issued April 14, 2009 (Docket No. 283246), at *3.

59. *Id.*

60. 2017 American Bar Association Private Target M&A Deal Points Study, p 66.

61. *Id.*

62. *Id.* at p 65, citing ABA Model Stock Purchase Agreement, 2d Edition.

63. *Id.*

64. *Rogath*, 129 F3d at 264-265, citing *Galli*, 973 F2d at 150.

65. *See id.*

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Shareholder Oppression and the Entire Fairness Standard: Reconciling MCL 450.1489 and MCL 450.1545a

By David F. Hansma

Introduction

The Michigan Court of Appeals' recent decision in *Castle v Shoham*[1] raises interesting questions about the interaction between sections 489 and 545a of the Business Corporation Act.[2] Section 489 is the shareholder oppression statute and creates a cause of action against directors or those in control of the corporation for illegal, fraudulent, and willfully unfair and oppressive conduct.[3] Section 545a governs conflict-of-interest transactions between corporations and their officers or directors. According to section 545a, such transactions "shall not, because of the interest, be enjoined, set aside, or give rise to an award of damages" if the interested party establishes that the transaction was approved by independent shareholders or directors, or if the "transaction was fair to the corporation at the time entered into."[4] Section 545a also includes a savings clause stating, "Satisfying the requirements of subsection (1) does not preclude other claims relating to a transaction in which a director or officer is determined to have an interest. Those claims shall be evaluated under principles of law applicable to a transaction in which a director or officer does not have an interest."[5]

The question addressed in this article is how the "principles of law" of the oppression statute, which creates liability based on "willfully unfair and oppressive" conduct, apply to a transaction that has been found fair under section 545a(1). Specifically, does section 545a(4) allow an oppression claim to proceed when the transaction has been found fair under section 545a(1)?

At least one panel of the Michigan Court of Appeals thinks so. Applying the Limited Liability Company Act's counterpart to section 545a, the court in *Castle* held, "[A] finding of 'fair' under MCL 450.4409(1)(a) is not conclusive as to whether the entire transaction was evidence of or amounted to willfully unfair and oppressive conduct[.]"[6] In other words, according to *Castle*, an action can be fair under one section of the act, but "willfully unfair and oppressive" under another section of the same act.

Castle is correct, but only in a narrow set of circumstances. As explained below, where a section 489 oppression claim challenges an interested transaction as violating traditional fiduciary duties of care, loyalty, and good faith, a finding of fairness under section 545a should be dispositive of the oppression claim. However, if the oppression claim arises from an interference with a shareholder's interests unconnected to fiduciary duties (e.g., because the transaction is ultra vires, or breaches a shareholder's agreement, or because minority shareholders are denied a vote) a finding of "fairness" is not necessarily dispositive.

Understanding The Entire Fairness Doctrine

Generally speaking, there are two standards courts use when reviewing the actions of corporate fiduciaries: the business judgment rule and the entire fairness rule. The business judgment rule acknowledges the "managerial prerogatives"[7] of corporate directors and is deferential to directors' decisions. Specifically, the business judgment rule "protects a disinterested director from liability with respect to any business decision on behalf of the corporation which was made 'on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.'"[8] Thus, the business judgment rule both protects directors from liability if they act in accordance with its requirements while preventing courts from improperly intervening in directors' management decisions.[9]

The entire fairness analysis, on the other hand, puts the burden on the fiduciary to prove that the conduct at issue is fair to the

corporation.[10] This is the analysis contemplated by section 545a. The burden of showing fairness "requires not only a showing of 'fair price' but also a showing of the fairness of the bargain to the interests of the corporation."[11] Fairness of the bargain to the corporation requires a showing that the transaction furthers a corporate purpose.[12]

In litigation over directors' fiduciary duties, the business judgment rule is the default rule. Courts presume that directors' decisions satisfy the business judgment requirement. As such, the initial burden is always on the party challenging the directors' decision to plead and prove facts rebutting the presumption.[13] Fairness "becomes an issue only if the presumption of the business judgment rule is defeated"[14] (such as where an interested director approves the transaction). "[W]hen the presumption of the business judgment rule has been rebutted, the entire fairness rule is implicated and defendants bear the burden of proof."[15]

Michigan's Application of the Entire Fairness Doctrine to Interested Transactions

Michigan common law historically and unambiguously accepts the business judgment rule and the entire fairness rule. In 1890, in *Hunter v Roberts, Throp & Co*,[16] the Michigan Supreme Court considered an action to compel payment of a dividend to shareholders. In reviewing the directors' decision regarding whether to pay a dividend, the court applied a form of the business judgment rule, holding:

> Courts of equity will not interfere in the management of the directors unless it is clearly made to appear that they are guilty of fraud or misappropriation of the corporate funds, or refuse to declare a dividend when the corporation has a surplus of net profits which it can, without detriment to its business, divide among its stockholders, and when a refusal to do so would amount to such an abuse of discretion as would constitute a fraud, or breach of that good faith which they are bound to exercise towards the stockholders.[17]

Numerous decisions have applied a similar framework to directors' decisions since then.[18]

Michigan also recognizes that the business judgment rule does not apply to directors who have an interest in the transaction at issue. In those cases, the business judgment presumption is rebutted and the entire fairness rule applies. Directors "may deal with the corporation only in good faith, with all the material facts made known to the other directors. Further, when questioned, the burden of proving the fairness of any contract between a corporation and a director thereof is upon the party asserting its validity."[19] If the director does not carry his burden, the transaction is void.[20]

The interaction of these rules is helpfully explained in the Michigan Court of Appeals' decision in *Miller v Magline*.[21] There, the court of appeals considered whether the plaintiff-shareholders or defendant-directors had the burden of proof in a suit challenging the compensation paid to the directors. In reviewing the caselaw, the court held that "the rule imposing the burden of proof on defendants [entire fairness rule] is applicable in cases where the action of the directors in fixing their own compensation is held void for the reason that it was accomplished by the vote of those benefiting thereby."[22] Because the defendant-directors in *Miller* did not vote on their own compensation, the court held that the votes did not constitute interested transactions requiring the directors to show the fairness of the compensation. Instead, the plaintiff-shareholders had the burden of establishing that the compensation was excessive.[23] In determining whether the compensation was excessive, the court applied a version of the business judgment rule. The court held that it could "readjust the salary ... only upon concrete proof that the salary evidences wrongdoing or inexcusable oppression to the point of being fraudulent. Less than this would constitute an intolerable interference with legitimate internal corporate management."[24]

Thus, *Miller* recognized the traditional entire fairness rule, but held that it does not apply where the subject transaction is approved by disinterested directors. However, approval by disinterested directors does not completely insulate the transaction from challenge. Instead, it subjects the challenge to a business judgment standard requiring the plaintiff to show that the decision was not an informed decision, was not made in good faith, or was not made in the honest belief that it was in the best interest of the company.

The Michigan Court of Appeals' recent decision in *Castle v Shoham*[1] raises interesting questions about the interaction between sections 489 and 545a of the Business Corporation Act.

MCL 450.1545a and Its Interpretation

The *Miller* framework is essentially codified in §545a(1). That section provides:

> A transaction in which a director or officer is determined to have an interest shall not, because of the interest, be enjoined, set aside, or give rise to an award of damages or other sanctions, in a proceeding by a shareholder or by or in the right of the corporation, if the person interested in the transaction establishes any of the following:
>
> (a) The transaction was fair to the corporation at the time entered into.
>
> (b) The material facts of the transaction and the director's or officer's interest were disclosed or known to the board, a committee of the board, or the independent director or directors, and the board, committee, or independent director or directors authorized, approved, or ratified the transaction.
>
> (c) The material facts of the transaction and the director's or officer's interest were disclosed or known to the shareholders entitled to vote and they authorized, approved, or ratified the transaction.[25]

An interested transaction will not be set aside "because of the interest" if it is approved by disinterested directors or shareholders who are in possession of the material facts of the transaction. In such cases, the transaction is not an interested transaction as explained in *Miller*. If the transaction is not approved by disinterested directors or shareholders, the interested director or officer must prove that the "transaction was fair to the corporation at the time entered into" (that is, the entire fairness test).[26]

Importantly, section 545a is only applicable to interested transactions being challenged "because of the interest[.]" Thus, as in *Miller*, approval of a director's salary by a majority of disinterested directors would not insulate the salary from other challenges, such as a claim that the salary is excessive. An excessiveness claim is independent of the interest and would therefore still be available, though subject to the business judgment rule. As one federal court explained, "This statute does not shield officers from all actions that have been ratified by the board or shareholders. It merely bars actions predicated solely upon the officer's interest in the corporation."[27]

Michigan common law historically and unambiguously accepts the business judgment rule and the entire fairness rule.

Unfortunately, the Michigan Court of Appeals incorrectly interpreted the statute in *Camden v Kaufman*.[28] In that case, the plaintiff alleged that the defendant-directors breached their fiduciary duty to obtain "maximum" value for the corporation's stock in a merger and approved the merger for their own personal benefit.[29] The trial court granted the defendants summary disposition because the transaction had been approved by disinterested directors and the majority of shareholders.[30] The Michigan Court of Appeals affirmed.

In so doing, the court held, "The statute itself does not name the type of action that is foreclosed, but rather, it appears that irrespective of the type of action involved, a transaction will not be set aside if three alternative criteria are present."[31] This is incorrect. The statute provides that it protects an interested transaction from being voided or giving rise to damages "because of the interest." Nothing in section 545a forecloses claims based on a breach of the directors' fiduciary duties.

The plaintiff in *Camden* tried to distinguish his breach of fiduciary duty claim from a claim challenging an interested transaction. The court rejected the plaintiff's argument, explaining, "[P]laintiff argued that the breach of fiduciary duty occurred because defendants Kaufman were acting in their own interests ... Plaintiff's contention that his claim of breach of fiduciary duty is unrelated to an interest of the directors or officers ... is merely an exercise in semantics."[32] Again, this is incorrect. It is not merely semantics to distinguish between a breach of the fiduciary duty of care (which may or may not be motived by a conflict of interest) and voiding a transaction solely based on a director's interest in the transaction. The distinctions between the two actions are readily apparent from the *Miller* decision and should have been followed in *Camden*.

The 2008 Amendment to Section 545a

In response to *Camden*, the Michigan Legislature passed 2008 PA 402 adding the savings provision to subsection (4) to section 545a.[33] This subsection is "intended to make clear that a transaction with an interested director or officer could still be subject to attack for other defects[.]"[34]

Legislative subcommittee comments on the amendment state:

> Section 545a was originally intended to remove the common law taint that would make a transaction in which a director or officer had an interest void or voidable. However, this section as originally enacted was not intended to give a conflicted transaction greater protection than a non-conflicted transaction. The amendment is intended to make clear that a transaction with an interested director or officer could still be subject to attack for other defects, such as insufficient corporate approval, breach of fiduciary or other duties, or illegality, even though the taint of the conflict is removed by satisfying section 545a(1), thereby overturning the decision in Camden v. Kaufman, 240 Mich. App. 389 (2000).
>
> Satisfying the requirements of subsection (1) does not preclude other claims relating to a transaction in which a director or officer is determined to have an interest. Those claims shall be evaluated under principles of law applicable to a transaction in which a director or officer does not have an interest.[35]

Michigan's Shareholder Oppression Statute

In 1989, the Legislature adopted section 489. That section creates a statutory cause of action for shareholders "to establish that the acts of the directors or those in control of the corporation are illegal, fraudulent, or willfully unfair and oppressive to the corporation or to the shareholder."[36] "Willfully unfair and oppressive conduct" is defined in the statute as "a continuing course of conduct or a significant action or series of actions that substantially interferes with the interests of the shareholder as a shareholder."[37]

In *Franchino v Franchino*, the Michigan Court of Appeals held that minority shareholders could bring suit for oppression only for "conduct that substantially interferes with the interests of the shareholder *as a shareholder*."[38] The *Franchino* court explained that the "rights that automatically accrue to shareholders ... are typically considered to include voting at shareholder's meetings, electing directors, adopting bylaws, amending charters, examining the corporate books, and receiving corporate dividends."[39]

Since then, the Michigan Supreme Court has held that the interests of a shareholder include those "rights and interests" provided to shareholders by statute, articles of incorporation, bylaws, and shareholder agreements.[40] Meanwhile, recent federal cases have held that the type of conduct prohibited by section 489 is the "type of conduct amounting to a breach of fiduciary duties in close corporations. Examples of such conduct include investments deemed not to be in the corporation's best interest, denying access to corporate books and records, diverting corporate opportunities and assets to other entities, removing minority shareholders from positions in management, refusing to declare dividends, and diluting minority equity interests."[41]

The Court of Appeals Decision in *Castle v Shoham*

In *Castle*, the majority member of the Filter Depot, LLC issued a consent resolution increasing management fees paid to itself.[42] The minority member of Filter Depot brought an action alleging, among other things, that a unilateral increase in the management fees paid to the defendant was willfully unfair and oppressive under the Limited Liability Company Act's oppression statute.[43] The plaintiff's claim was based not only on the defendant's conflict of interest in the transaction, but also on the fact that the plaintiff was denied a right to vote on the transaction, in violation of Filter Depot's operating agreement. Nevertheless, the trial court found that the management fees were not oppressive because they were fair under MCL 450.4409 (the LLC Act's counterpart to section 545a).

The Michigan Court of Appeals held that the trial court's analysis was erroneous. Looking at the language of the statute, the court held, "[A] transaction in which a manager has an interest will not be enjoined, set aside, or give rise to damages *simply because of the manager's interest* so long as the manager proves the transaction was fair to the company. This does not mean, though, that the transaction will be found sound in all cases as long as the manager establishes it was fair[.]"[44] The court explained, "[A] finding of 'fair' under MCL 450.4409(1)(a) is not conclusive as to whether the entire transaction was evidence of or amounted to willfully unfair and oppressive conduct[.]"[45] Instead, "[i]t is not until [the fairness determination is made under MCL 450.4409] that [the court could] tackle the next step and review whether, if the fee was indeed fair to Filter Depot, it nev-

Both section 545a and section 489 impose a duty of fairness on directors in certain situations. These duties of fairness arise from long-standing common law obligations.

ertheless constituted 'willfully unfair and oppressive conduct toward the limited liability company or the member.'"[46] The court of appeals went on to hold that the management fees were unfair under MCL 450.4409, and therefore did not analyze if the fees were simultaneously fair but also "willfully unfair and oppressive."

Is *Castle* correct that an interested transaction can be fair and willfully unfair and oppressive simultaneously? The answer is yes, but only in limited circumstances such as in *Castle* where the plaintiff was denied the right to vote on the transaction, or the transaction violates another specific shareholder right. There is no Michigan case holding that a fairness defense applies to a corporate action that breaches bylaws or shareholder agreements, or that violates a statute. In those cases, the interests of the shareholder are substantially interfered with regardless of the fairness to the corporation. Fairness will obviously impact the equities of the case and will be relevant to the appropriate equitable remedy. But, in those situations, it is possible for an interested transaction to be fair under section 545a, but still oppressive under section 489.

However, where the oppression claim challenges an interested transaction as "willfully unfair and oppressive" because it breaches traditional fiduciary duties, a finding of "fairness" under section 545a should put an end to the inquiry under section 489.[47] As explained above, fairness is the standard of review for transactions that do not fall within the business judgment rule. Something either meets the presumption of the business judgment rule or it is proved fair by the director. It does not make sense to examine whether a transaction is fair for purposes of the conflict of interest analysis and then examine again whether it is fair for purposes of some separate breach of fiduciary duty. The analysis is the same.

Consider the *Miller* case. Today, the *Miller* plaintiffs might challenge the directors' compensation decision as an interested transaction and as willfully unfair and oppressive because the compensation was excessive. If the directors proved the compensation was fair for purposes of the conflict of interest analysis, there would be no point in then separately determining if the compensation was excessive. The compensation could not possibly be "fair to the corporation" and excessive at the same time. In other words, if an oppression claim challenges a transaction as breaching the directors' traditional duty to govern the corporation with due care, loyalty, or good faith, a finding of "fairness" under section 545a also resolves the oppression claim.

It should be noted that published Michigan appellate court decisions have not explicitly held that oppression claims under section 489 are governed by the common law entire fairness and business judgment standards of review. But, when the oppression claim is based on breaches of fiduciary duty, the common law standards of review would seem to apply. Binding precedent has held that oppression claims are "similar to a common-law shareholder equitable action[.]"[48] Further, one court has recently held that "the same analysis should be conducted with respect to the Section 1489 and common law breach of duty claims."[49] Thus, if the underlying oppressive conduct will be judged by a fairness analysis anyway, it simply makes no sense to conclude that an action could be "fair to the corporation" under section 545a, but "willfully unfair" to the corporation under section 489.

Conclusion

Both section 545a and section 489 impose a duty of fairness on directors in certain situations. These duties of fairness arise from longstanding common law obligations. Where a director proves fairness under section 545a, it cannot be argued that the same conduct is "unfair" under section 489. However, it is possible for other oppression claims, unrelated to fairness, to still proceed. Those oppression claims would be unconnected to traditional fiduciary duties and arise from other shareholder interests set forth in agreements or statutes.

NOTES

1. *Castle v Shoham*, No 337969 (Mich Ct App Aug 7, 2018) (unpublished).
2. The *Castle* decision arose in the context of the LLC Act. However, this article will focus on the corresponding provisions of the Business Corporation Act. This is because the Business Corporation Act provisions are likely more familiar to the reader and because the common law cases discussed in this article arose in the context of corporations, not limited liability companies.
3. MCL 450.1489.
4. MCL 450.1545a(1).
5. MCL 450.1545a(4).
6. *Castle, supra* at 7.
7. *Aronson v Lewis*, 473 A2d 805, 812 (Del 1984)
8. *In re Dalen*, 259 BR 586, 609 (Bankr WD Mich

2001), quoting *Aronson*, 473 A2d at 812.

9. Chalian & Bandura, *The Business Judgment Rule and the Entire Fairness Doctrine*, http://www.rc.com/documents/Primer%20on%20Business%20Judgment%20Rule.pdf, (accessed October 1, 2018).

10. See MCL 4501545a(1).

11. *Fill Bldgs, Inc v Alexander Hamilton Life Ins Co*, 396 Mich 453, 461 (1976).

12. *Id.* at 461-62, n.6.

13. *Aronson*, 473 A2d at 812; *Churella v Pioneer State Mut Ins Co*, 258 Mich App 260, 272 (2003).

14. *Grobow v Perot*, 539 A2d 180, 187 (Del 1988), overruled on other grounds, 746 A2d 244 (2000).

15. *Krasner v Moffett*, 826 A2d 277, 287 (Del 2003).

16. 83 Mich 63 (1890).

17. *Id.* at 71.

18. *In re Estate of Butterfield*, 418 Mich 241, 254-55 (1983).

19. *Kukla v Perry*, 361 Mich 311, 328 (1960).

20. *McKey v Swenson*, 232 Mich 505, 513-14 (1925).

21. 76 Mich App 284 (1977).

22. *Id.* at 296-97, quoting *Garwin v Anderson*, 334 Mich 287, 295-96 (1952).

23. *Id.*

24. *Id.* at 300, quoting *Nahikian v Mattingly*, 265 Mich 128, 132 (1933).

25. MCL 450.1545a(1).

26. *Id.*

27. *Boyd v Sachs*, unpublished opinion of the United States District Court for the Western District of Michigan, issued April 22, 1993 (Case No. 93-cv-138). See also *Edelman v Fruehauf Corp*, 798 F2d 882, 886 (6th Cir 1986) (holding that authorization by disinterested directors will not insulate transaction from challenge where directors also breached their fiduciary duties).

28. 240 Mich App 389 (2000).

29. *Id.* at 392.

30. *Id.*

31. *Id.* at 395-96.

32. *Id.* at 397.

33. MCL 450.1545a(4).

34. Quoted in Schulman, Moscow & Lesser, *Michigan Corporation Law & Practice* (2018 Supp) § 2.13, p 5-52.

35. *Id.*

36. MCL 450.1489(1).

37. MCL 450.1489(3).

38. *Franchino v Franchino*, 263 Mich App 172, 184 (2004) (emphasis in original).

39. *Id.* The Michigan Legislature subsequently amended the definition of oppression in § 489(3) to include "the termination of employment or limitations on employment benefits to the extent that the actions interfere with distributions or other shareholder interests disproportionately as to the affected shareholder."

40. *Madugula v Taub*, 496 Mich 685, 718-19 (2014).

41. *Blankenship v Superior Controls, Inc.*, 135 F Supp 3d 608, 618 (ED Mich 2015) (citations omitted), quoting *Bromley v Bromley*, unpublished opinion of the United States District Court for the Eastern District of Michigan, issued Oct 4, 2006 (Case No 05-71798), p 10.

42. *Castle*, *supra* at 2.

43. MCL 450.4515. This statute is essentially identical to §489 in the Business Corporation Act.

44. *Castel, supra* at 7 (emphasis in original).

45. *Id.*

46. *Id.*

47. It is possible that an otherwise "fair" interested transaction could lead to oppressive conduct downstream. For example, moving business from the corporation to a related entity might be "fair," but also might become the impetus to squeeze out a minority shareholder. In such a case, the interested transaction would be relevant to the oppression analysis. However, if the transaction is "fair" (i.e., fair price and advances a corporate purpose), the oppression statute should not be grounds to set aside the transaction itself.

48. *Estes v Idea Eng'g & Fabricating, Inc*, 250 Mich App 270, 278 (2002).

49. *Blankenship, supra* at 619.

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Some More Observations on Restrictive Employment Agreements

By William H. Horton

Introduction

In 2000, we made some observations on the use and enforceability of restrictive employment agreements.[1] Since then, much has changed. Michigan courts have become friendly to restrictive contracts as written. The use of non-competition agreements in employment has become more common. Once used only among corporate executives, some professions, and salespersons, they are now in widespread use, with about one in five employees subject to a non-competition agreement.[2] Eighteen more years of experience has also illuminated factual situations not previously addressed in Michigan. As a result, this article provides some more observations regarding the statute and these contracts.

The Statute in Historical Context

Prior to 1905, Michigan had a common law rule allowing restrictive contracts if they protected the "legitimate interests" of the party obtaining the restriction.[3] But in 1905, Michigan enacted a statutory prohibition on all non-competition contracts.[4]

That prohibition lasted 80 years, until the enactment of the Michigan Antitrust Reform Act (the "Act") in 1985. The Act, as its title indicates, was intended to reform Michigan's antitrust laws and was based on the Uniform State Antitrust Act. In enacting the Act, as is usual and proper, the Michigan Legislature repealed statutes thought to be conflicting or superseded. But the repealer also included the seven sections of the 1905 act prohibiting non-competes.[5]

It appears the 1985 repeal of the 1905 Act was unintentional. The Uniform State Antitrust Act did not address non-competition contracts. Commentators who have interviewed some of those who participated in the drafting, committee hearings, and floor debate regarding the Act have concluded "that the 1905 statute prohibiting non-competes was inadvertently repealed as part of the antitrust reform."[6]

This was a major policy change in Michigan, but it could only be discerned by analyzing the arcane repealer provisions of the Act. As a result, it took some time before non-competition contracts began appearing. After it became apparent what had accidently occurred, the Legislature was asked to address the issue. As one of the lawyers involved in the legislation stated:

> The original prohibition was contained in an old statute that was revised for other issues [and] we were not even thinking about noncompete language. All of a sudden the lawyers saw no proscription of non-competes. We got active and the legislature had to go back and clarify the law.[7]

But, rather than return to the long-standing policy of prohibition, the Legislature amended the Act by inserting MCL 445.774a. The amendment allows non-competition contracts but, if an employment relationship is involved, it requires them to meet two conditions: 1) the contract must protect a "reasonable competitive business interest," and 2) it must be "reasonable" in duration, geography, and line of business. It also allows a court to limit or refuse to enforce an unreasonable contract to make it reasonable. The amendment states:

> An employer may obtain from an employee an agreement or covenant *which protects an employer's reasonable competitive business interests* and expressly prohibits an employee from engaging in employment or a line of business after termination of employment *if the agreement or covenant is reasonable* as to its duration, geographical area, and the type of employment or line of business. *To the extent any such agreement or covenant is found to be unreasonable in any respect, a court may limit the agreement to render it reasonable in light of the circumstances in which it was made* and specifically enforce the agreement as limited.[8]

Researchers immediately recognized that Michigan's change presented a rare opportunity to measure the effects of the legislation, since employment non-competes were previously non-existent. Some peer-reviewed researchers have concluded the change caused "a strong decrease in average Michigan mobility [in employment] once non-competes began to be enforced."[9] A study by the United States Department of the Treasury found, among other things, that non-competes tend to restrict mobility without adding protection of trade secrets.[10]

The debate as to the wisdom of allowing such contracts has intensified, fueled by companies that have clearly overreached. Consider Jimmy John's sandwich shops. It has required its minimum-wage sandwich-makers and drivers to agree not to work at any other sub shop within three miles of any of Jimmy John's locations for two years.[11] Since Jimmy John's has about 2,500 locations, obtaining a sandwich from Subway, Quiznos or Jersey Mike's made by a recently-separated Jimmy John's employee is probably impossible. Likewise, Goldfish Swim School requires its $11-an-hour swim instructors not to work for a competitor within 20 miles for one year. The Michigan Court of Appeals rightly affirmed the dismissal of a Goldfish case attempting enforcement.[12] Teaching the backstroke is hardly a "reasonable competitive business interest."[13]

Thus, these contracts pose a conflict between fundamental policy and legal issues—competition is favored but contracts generally should be enforced. Against this background and additional experience, we pose the following questions and make the following observations.

Is Continued Employment Really Consideration?

For a while after MCL 445.774a was enacted, the law was unsettled as to whether continued employment of an at-will employee constituted consideration to support a newly imposed restrictive contract. In other words, could an employer present an existing employee with a contract restricting post-employment activities on a sign-it-or-be-fired basis where continuation of employment is the consideration for the contract? Since 1991, the answer has been "yes," based on a federal case applying what it believed to be Michigan law. That case is now cited reflexively for that proposition.[14]

However, a review of the case, *Robert Half Int'l v Van Steenis*,[15] calls that conclusion into question. There, the federal court simply stated its conclusion previously unaddressed by Michigan courts, "As to lack of consideration, continued employment constitutes sufficient consideration for the Defendant's execution of the restrictive covenants in the Employment Agreement – where, as here, the Defendant's employment is otherwise 'at will.'"[16] The court did not cite a Michigan case, but rather an Iowa case, *Insurance Agents, Inc v Abel*.[17]

But *Abel*—while stating in *dicta* the statement relied on in *Robert Half*—stands for exactly the opposite proposition. The Iowa court stated that "[w]hile as a general legal principle it might be said that employment does provide consideration for a noncompetition agreement in an employment contract," it held that "[t]he promise of continuing employment [in this case] does not provide consideration for the 1978 agreement."[18] Subsequent Iowa cases cite *Abel* for the proposition that "a promise of 'continuing employment' did not provide consideration for an additional agreement between the parties."[19]

The cases around the country are split. Some states require new consideration and are perhaps best summarized below:

> New and independent consideration for a covenant not to compete is required whenever an employment contract containing an anticompetitive covenant is entered into subsequent to employment, or when a covenant not to compete is contracted after employment has commenced, or after the relationship of employer and employee has been established without such a covenant.[20]

A number of other states do not require new consideration.[21]

But what might a Michigan court do on a deeper analysis? Michigan has long required a "bargained-for exchange" to support a contract. Consideration is "a benefit on one side, or a detriment suffered, or service done on the other."[22] Future cases should consider the foundation on which *Robert Half* was built and whether it accurately reflects Michigan law. There was no analysis by the federal district court sitting in diversity as to what the Michigan Supreme Court might do.

In the employment relationship, it seems that the imposition of a non-compete after employment has begun without more does

For a while after MCL 445.774a was enacted, the law was unsettled as to whether continued employment of an at-will employee constituted consideration to support a newly imposed restrictive contract.

not provide any benefit to the employee or detriment to the employer.[23] The "bargained-for exchange" of continued employment is that the employee will provide services, and the employer will pay for them. A Michigan employer can clearly change many conditions of at-will employment without consideration—pay, benefits and responsibilities, for example. In order to distinguish the restrictive agreement situation from these typical changes, some states have held that a new restrictive agreement must be "ancillary to" these other features of employment. A review of some of these cases suggests that this means something new must be offered by the employer—which seems like another way of saying "consideration."[24]

What happens if termination occurs shortly after a newly imposed restrictive agreement is signed? It can certainly be argued that there is an implied promise of continued employment in exchange for the restrictive agreement. Termination within a short period after the restrictive agreement is signed may make the contract unenforceable because the implied promise of continued employment was illusory, as some courts have held.[25]

Perhaps more compelling is the situation where a potential new employer makes an offer of employment, the employee accepts and gives notice of termination to the former employer and—shortly after arriving at the new job—the new employer presents a non-competition contract not previously discussed. The U.S. Department of Treasury reports this occurs about 37 percent of the time.[26] The employee—otherwise unemployed—has no real choice but to sign the agreement. Some courts have held that the contract may be voidable on principles of fraudulent inducement or lack of consideration.[27]

One may argue that this issue should be addressed by the Legislature because it is a policy issue, not a legal issue. But a closer look suggests it is a legal issue. Contract formation is fundamentally a legal question. Whether the existing caselaw should be followed requires a thorough analysis of the earlier cases. S*tare decisis* is not a barrier where "the earlier decision was wrongly decided."[28]

More fundamentally, the Legislature has already addressed the issue—it authorizes judges to restrict or limit any contract found to be "unreasonable in any respect."[29] Imposing a non-compete on an existing employee—especially a lower level employee—without anything in exchange except for the privilege of coming to work the next day can certainly be unreasonable. In addition, at the outset of employment, it seems that under many circumstances, it is misleading or fraudulent to fail to inform a potential employee that a restrictive contract is part of the employment until after the person has terminated their prior employment.

The specific facts and circumstances should, of course, drive any decision, but the relative bargaining power, position within an organization, and prior experience in the industry should be factors in that decision. When all is said and done, something real should be given and received in exchange for a new restrictive promise—a bonus, raise, promotion, cash, access to confidential information, or similar item of real value.

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When Isn't There a "Reasonable Competitive Business Interest"?

Michigan courts consistently recite the statutory phrase that restrictive contracts may only protect "reasonable competitive business interests" because a contract may not insulate a business from simple competition itself.[30] An analysis of the specific interest is required.

While the phrase is general and somewhat vague, it is not without meaning. Multiple factors are at work. First, contracts not to compete run contrary to Michigan's long-established policy to promote competition. The antitrust laws have been part of the national fabric for over 100 years. This has been Michigan's long-standing policy, with recent legislation, for example, seeking to "promote competition" in banking and cable television.[31] Generally, contracts or combinations that prevent competition are void and, under certain circumstances, are criminal.[32]

Second, a "business interest" must be at least something of value connected to the employer that it acquired in the marketplace, invented, or provided to the employee. Examples include introducing the employee to existing customers, disclosing trade secrets, or providing special training. General skills and knowledge—such as making sandwiches, teaching well-known swimming strokes, and being the typical security guard—lack a reasonable competitive business interest.[33]

When, for example, an experienced salesperson brings existing customers to a new employment relationship, under what cir-

cumstances does the employer obtain a protectable interest in those customers? And what about the employee who signed a contract prohibiting solicitation of the employer's customers but, after leaving the employment, the employee solicits a customer with whom he never had contact? How is the employer's interest any different than if the employee had never joined the firm? A number of courts have held a restriction against soliciting a customer with whom the employee never had contact is unenforceable.[34]

Third, the contract as a whole matters. Many restrictive contracts contain a series of promises. It is common to see a promise to keep confidential information secret, not to solicit existing customers, and not to solicit employees. Some contracts also contain a non-competition provision. But after protecting confidential information and prohibiting solicitation of employees and customers, there remains no legitimate protectable interest, as some courts have recognized. One federal district court perhaps said it best:

> Defendants cannot share with competitors or make use of Plaintiff's confidential information or the inventions assigned to Plaintiff. They cannot siphon off Plaintiff's customers or other employees. Even if working at Plaintiff's competition, all Defendants can do is use the skills they acquired while working for Plaintiff at their new jobs. Plaintiff has no legal right to stop them from doing so.[35]

Reasonable Duration, Geography and Line of Business

The statutory factors of duration, geography, and line of business must be considered. Duration is perhaps the most straightforward. The only reasonable competitive business interest an employer has is to protect its position for as long as it takes any confidential information known to the employees to become stale, for a period of time for the employer to transfer its customer relationships to a new salesperson, or for special skills to become dated. It seems that, in many circumstances, none of those factors apply for more than a year or so. For example, general financial information known by a finance or accounting employee is unlikely to be of any or much value to a competitor a year later, and a year or so is sufficient for an employer to establish a customer relationship through a new employee. These are general considerations and, of course, subject to the facts of each case.

An analysis of the line of business requires a specific inquiry. The question is whether the former employer and the current employer actually compete in some material way, not that they are generally in the same line of work. A good example of what should be the required inquiry is *Huron Tech Corp v Sparling*.[36] In that case, the defendant left one manufacturer of material handling equipment and joined another. The trial court denied a motion for an injunction and dismissed the case because the evidence showed little, if any, actual competition between the two companies. While both companies were in the material handling business, the plaintiff primarily sold custom equipment, and the defendant mostly sold catalog or standard equipment. The Michigan Court of Appeals affirmed, holding that, while there was some overlap in the line of business, the minimal overlap between the two companies did not constitute actual competition. Thus, there was no reasonable competitive business interest that could be protected.[37]

The rule of geographical limitation, like duration, should be straight-forward—there must be some limit, and it must be reasonably related to a protectable business interest. Failure to include a limit will doom the agreement.[38] Likewise, a multi-location employer may usually only restrict the employee from working for a competitor near the employee's former workplace.[39]

When Should the Blue Pencil be Used?

The statute expressly authorizes the court to limit a contract that it finds to be unreasonable.[40] Generally referred to as a "blue pencil" rule, the discretion works both ways. It gives the court the option to limit an unreasonable contract, but it also gives the court discretion to refuse to enforce it. The facts of a particular case may make a non-compete marginally unreasonable, and it should be limited and enforced. However, an unreasonable non-compete applied broadly and without a reasonable attempt to apply it to the position at hand requires the court to essentially rewrite the contract. That situation calls for a refusal to enforce. Such a refusal also has a prophylactic effect—a rational employer will change those contracts in the future.

The statutory factors of duration, geography, and line of business must be considered.

Are Lawyers Subject to Restrictive Agreements?

Michigan's lawyer ethics rules generally prohibit a lawyer from entering into a contract that restricts the lawyer's right to practice after leaving the employment.[41] But the Legislature has enacted a statute that allows any employer to obtain such a contract from any employee.

Is a non-solicitation or non-competition contract between a law firm and a lawyer enforceable in the face of the disciplinary rule? It would certainly seem so. The Legislature makes substantive law. The statute allows any employer to enter into a restrictive agreement with any employee; lawyers are not excepted. The regulatory rules of a body governing lawyer licensing do not override the Legislature's policy decision and statutory statement. Nonetheless, some courts have refused to enforce a post-employment restrictive agreement between a lawyer and a law firm.

This issue was almost certainly put to rest recently in *In re Mardigian Estate*.[42] In that case, the lawyer drafted an amendment to a trust for a life-long friend (but non-family member), which increased the amount he was to take under the estate plan. Such action – not prohibited by any substantive rule of law – was prohibited by rule 1.8 of the Michigan Rules of Professional Conduct because the settlor was a non-family member. After the settlor died, and the family challenged the trust, the probate court held that the lawyer was disqualified from taking anything under the trust because he violated MRPC 1.8.

The Michigan Court of Appeals reversed, holding that the Michigan Trust Code controlled, not the Rules of Professional Conduct. The case was eventually appealed to the Michigan Supreme Court. In an evenly divided decision that affirmed the court of appeals, three justices of the Michigan Supreme Court held that "standards of professional conduct do not create or modify substantive law."[43]

In short, there is no basis to refuse to enforce a restrictive agreement signed by a lawyer that is enforceable if otherwise in compliance with the statute. The unanswered question is whether the statute prohibits enforcement of the rule in a disciplinary proceeding.[44]

Conclusion

Restrictive agreements in employment present a significant conflict between long-established and well-recognized policy choices —competition versus contract. As usual, experience has shown that the specific facts matter. A deep analysis of the actual interest to be protected is required. If the contract is properly made and protects a real business interest, it should be enforced, but not otherwise. Easier said than done.

NOTES

1. Horton and Turco, *Some Observations on Restrictive Employment Agreements in the Information Age*, 79 Mich Bar J (November 2000).

2. Losing the Right to a New Job, New York Times, May 14, 2017 (Sunday Business), at 1.

3. *Hubbard v Miller*, 27 Mich 15, 19 (1873).

4. Former MCL 445.761 stated:

> All agreements and contracts by which any person, copartnership or corporation promises or agrees not to engage in any avocation, employment, pursuit, trade, profession or business, whether reasonable or unreasonable, partial or general, limited or unlimited are hereby declared to be against public policy and illegal and void.

The only exception was when such a contract involved the sale of a business. MCL 445.766 (repealed).

5. The repealer is contained in the final two section of the Act. The material provision, MCL 445.787, repealed the 1905 Act in subsection (b):

> The following acts and parts of acts are repealed:
>
> (a) Act No. 255 of the Public Acts of 1899, being sections 445.701 to 445.712 of the Michigan Compiled Laws.
>
> (b) Act No. 229 of the Public Acts of 1905, being sections 445.731 to 445.736 of the Michigan Compiled Laws.
>
> (c) Act No. 329 of the Public Acts of 1905, being sections 445.761 to 445.767 of the Michigan Compiled Laws.
>
> (d) Sections 553 to 555 and 557 to 560 of Act No. 328 of the Public Acts of 1931, being sections 750.553 to 750.555 and 750.557 to 750.560 of the Michigan Compiled Laws.
>
> (e) Section 2155 of Act No. 236 of the Public Acts of 1961, being section 600.2155 of the Michigan Compiled Laws.
>
> (f) Act No. 135 of the Public Acts of 1913, being sections 445.791 to 445.798 of the Michigan Compiled Laws.
>
> (g) Act No. 282 of the Public Acts of 1937, being sections 445.171 to 445.184 of the Michigan Compiled Laws.

6. Marx and Strumsky, Fleming, *Mobility, Skills, and the Michigan Non-Compete Experiment*. 55 Mgt Sci 875, 877 (2009). Two Michigan lawyers involved in the legislation have reported as follows:

> There was no buildup, discussion, or debate of which I was aware—it was really out of the blue. As I talked to others, this appeared to be a rather uniform reaction. I have never been able to identify any awareness—and I examined this at the time—that this was a conscious or intentional act. It was part of the antitrust reform and it may have been overlooked.

I am unaware of anyone that lobbied for the change. Another reported: "There wasn't an effort to repeal non-competes. We backed our way into it." *Id.*

7. Marx and Strumsky, *supra* note 6, at 877.

8. MCL 445.774a. (Emphasis added).

9. Marx and Strumsky, *supra* note 6, at 888.

10. United States Department of the Treasury, Non-Compete Contracts: Economic Effects and Policy Implications (March 2016).

11. Does Jimmy John's Non-Compete Claim for Sandwich Maker Have Legal Legs?, Forbes, Oct 15, 2014.

12. *BHB Investment Holdings LLC v Ogg*, unpublished per curiam opinion of the Court of Appeals, issued Feb 21, 2017 (No. 330045). Likewise, there was no reasonable business interest to prevent security guards at the Flint bus station from competing. *Teachout Security Servs v Thomas*, unpublished per curiam opinion of the Court of Appeals, issued Oct 19, 2010 (No. 293009).

13. As a result of similar abuses, a number of states have passed legislation regulating the manner in which such agreements are imposed and limiting their application and enforcement. For example, non-competition contracts are unlawful in California, Colorado and North Dakota. Cal Bus & Prof Code 16600; Colo Rev Stat 8-2-13; ND Cent Code 9-08-06. Hawaii bans non-competes for technology workers. Haw Rev Stat 480-4 (2015) (as amended by Act 158). New Mexico prohibits non-competes for health care professionals. NM Stat Ann 24-1I-2 (2015) (as amended by SB 325). Oregon requires a written notice of a non-compete with a two-week waiting period before execution and a maximum period of 18 months. Or St 653.295 (2015). Utah allows a maximum duration of one year. Utah Code Ann 34-51-101 (2015). Massachusetts recently enacted a comprehensive regulation of non-competition agreements. Mass Gen Law Ann 149.24L. At least one bill has been introduced in the Michigan Legislature to prohibit such contracts. HB 4198 (2015).

14. E.g., *QIS v Quality Indus Controls*, 262 Mich App 592, 594; 686 NW2d 788 (2004) ("Mere continuation of employment is sufficient consideration to support a noncompete agreement in an at-will employment setting.") citing *Robert Half Int'l, Inc v Van Steenis*, 784 F Supp 1263, 1273 (ED Mich 1991).

15. 784 F Supp 1263 (ED Mich 1991).

16. *Id.* at 1273.

17. 338 NW2d 531 (Iowa App, 1983).

18. *Abel*, 338 NW2d at 534.

19. E.g., *Stieneke v United Bank of Iowa*, 840 NW2d 726 (Iowa App, 2013).

20. Am Jur 2d, Monopolies, 886.

21. Examples include: *Runzheimer Int'l v Friedlen*, 362 Wis 2d 100; 862 NW2d 879 (2015) (consideration); *Lucht's Concrete Pumping v Horner*, 255 P3d 1058 (Colo, 2011) (consideration); *Access Organics v Hernandez*, 341 Mont 73; 175 P3d 899 (2008) (no consideration); *Labriola v Pollard Group*, 152 Wash 2d 828; 100 P3d 791 (2004) (no consideration).

22. *Gen Motors v Dep't of Treasury*, 466 Mich 231, 238-39; 644 NW2d 734 (2002).

23. On the other hand, when a non-compete is part of the offer of new employment or part of a bona-fide promotion, access to confidential information or other real benefit to an existing employee, consideration has almost certainly been provided.

24. E.g., *Marsh USA v Cook*, 354 SW3d 764 (Tex, 2011); *Safety Center, Inc v Stier*, 903 NW2d 896 (Minn App 2017); *Cranston Print Works v Pothier*, 848 A2d 213 (RI 2004).

25. *Fifield v Premier Dealer Servs, Inc*, 993 NE2d 938, 942 (2013); *Runzheimer Int'l*, 362 Wis 2d at 125-26.

26. United States Department of the Treasury, Non-Compete Contracts: Economic Effects and Policy Implications, at 4.

27. *Runzheimer*, *supra* note 21, at 125-26; *Safety Center*, *supra* note 24.

28. *Robinson v Detroit*, 462 Mich 439, 464; 613 NW2d 307 (2000).

29. MCL 445.774a.

30. E.g., *St. Clair Med v Borgiel*, 270 Mich App 260, 266; 715 NW2d 914 (2006) ("an employer's business interest justifying a restrictive covenant must be greater than merely preventing competition.").

31. E.g., MCL 487.11102 ("It is the policy of this state that the business of all banking organizations shall be supervised and regulated in a manner that insures the safe and sound conduct of business, to conserve their assets, promote competition among banking organizations…."); PA 480 of 2006 ("AN ACT to provide for uniform video service local franchises; to promote competition in providing video services in this state….").

32. MCL 445.779 (up to 2 years in prison and $1 million fine).

33. E.g., *Follmer, Rudzewicz v Kosco*, 420 Mich 394, 402, n 4; 362 NW2d 676 (1984).

34. E.g., *Peat Marwick Man & Co v Haass*, 818 SW2d 381, 388 (Tex, 1991).

35. *Unisource Worldwide v Swope*, 964 F Supp 2d 1050, 1065 (D Ariz 2013). See also, *Elexco Land Servs v Hennig*, unpublished opinion of the United States District Court for the Western District of New York, issued Oct 23, 2012 (No. 11-CV-214) (citing cases).

36. Unpublished per curiam opinion of the Court of Appeals, issued Sept 11, 2014 (No. 316133).

37. *Id.* ("But in this case, the non-compete agreement prohibits defendant from working for a business that offers a single product or service that is 'competitive' with any product or service offered by plaintiff, regardless of whether the business is in actual competition with plaintiff.").

38. E.g., Coleman v Retina Consultants, 286 Ga 317; 387 SE2d 457 (2009); Beverage Sys of the Carolinas v Associated Beverage, 368 NC 693; 784 SE2d 457 (2016).

39. *Unlimited Opportunity v Waadah*, 290 Neb 629, 638-39; 861 NW2d 437 (2015).

40. MCL 445.774a ("To the extent any such agreement or covenant is found to be unreasonable in any respect, a court may limit the agreement to render it reasonable in light of the circumstances in which it was made and specifically enforce the agreement as limited.").

41. MPRC 5.6.

42. 502 Mich 154, 917 NW2d 325 (2018).

43. *Id.* at 174.

44. While the Supreme Court has the "implied power to regulate and discipline the bar," *Schlossberg v State Bar Grievance Board*, 388 Mich 389, 395, 200 NW2d 219 (1972), the power to make substantive law resides in the Legislature. Const 1963, art 4, 1. Most states have similar constitutional and statutory rules. Our research, however, has not revealed any case where this issue has been addressed.

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What's a Business Litigator To Do – The Vanishing Jury Trial and the Litigotiation Option

By Richard L. Hurford

It was so easy when I embarked upon a litigation career in 1978 at a major Detroit law firm. My mentor's then sage advice was straightforward and succinct—"aggressively prepare every case as if it will be tried and leave no stone unturned." In that bygone era, corporate clients, by and large, expected and demanded aggressive (some might say oppressive) litigation tactics, and there was no dearth of extremely talented trial lawyers ready and willing to satisfy the desires of these clients. Litigation budgets were still in the future; a cost-benefit analysis for continued litigation paled in importance to the business principle that needed to be established, ADR was virtually unknown and, in any event, only for the "weak of heart;" and, trial courts had not yet been exposed to concepts such as "evidence-based practices"[1] or staged[2] and proportionate[3] discovery. It was not unusual for the true business litigator to try five or six cases in a single calendar year. Indeed, I was well on my way to American Board of Trial Advocates (ABOTA) eligibility as a diplomate[4] when, in the early 1990s, I opted to take an internal legal position with a client to manage its litigation and claims department—the prime directive given: "cut litigation costs." It was only then the world of ADR became a critically important option for me to achieve the client's goals.

The Current Litigation Environment

Let us fast forward 40 years and explore the radically different environment for business litigators today. According to the most recent statistics from the Supreme Court Administrative Office (SCAO),[5] the summary below underscores the reality of the vanishing jury trial and the sea change that has occurred in the world of business dispute resolution:

Using the total number of business cases filed in 2017 as the denominator, the disposition rate by a jury trial was 0.24%, 0.63% by a bench trial, 11% dismissed by the trial court, and 41% settled by the parties. Forty years ago very few foresaw the day bench trials would be far more common than jury trials, and trials of all nature would dispose of only 0.87% of business cases. This vanishing jury trial trend is not unique to business cases. In 2017, the bench and jury trial rate in the Michigan Circuit Courts was less than 1% in all classes of cases, over 50% of all such cases were settled, and less than 10% dismissed by the trial court. Medical malpractice cases had the highest jury trial disposition rate at 5%, while employment discrimination, products liability, and breach of contract trailed far behind at 1%, 0.3% and 0.3% respectively. Even in the medical malpractice, employment discrimination, products liability, and breach of contract arenas, over 50% were disposed of via a negotiated settlement.

There are multiple reasons for the vanishing jury trial, and a cursory overview of those reasons underscores how those trends will probably not reverse in the near future.

Most businesses do not view litigation as a profit center and abhor the business disruption, uncertainty, and the cost of litigation. The ever-escalating cost of litigation was one of the prime motivators of the Association of Corporate Counsel's "Value Challenge"[6] that has been at the forefront of the ACC's agenda for the past 20 years. ACC has driven initiatives such as flat fees, bundled services, billing audits, value added billings, billing auctions, and commodity legal billings, just to name a few, all in an effort to reduce legal costs. However, experience demonstrates that no initiatives drive down business litigation costs more effectively than develop-

Summary of Business Court Litigation/Disposition in 2017

Total Business Cases Filed	Jury Verdicts	Bench Verdicts	Settled	Dismissed by the Court	Transferred
2,817	7	18	1,156	312	102

ing strategies to close cases as quickly and as reasonably as practicable. Case aging, the number of days a case is open, is a primary driver in the cost of a legal dispute. As increasing litigation costs is not on the agenda of many businesses, various strategies to reduce case aging will undoubtedly continue.

To reduce case aging and litigation costs, businesses have increasingly embraced all forms of ADR. Thomas Stipanowich, the Associate Dean of the Straus Institute of Dispute Resolution at Pepperdine University, undertook two comprehensive studies in 1997 and 2011, evaluating the use of ADR by major businesses in the United States.[7] These two studies demonstrate the significant percentage of businesses that embrace ADR, the increasing diversity of ADR techniques relied upon, and the growing reliance upon early ADR techniques to avoid litigation altogether.

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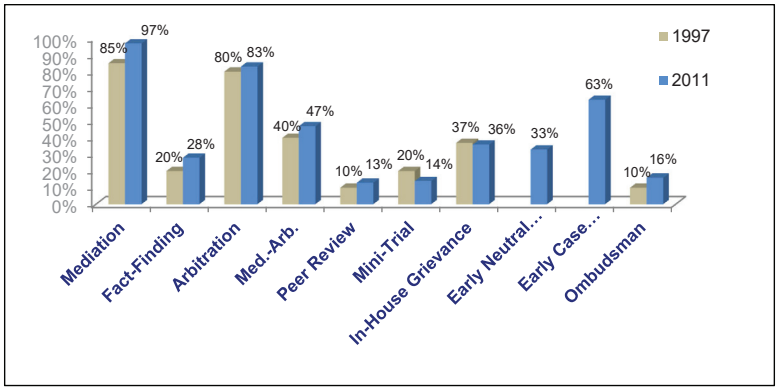

As documented in these studies, the primary reasons driving the increasing use of ADR by businesses are the desire to save time, reduce costs, and preserve important relationships. To the extent the vast majority of business disputes involve four critical stakeholders (employees, customers, suppliers, and stockholders) the primary motivating factors to use ADR are not anticipated to wane.

Finally, the courts of Michigan (just like other jurisdictions) are being incentivized and encouraged to become more efficient in the delivery of justice that is cost effective and speedy. Every Michigan trial court's performance is now the subject of a "dashboard" that can be publicly viewed and evaluated.[8] Among the metrics on each court's public dashboard are case age and clearance rates. SCAO describes the rationale for each of these metrics as follows:

Clearance Rates

Clearance rates compare the number of case adjudications to the number of cases filed, which measures whether a court is keeping up with its caseload. A rate of more than 100 percent demonstrates that the court is reducing the pending caseload; a rate of less than 100 percent indicates the court is adding to its pending caseload. Clearance rates naturally fluctuate above and below 100 percent, but clearance rates that are consistently under 100 percent increase the size of the pending caseload and can lead to backlogs.[9]

Case Age

Case age measures the time from filing to adjudication, and "case age disposition rate" measures the extent to which courts are adjudicating cases within appropriate time guidelines. Case age rates measure how many cases are disposed within certain time frames, or how long it takes to resolve a case through the courts. For the Court of Appeals, the measurement [standard] is eighteen months. For trial courts, the measurements vary based on the case type. Michigan Supreme Court Administrative Order 2013-12 provides these time guidelines.[10]

The trial courts have increasingly embraced and encouraged the use of ADR in case management; this has proven to be one of the most effective drivers in reducing case age and increasing clearance rates.[11] There is no suggestion anywhere these judicial dashboards will be eliminated in Michigan, or the incentive for trial judges to reduce case age or increase clearance rates will abate. In fact, SCAO has been a significant driver for the use of ADR by the trial courts and recently offered training to all Michigan trial court judges in a publication entitled *Michigan Judges Guide to ADR Practice and Procedure*.[12] That guide generally describes for the judiciary[13] dozens of ADR processes and provides an overview of the indications and contraindications for each. Certainly if the courts have information as to when such ADR processes as early neutral fact finding, an early neutral evaluation, an expert hearing, or a summary jury trial might be advisable to either streamline or narrow the issues in dispute at the earliest practicable date, counsel should be knowledgeable and familiar with these processes and prepared to address these issues in an early meeting with the court. If one or more of these processes are inadvisable to further the best interests of the client, counsel might develop the appropriate rationale to respond to the court's suggestions and potentially be prepared to advocate for other processes that may be more effective in achieving the client's BATNA (best alternative to a negotiated settlement).[14]

If all signs point to the inevitable fact the vanishing jury trial phenomenon is here to stay, and less than 1% of business disputes will ever end in a bench or jury trial, business litigators have limited options in those 50% of cases that will be terminated by a negotiated settlement. First, they may choose only to provide services to those business clients who perceive all litigation as "bet the company" matters and are willing and can afford to take every case to trial. However, this is becoming an increasingly limited niche practice, and, as business clients become more sophisticated, even this niche market will shrink. Second, business litigators can certainly bemoan the inevitable and buck the trend and litigate each case as if it will go to trial. Such an approach will have an increasingly limited appeal to current and prospective business clients and will not be looked upon favorably by a judiciary that increasingly focuses on expediting the litigation process. In the alternative, litigators might consider embracing current and long-term realities by distinguishing themselves in harnessing evolving judicial case management practices and ADR strategies that result in the timely, cost effective, and client centric resolution of business disputes.

Litigotiation May Be One Approach to Consider

Professor Mark Galanter first coined the concept of "Litigotiation." He described this process as:

> On the contemporary American legal scene the negotiation of disputes is not an alternative to litigation, it is litigation. There are not two distinct processes, negotiation and litigation; there is a single process of disputing in the vicinity of official tribunals that we might call LITIGOTIATION; that is, the strategic pursuit of a settlement through mobilizing the court process."[15]

In sum, litigation no longer involves simply preparing for a trial that statistically will not be held in 99% of filed business cases, but being familiar with and effectively employing new and evolving judicial case management techniques and various ADR processes to augment dispute resolution negotiations and vice versa. Early evaluation and assessment of the dispute, an early exploration of the client's BATNA, and the early formulation of integrated litigation and negotiation strategies to achieve the client's BATNA within a litigation budget are now the skill sets that are becoming increasingly important.

Whether in Michigan state trial courts (particularly the business courts) or federal courts, judicial case management practices increasingly emphasize many of the recommendations made during the *Early ADR Summit*[16] convened by SCAO:

- Early judicial involvement and the formulation of a differentiated case management order established during a preliminary meeting with lead counsel;
- The appointment of a mutually agreed upon neutral at the early case management conference who can be utilized to resolve discovery and other litigation sub-disputes prior to the overall resolution of the case;
- The mutual development of cost effective electronic discovery proto-

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cols;

- The early mandatory exchange of information either before or immediately after the early case management meeting;
- After consultation with counsel, the development of a staged/proportionate discovery plan that supports meaningful ADR events as soon as practicable;[17]
- A growing reluctance to require traditional case evaluation pursuant to MCR 2.403 at all or, at the very least, to reject case evaluation as the first and only ADR strategy for the case; and,
- The exploration of a broader array of ADR processes other than just mediation and case evaluation.[18]

Long gone are the days a party will be afforded the opportunity to pursue interminable discovery disputes, complete all discovery necessary to prepare for a trial, then engage in a case evaluation as the first ADR process for the dispute, then possibly pursue a late stage mediation if, as is typical, the case evaluation fails to resolve the dispute. In fact, studies undertaken by SCAO clearly reflect that unsuccessful case evaluation followed by mediation actually lengthens case age and decreases the likelihood of a negotiated settlement.[19] Evidence based practices clearly indicate that if case evaluation is ordered at all it should always be after attempts to mediate the dispute have been exhausted.

In the new "litigotiation" world, the business litigator will be expected to consider how to harness the court's processes to effectively assist the client's negotiation strategy. At the outset of the case during the case management conference, the business litigator, who seeks to achieve the client's BATNA, will be called upon to address aspects of how best to stage proportionate discovery, the protocols for needed electronic discovery, the terms of any stand-still agreement, the provisions in any desired protective order, the identity of an effective neutral who can be called upon to address discovery and other issues during the life of the case,[20] and explore what ADR process(es) (including the timing of those processes) are most appropriate to the potential resolution of the dispute. It is a brave new world for the business litigator that calls for a different and evolving skill set.

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Permit a number of examples that underscore the concept of litigotiation and its potential efficacy in the resolution of business disputes.

Two business partners (with ownership interests of 51% and 49% respectively) experienced a significant deterioration in their personal relationship over a number of years to the extent they could no longer work together (the final break came when one partner had an affair with the other partner's wife). The inevitable shareholder oppression lawsuit followed supplemented with the typical add-on claims of fraud and self-dealing. During the case management conference it was clear a critical issue was what business evaluation process would be used to determine the departing partner's compensation. In reality, the evaluation dispute was a placeholder for their mutual animosity. Counsel for the partners, as well as the trial court, recognized the litigation of this dispute could be a very long, costly, and hostile exercise consuming the court's resources and ultimately ending in an unpredictable result.

At the case management conference counsel agreed to the selection of an experienced mediator who was appointed by the trial court. This mediator worked with counsel to establish a standstill agreement and a protective order and also discussed with the parties the potential efficacy of an expert hearing,[21] as it was apparent the optimal valuation methodology was going to be a "battle of experts." The court entered an order approving the standstill agreement, the protective order, endorsed the expert hearing, and staged the discovery to initially and solely focus on that information and financial data important for an effective expert hearing. The court also entered an aggressive case management order setting time deadlines in the event the expert hearing and subsequent mediations were not successful in resolving the dispute.

The opposing experts essentially agreed on the limited financial and other information necessary to finalize their opinions and counsel cooperated in providing the experts with the information requested. During the subsequent expert hearing the opposing experts effectively and persuasively endorsed the bases of their opposing evaluation methodologies and were able to identify a number of areas of agreement including the impact of the differing models on the payment to the departing partner. Mediation sessions followed that initially focused on how the competing valuation models might be modified to achieve a "fair" evaluation process as

well as the terms of the payments to be made. Once the parameters of the business evaluation methodology were generally discussed (but not yet agreed upon), the mediation proceeded to address a number of underlying issues that proved to be an impediment to a global resolution. The case was ultimately resolved after three mediation sessions that spanned six months.

The total litigation savings to the parties were significant and enabled the remaining partner to "sweeten the deal" to a limited extent in exchange for a non-compete agreement from the departing partner. Judicial involvement in the dispute was minimal although the time deadlines set forth in the court's case management plan were extremely helpful in incentivizing the parties to complete the mediation process in a timely fashion. Although the personal animosity of the former partners was not resolved, counsel followed a creative "litigotiation" path harnessing judicial procedures to augment a negotiation approach that achieved the BATNAs of their respective clients in a very cost effective and timely manner.

Another example of litigotiation outside the judicial setting underscores the importance of creativity and flexibility by counsel. Two businesses were involved in a dispute that had significant economic consequences and the potential to negatively impact the long term viability of the losing party. The dispute was subject to the AAA Rules for Commercial Arbitration and called for a panel of three arbitrators. Following the filing of a demand for arbitration, the respondent appointed an arbitrator, the claimant selected an arbitrator, and the respondent and claimant arbitrators selected the neutral arbitrator. Fortunately, the selected respondent and claimant arbitrators were experienced business mediators as well.

The arbitration proceeded through a very contentious period of discovery and extensive motion practice and was heading toward the scheduled hearing date and the uncertainty of what the final award might be. Although two prior mediations had failed, during a status conference with the arbitrators, there was a discussion of renewed efforts to resolve the dispute. Initially, the parties were unable to agree on an acceptable mediator. It was then decided the claimant arbitrator and the respondent arbitrator would act as co-mediators of the dispute during the subsequent mediation. Of course, the parties and the co-mediators had to agree to certain ground rules so as not to taint any arbitration hearing with information or evidence that might violate mediation confidentiality. However this concern with co-mediators was far less significant than what might otherwise occur during the standard med-arb process using a single neutral.[22] The co-mediated mediation resulted in a resolution that optimized the long-term viability of both organizations.

In the final example, the parties were involved in a small business-to-business dispute with a maximum exposure of approximately $100,000. Prior to the filing of a lawsuit, the parties engaged in an early mediation as they recognized the cost of litigation and a trial would not be prudent from an economic point of view. At the mediation, the parties made very little progress, and the last offer by the defendant was $17,500 and the last demand was $85,000. The damages were not significantly disputed, but there existed a clear issue of liability. Rather than proceed through the normal costly and lengthy litigation process, the early mediation concluded with the parties agreeing to pursue a summary jury trial[23] with a high-low agreement of $75,000 and $22,000. That is, regardless of the jury's verdict, the plaintiff's recovery was capped at $75,000, but the plaintiff would receive no less than $22,000 even in the event of a no cause. If the jury's verdict was between $22,000 and $75,000, the plaintiff would be entitled to receive that amount.

The complaint was filed in court together with a stipulation for the summary jury trial process. The court accepted the parties' stipulation, and, within two months of filing, a jury was selected from the county's jury pool. The trial was conducted in an available county courtroom presided over by a "hearing officer" selected by the parties. The jury heard all evidence and made a decision in one day, and the jury was not apprised of the high-low agreement. The litigation savings from the decision not to pursue a standard jury trial were significant, and all parties and counsel believed the process was fair and effective. It is worth noting that ABOTA has endorsed the use of such summary jury trials in appropriate cases.[24]

Conclusion

Business litigators have a far more challenging and evolving future than I confronted when starting my litigation career. The vanishing jury trial is not a passing phenom-

The vanishing jury trial is not a passing phenomenon, and business litigators and their clients need to adapt to the evolving dispute resolution landscape.

enon, and business litigators and their clients need to adapt to the evolving dispute resolution landscape. While there will always be a number of disputes that need and should be tried, and the trial will always play an extremely important role in dispute resolution, not every case can be tried and "litigotiation" may be a viable option. In the vast majority of disputes that will not result in a trial, the issue is how best can the business litigator leverage the ever expanding and changing court processes to support negotiations that achieve a resolution in the client's best interests. This new and evolving environment requires creativity, flexibility, and familiarity with the judicial case management protocols of each business court and the evidence based practices outlined in the *Caseflow Management Guide*. It will also be important to become familiar with all of the ADR processes outlined in the *Michigan Judges Guide to ADR Practice and Procedure* and to creatively harness and stage the most appropriate process(es) to negotiate a resolution of the litigation.

NOTES

1. The use of evidence based practices by trial courts in case management has been defined as: "The conscientious, explicit and judicious use of current best evidence in making decisions about the management of a dispute. It means integrating individual judicial and legal expertise with the best available external evidence from systematic research." See David C. Steelman, *Caseflow Management: The Heart of Court Management in the New Millennium*, National Center for State Courts (2004), .http://www.yourhonor.com/pdfs/PDP10/Caseflow.pdf.

2. Staged discovery should not be confused with proportionate discovery. Staged discovery involves delaying costly and burdensome discovery until after the initial discovery phase (which may solely focus on, for example, the issue of liability). Greater use of staged litigation—litigating and resolving some potentially case-dispositive issues before discovery on other litigation occurs on more discovery-intensive issues—is a potentially very potent and effective evidence based practice for the trial courts. *See* the *Caseflow Management Guide*, SCAO (2013), https://courts.michigan.gov/Administration/SCAO/Resources/Documents/Publications/Manuals/cfmg.pdf. Notably, staged litigation preserves the plaintiff's access to information and right to a jury trial if, in fact, that right is established during the initial discovery phase that focuses, for example, on liability. See Greg Reilly, *Linking Patent Reform and Civil Litigation Reform*, 47 Loy. U. Chi. L. J. 179 (2015). Available at: http://lawecommons.luc.edu/luclj/vol47/iss1/5. Proportionate discovery involves the denial of potentially relevant discovery if the cost and burden of the discovery is not justified given the issues presented by the case. See Rule 26 of the Federal Rules of Civil Procedure. *See also, Recent Decisions Regarding Discovery Scope and Proportionality Requirements Under New Federal Rules* (2017), https://www.quinnemanuel.com/the-firm/news-events/article-may-2017-recent-decisions-regarding-discovery-scope-and-proportionality-requirements-under-new-federal-rules/.

3. There can be little doubt the concept of proportionate discovery will soon be coming to Michigan. On November 28, 2018, the Michigan Supreme Court issued an order calling for comments on proposed amendments to the Michigan Court Rules that require, *inter alia*, mandatory initial disclosures and incorporate principles of proportionate discovery. See https://courts.michigan.gov/Courts/MichiganSupremeCourt/rules/court-rules-admin-matters/Court%20Rules/2018-19_2018-11-28_publish%20order.pdf.

4. The "Vanishing Trial" phenomenon has resulted in evolving changes for membership in ABOTA. At one time it was restricted to attorneys who tried 100 cases to a jury verdict or hung jury as lead counsel. Meeting this requirement entitles one to "Diplomate" status today. "Members" status is currently extended to litigators who have completed (10) civil jury trials to jury verdict or hung jury as lead counsel. "Associate" membership includes those who have tried a minimum of twenty (20) civil jury trials to a jury verdict or hung jury as lead counsel. "Advocates" are those who have at least eight (8) years of active experience and tried a minimum of fifty (50) civil jury trials to a jury verdict or hung jury as lead counsel. https://s3.amazonaws.com/membercentralcdn.

5. In fact, SCAO has a significant portion of its website devoted to advising trial courts on how to achieve greater efficiencies and time savings through the use of recommended evidence based practices. *See, e.g., Reengineering Courts to Streamline Operations & Save Money*, https://courts.michigan.gov/administration/scao/pages/re-engineering-courts.aspx; *see also Caseflow Management Guide, supra*.

6. https://www.acc.com/valuechallenge/.

7. Thomas J. Stipanowich and J., Ryan Lavare, *Living with ADR: Evolving Perceptions and Use of Mediation, Arbitration and Conflict Management in Fortune 1000 Corporations*, Harv. Negotiations L. R. (Spring 2014).

8. See https://courts.michigan.gov/education/stats/performance-measures/pages/default.aspx.

9. https://courts.michigan.gov/education/stats/dashboards/Pages/Dashboard-Clearance-Rates-Why.aspx.

10. https://courts.michigan.gov/education/stats/dashboards/pages/dashboard-case-age-dispo-rate-why.aspx.

11. *Civil Justice Improvements Task Force Report to the Chief Justice* (June 2018), https://www.ncsc.org/~/media/Microsites/Files/Civil-Justice/OregonCJIreport.ashx.

12. See http://courts.mi.gov/Administration/SCAO/ OfficesPrograms/ODR/Documents/ADR%20Guide%2004092015.pdf.

13. The author contributed to drafting the *Michigan Judges Guide*. A more expansive handbook for litigators on ADR techniques and processes, *A Taxonomy of ADR*, can be downloaded from the author's website, www.hurfordresolution.com.

14. BATNA was first explored and popularized in Roger Fisher and William Ury seminal best seller on negotiations, *Getting to Yes: Negotiating Without Giving In* (1981). In its simplest terms, BATNA represents a methodology for evaluating offers and demands during the negotiation process.

15. https://media.law.wisc.edu/m/fwfmm/gargoyle_14_1_1.pdf.

16. Following the business court initiative in Michigan, SCAO convened a summit of neutrals, litigators and judges to explore and make recommendations concerning evidence based practices that would improve the litigation process in terms of lowering costs and

enhancing efficiencies. See Early ADR Summit, https://courts.michigan.gov/Administration/SCAO/OfficesPrograms/ODR/Documents/ADR%20Summit%20Report.pdf#search=%22ADR%20Summit%22. Virtually all of the recommendations made during this Summit have been incorporated into the various Michigan business court administrative orders that contain important information on how these courts will case manage business litigation. https://courts.michigan.gov/Administration/admin/op/Business-Courts/Pages/Business-Courts.aspx. Many business court Judges, such as Judges Alexander and Anderson (Judge Potts recently retired and was succeeded by Judge Anderson) in Oakland County, have supplemented these Administrative Orders with additional requirements, suggested forms and protocols concerning the case management of a dispute including a program that requires the mediation of discovery disputes by volunteer mediators immediately before the hearing on a Motion to Compel. See e.g., https://www.oakgov.com/courts/businesscourt/Documents/ocbc-pro-case-management.pdf. Of course, it is a standard practice prior to filing any Motion in a business court to review the written business court decisions that are published either on the web site of the County business court in question or universally compiled for all the business courts on the SCAO web site. https://courts.michigan.gov/opinions_orders/businesscourts-search/pages/default.aspx.

17. *The Caseflow Management Guide* published by SCAO in 2013, is a compendium of various "evidence based practices" to assist Michigan trial courts in effective case management, extols the virtues of staged discovery. One suggestion made to the trial courts in the *Guide* is:

> "Developing a process where initial discovery focuses on the information needed for settlement with discovery for trial provided only in cases that are likely to be tried." *Guide*, p 22. https://courts.michigan.gov/Administration/SCAO/Resources/Documents/Publications/Manuals/cfmg.pdf.

18. *See Michigan Judges Guide to ADR Practice and Procedure, supra*.

19. *Case Evaluation and Mediation in Michigan Circuit Courts: A Follow Up Study* (SCAO) (2018). https://courts.michigan.gov/Administration/SCAO/OfficesPrograms/ODR/Documents/2018%20Mediation%20and%20Case%20Evaluation%20Study.pdf).

20. For example, most experienced business mediators can be of assistance in developing staged and proportionate discovery plans, electronic discovery protocols, standstill agreements, receivership processes, resolving discovery disputes, the terms of protective orders, and addressing similar issues that occur during the course of the litigation. Most of these matters can be dealt with cost effectively over the phone and at a far lesser cost and with greater speed than formal Motion practice.

21. The expert hearing process is overviewed on page 31 of the *Michigan Judges Guide to ADR Practice and Procedure, supra*.

22. Various med-arb processes, including confidentiality issues, are discussed on pages 36-39 of the *Michigan Judges Guide to ADR Practice and Procedure, supra*.

23. The summary jury trial process is overviewed in the *Michigan Judges Guide to ADR Practice and Procedure, supra*, at p 39-41. SCAO has also issued a helpful description of the process, see, https://courts.michigan.gov/administration/admin/op/pages/summary-jury-trial.aspx. Forms for Stipulating to a Summary Jury Trial, Appointing a Hearing Officer and a Summary Trial Verdict form are available at http://circuitcourt.macombgov.org/CircuitCourt-SummaryJuryTrial.

24. The American Board of Trial Advocates (ABOTA) issued the following resolution on January 14, 2012:

> Whereas, ABOTA recognizes that the number of civil cases in the United States actually tried to a jury is rapidly decreasing and that litigation costs and delays are a major contributor to the reduction in the number of civil juries trials, and
> Whereas, ABOTA recognizes that several states have adopted expedited jury trial programs which provide for streamlined pretrial procedures and abbreviated jury trials in many civil cases in an effort to thereby reduce the cost and time involved, yet preserving the civil jury system in this Country,
> It is therefore, RESOLVED, that ABOTA supports the concept of streamlined pretrial procedures and expedited jury trials and that ABOTA, through its leaders and members, should support existing expedited jury trial programs and encourage the adoption of similar programs throughout all jurisdictions.
> https://www.abota.org/index.cfm?pg=Resolutions.

Richard L. Hurford is the President of Richard Hurford Dispute Resolution Services, P.C., and a principal in Strongbridge Negotiation Strategists, P.C. He is a former Chair of the ADR Council of the State Bar of Michigan, a past Chair of the Macomb County and Oakland County ADR Sections, the current Co-Chair of the ADR Committee of the Federal Bar Association of the Eastern District of Michigan, and a past President of the Michigan Chapter of the Association for Conflict Resolution. He is a frequent lecturer and a co-author of the nationally recognized A Taxonomy of ADR (2015) and a contributor to the Supreme Court Administrative Office's publication, Michigan Judges Guide to ADR Practice and Procedure (2015).

Case Digests

Stenzel v Best Buy Co, Inc, No 156262, ___Mich___, ___NW2d___ (Apr 22, 2019)

Paullett Stenzel purchased a Samsung refrigerator from Best Buy. When Best Buy installed the refrigerator, they connected the ice maker and water dispenser to the water line in the house. A few days later, Stenzel came home and noticed water all over the floor from the refrigerator that was spraying water through the dispenser. Stenzel contacted Best Buy and the employee told her to shut off the water line. Upon the employee's direction, Stenzel went into the crawl space in her house and shut off the line and found that the crawl space also had water leaking from the refrigerator. Stenzel took all of her towels and attempted to cover the surfaces where the water had been standing. She wrung out the towels in her sink and put some of the other towels in the laundry basket. Stenzel grabbed her laundry basket, dragging it on the floor, into her sunroom to hang the towels outside. After hanging her towels outside, Stenzel came back inside to get more wet towels. While trying to drag her second laundry basket full of wet towels through her sunroom, she slipped and fell, causing her to break her leg and ankle. Stenzel noted that the floor in the sunroom was wet, but she was not sure if the water came from her foot or from the refrigerator leak.

Stenzel brought suit against Best Buy arguing negligence, breach of contract, and breach of warranty. She later amended her complaint to add Samsung as a party to the claims. The trial court granted summary disposition in favor of Best Buy and Samsung. Stenzel appealed. The Michigan Court of Appeals reversed its grant of summary disposition in favor of Stenzel, holding that but for Best Buy and Samsung's negligence, she would not have had water on either her feet or on the floor, and she would not have fallen while cleaning it up. The court went further and found that Stenzel slipping and falling in the sunroom while cleaning up the water from a defective refrigerator is a foreseeable consequence. It did not break the chain of causation because the incident occurred in a different room than the refrigerator.

Additionally, the court declared a conflict with *Williams v Arbor Home,* Inc, 254 Mich App 439, 656 NW2d 873 (2002). Williams held that MCL 600.2957, read in conjunction with MCR 2.112, required leave of the court before an amended pleading adding a nonparty became effective. The court, finding the Williams' dissent compelling, held that plaintiff Stenzel properly added Samsung as a party under the requirements of the court rule, not the statute, and her amended complaint was timely because it related back to the date of her original complaint against Best Buy.

The court further held that the relation-back language of MCL 600.2957(2) is fully enforceable for a pleading timely amended pursuant to MCR 2.112(K)(4), despite the contrary procedural language in the first sentence of the statutory subsection. The Michigan Supreme Court affirmed the court of appeals decision, holding that MCL 600.2957(2) and MCR 2.112(K) do not conflict. The court held that MCR 2.112(K)(4) was adopted to implement MCL 600.2957, not to replace it. A party may amend a pleading on receiving a notice of nonparty fault under MCR 2.112(K) without filing a motion for leave to amend. Whether a party files a motion or not, amendment must be permitted if it is timely, and an amended pleading relates back to the original action pursuant to MCL 600.2957(2). Therefore, the Michigan Supreme Court found that plaintiff's amended complaint adding Samsung as a defendant was timely filed and related back to her original complaint against Best Buy under MCL 600.2957(2).

Hayes v Ginosko Dev Co, No 340725, (Mich Ct App Feb 28, 2019)(Unpublished)

Plaintiff John Hayes incorporated Ginosko Development Company ("GDC") and assigned himself 49 percent of the stock and 51 percent to defendant Amin Irving. The company employed defendant Mary Tischler as the chief financial officer. In 2012, the parties entered into various agreements to restructure GDC's operation and ownership. The restructuring included making plaintiff GDC's chief executive officer, and he signed a partial stock redemption agreement ("PSRA") to redeem stock from plaintiff amounting to 15 percent of ownership interest. Tischler was to receive the stock, after it was independently valued, and reimburse GDC its purchase price. Plaintiff disagreed with the initial valuation.

In December 2015, plaintiff and defendants signed an agreement providing for plaintiff's termination and buyout. The agreement outlined how the stock would be valued, determined exclusively by Baker Tilly. It also stated that the provisions outlined in "Option B" in the Buy-Sell Agreement will not apply. This provision was clearly in dispute with the earlier signed Buy-Sell Agreement, which states that the purchase price of the shares shall be the based on the fair market value, and, if two accountants cannot agree to the fair market value within 45 days, the parties shall appoint a third accountant.

Plaintiff disagreed with the valuation and insisted that the December 2015 agreement obligated GDC to resolve the valuation dispute in accordance with the Buy-Sell Agreement terms. GDC disagreed to resolving this issue and plaintiff filed suit. The defendants filed separate motions for summary disposition arguing that the December 2015 agreement superseded Option B in the Buy-Sell Agreement, and that it expressly stated that the value of the plaintiff's stock was to be determined only by Baker Tilly. The trial court granted defendants' motions for summary disposition. The trial court found that "the statement in the December 2015 agreement…prevailed because it unambiguously expressed the parties' intent." The plaintiff appealed this order. The court of appeals affirmed the trial court's interpretation of the parties' December 2015 agreement from GDC and affirmed summary disposition for defendants.

Karmanos v Bedi, No 336577 (Mich Ct App Nov 29, 2018)(Unpublished)

Plaintiff Peter Karmanos Jr. founded Compuware with two of his colleagues in 1973. Before Karmanos' retirement, Elliot, a private equity firm, acquired 8.3 percent of Compuware's common stock. In December 2012, Elliot made an offer to acquire Compuware for $11 per share. The offer was initially rejected due to an undervaluation of the stock. Compuware ended up retaining Goldman Sachs Groups, Inc. to evaluate the offer. In April 2014, after Goldman Sachs reviewed the purchase offer, Compuware announced a merger/acquisition agreement with Thoma Bravo for a per share price of $10.25, plus further compensation for a spin-off of a division of the company.

The plaintiffs initiated a case in October 2015, alleging breach of fiduciary duty, breach of the Michigan Uniform Securities Act, fraud, conversion, civil conspiracy, unjust enrichment, and constructive reformation. The defendants filed a motion for summary disposition under MCR 2.116(C)(5), (7), and (8), arguing that plaintiffs lacked standing due to the derivative nature of the lawsuit, plaintiffs were barred from an earlier shareholder class action suit, and that plaintiffs failed to state a claim upon which relief could be granted. The trial court granted defendants summary disposition to each of the plaintiffs' claims under MCR 2.116(C)(5), (7), and (8). Plaintiffs appealed, challenging the trial court's order.

The court of appeals found that the plaintiffs did not demonstrate that they sustained a loss distinct from that of other shareholders generally and failed to show a violation of a duty owed directly to them and not to the corporation generally. Therefore, the trial court did not err in finding plaintiff's claims to be derivative.

Additionally, the plaintiffs were not shareholders of the corporation at the time most of the acts occurred and also not shareholders when the trial court's order was entered. Therefore, plaintiffs lacked standing to bring a shareholder derivative suit against defendants.

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SECTION CALENDAR

Council Meetings

DATE	TIME	LOCATION
June 11, 2019	3:30 p.m.	Southfield, MI