CONTENTS

Section Matters

From the Desk of the Chairperson 1
Officers and Council Members 2
Committees and Directorships 3

Columns

Taking Care of Business: The Changing Landscape for Nonprofits
Alexis Derrossett 5
Tax Matters
Eric M. Nemeth 7
Technology Corner: Michigan Adopts Insurance Cybersecurity Law
Michael S. Khoury and Paul F. Doyle 9
Touring the Business Courts
Douglas L. Toering and Ryan A. Hansen 11
In-House Insight: Legal Best Practices for Nonprofits in the COVID-19 Era
Jordan B. Segal and Maria Toma 15

Articles

Disaster Relief Philanthropy
Jennifer Oertel 17
Managing Endowment Funds During an Economic Downturn
Celeste E. Arduino 23
Program-Related Investments: Are They Too Risky?
Jay Long 26
Community Foundations and Variance Power: A View from the Inside
Brett Hunkins 31
Senior Secured Bank v. MCA: A Recurrent Financial Feud and How to Better Control the Damage Done
Stephen J. Brown 36

Case Digests

Index of Articles

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

<table>
<thead>
<tr>
<th>Issue</th>
<th>Article Deadline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spring 2021</td>
<td>November 30, 2020</td>
</tr>
<tr>
<td>Summer 2021</td>
<td>March 31, 2021</td>
</tr>
<tr>
<td>Fall 2021</td>
<td>July 31, 2021</td>
</tr>
<tr>
<td>Spring 2022</td>
<td>November 30, 2021</td>
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All advertising is on a pre-paid basis and is subject to editorial approval. The rates for camera-ready digital files are $400 for full-page, $200 for half-page, and $100 for quarter page. Requested positions are dependent upon space availability and cannot be guaranteed. All communications relating to advertising should be directed to Publications Director, Brendan J. Cahill, the *Michigan Business Law Journal*, 39577 Woodward Ave., Ste. 300, Bloomfield Hills, MI 48304, (248)203-0721.

**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 Jennifer E. Consiglio

Shortly after I wrote my column for the Spring 2020 edition of the Business Law Journal, the World Health Organization declared the outbreak of coronavirus disease 2019 (COVID-19) a pandemic. Soon thereafter, the Governor of the State of Michigan announced the first case of COVID-19 in the state, and declared a state of emergency and a state of disaster. Over the next several weeks, Governor Whitmer ordered Michiganders to “shelter in place” and issued in excess of 100 executive orders. Business and social activity worldwide came to a screeching halt. The scale of the crisis and its impact on every facet of life, including the practice of law, is beyond anything we have ever experienced.

As I write this column, in Michigan alone, the pandemic has claimed over 5,500 lives, shuttered businesses and court houses, required employees to work from home, and caused millions of others to file for unemployment. Michiganders remain subject to some version of a “stay home and stay safe” executive order as well as social distancing guidelines. We’ve been challenged, as legal practitioners, to adapt and serve our clients and the public under dramatically different and ever-shifting conditions. As we continue to navigate these unchartered waters, there is still much uncertainty ahead.

The Council of the Business Law Section has not had the opportunity to meet in person since early December 2019. Various other Section meetings and events have moved online or been rescheduled. It remains unclear when large groups of people will be allowed, or even comfortable, to assemble again in person. Nevertheless, the Business Law Section has remained active and engaged.

Representatives of the Section have participated in various multi-section task forces convened by the State Bar. Among other things, those efforts produced specific recommendations, presented to the Office of the Governor, to enable attorneys to competently and effectively represent clients, and to otherwise meet ethical obligations mandated by the Michigan Rules of Professional Conduct during the pandemic. Section members have collaborated with the Institute of Continuing Legal Education (ICLE) and others to create webcasts addressing the practice of business law, in its various forms, during COVID-19. They have volunteered to staff legal helplines and otherwise serve as legal resources to underserved Michiganders during the pandemic. And, they have continued to provide traditional resources on established and emerging business law topics for transactional attorneys, business litigators, and members of the judiciary.

The Section’s Committees and Directorships, which cover a wide range of practice areas—such as corporate laws, limited liability companies and partnerships, commercial litigation, nonprofit corporations, debtor/creditor rights, securities regulation, the Uniform Commercial Code, financial institutions, and in-house counsel—have been meeting, formally and informally. Their members have shared ideas and resources, among themselves and with other Section members, to address critical issues, develop best practices for lawyers and their clients, and provide guidance on evolving legal uncertainties created by the COVID-19 pandemic. The Section’s applicable Committees and Directorships have evaluated requests for the submission of briefs amicus curiae, provided comments and technical guidance on draft legislation, and otherwise continued to work diligently to provide the core services historically offered by the Section.

The Section’s Publications Directorship, partnering with ICLE, has coordinated the publication of this edition of the Business Law Journal containing articles presented by—and for—practicing attorneys in Michigan. For the convenience of Section members, the Journal is searchable online at https://connect.michbar.org/businesslaw/newsletter. Past issues of the Journal likely contain an article to educate and guide you with respect to nearly any business law issue with which you may be confronted.

The Section’s Programs Directorship, also in partnership with ICLE, has been planning the substantive and social programming for the 32nd Annual Business Law Institute (BLI), which is currently scheduled to take place at the JW Marriott Hotel in Grand Rapids on October 2, 2020. The Section’s Annual Meeting is also scheduled for October 2, 2020 during the lunch break for the BLI. Given the current uncertainty regarding live events involving large groups, it is possible that the BLI and Annual Meeting will held virtually or presented in an alternative format. In any event, the Business Law Institute will undoubtedly present an excellent opportunity to learn more about current legal issues in the practice of business law, and, hopefully, to network with business law colleagues.

On behalf of the Section, I thank all of the Committee and Directorship Chairs and members for the extensive time and effort they contribute to Section activities. As we emerge from quarantine and beyond, if you are looking to make the most of your Section membership and to help enhance the practice of law in Michigan, I highly recommend joining and actively participating in one or more of the Section’s Committees or Directorships. You can help make Michigan a relevant and hospitable place to do business and to practice business law. A list of these Committees are Directorships, and contact information for their respective leadership, can be found on the Section’s website at https://connect.michbar.org/businesslaw.

This is my last column as Chair of the Business Law Section. During my tenure, I received invaluable assistance in many ways from other lawyers in our Section, including fellow Council members as well as many of the Chairs who preceded me. I thank you for the wise counsel. I’d also especially like to thank my fellow officers, Julia Dale (Vice Chair), John Schuring (Treasurer), and Mark Kellogg (Secretary), and our Section Administrator, Terri Shoop, for their diligence and dedication in helping to navigate the issues before our Section, and to adapt (often on the fly) plans and activities when confronted by a pandemic. Finally, thank you, members of the Business Law Section, for the honor and privilege of serving you.
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Directorships
Corporations Division Update

The landscape outside of the Corporations Division is the same—the hosta plants have sprouted, and the trees are in full bloom. Yet, at the same time, the flag is flying at half-staff to honor and mourn the lives that have been lost due to coronavirus (COVID-19).

Since Monday, March 16, 2020, the Corporations, Securities & Commercial Licensing Bureau has been closed to public visitors and walk-in customers until further notice. The Corporations Division quickly transitioned to new processes and procedures while continuing to serve businesses, the public, and stakeholders so as not to disrupt the services and support provided by our team. As such, we ask for your understanding during this state of emergency, and we strongly encourage you to conduct business with us online through our Corporations Online Filing System (COFS) at www.michigan.gov/corpfileonline, instead of by U.S. mail, FedEx, or UPS.

Documents that cannot be submitted online may be submitted by email to LARA-CSCL-CorpsEFile@michigan.gov. After the document is submitted by email, you will be provided with a link to pay the filing fee by credit card.

The Corporations Division is meeting statutory requirements and reviewing documents within ten business days, perhaps even sooner, but it is not guaranteed. If you would like to request expedited service, please complete and include the Expedited Service Request Form CSCL/CD-272 with your submission. When submitting a document online, a level of expedited service may be selected, or otherwise standard service will apply.

Virtual Meetings and Electronic Voting

Due to the coronavirus pandemic resulting in federal, state, and local restrictions, many nonprofit corporations will undoubtedly seek to hold meetings through remote communication, such as a teleconference call or video conferencing. The Michigan Nonprofit Corporation Act (the “Act”) allows members or directors to participate in meetings by conference telephone or remote communication if all of the individuals participating can communicate with the other attendees. However, the corporation has authority to restrict participation in meetings by remote communication in its articles of incorporation or bylaws. It is important to review those governing documents along with sections 405 and 521 of the Act so that the specific, procedural requirements are followed if a remote meeting is planned. Also, there are many resources available to provide ideas and best practices for nonprofit corporations. For example, BoardSource has compiled articles and frequently asked questions to assist nonprofits, which are available through its website at www.boardsource.org.

Electronic voting without a meeting is more complicated. Michigan nonprofits should carefully review the legal requirements so that action taken by an electronic vote is authorized and enforceable. For directors—unless prohibited by the articles of incorporation or bylaws—action can be taken without a meeting if all of the directors then in office consent to the action in writing or by electronic transmission. The written consents must be filed with the minutes of the proceedings of the board. Since all of the directors in the office must consent, the vote must be unanimous. Proxy voting is limited for directors (unless prohibited by the articles or bylaws) to the election of directors.

There are more options available for members (or shareholders of a stock-based nonprofit) to take action without a meeting. However, in nearly all instances, the articles of incorporation or bylaws must allow these methods to be used. The only exception is action taken by written consent. Action may be taken by unanimous written consent of the members, and the written consent can be transmitted electronically. The written consent may be less than unanimous if this is provided for in the articles of incorporation. If permitted by the articles or bylaws, ballot voting and voting by proxy are other physically-distant methods available for members to take action without a meeting.

Additional information and a thorough explanation of the requirements is provided in “Taking Action Without a Meeting: Electronic Voting and Other Options for Members and Directors of a Michigan Nonprofit Corporation” from the Summer 2018 issue of The Michigan Business Law Journal.

Good Standing

When applying for a loan, grant, or other program it may be required for the nonprofit corporation or other business entity to be in good standing. If the entity needs to demonstrate that it is in good standing, a Certificate of Good Standing can be ordered online from the Corporations Division at www.michigan.gov/corporderform. The fee is $10.00. When placing the order, you will choose whether the certificate will be returned by email or through the mail. If email is selected, then the certificate will be emailed to the requestor’s designated email address within minutes. The seal of the Corporations, Securities & Commercial Licensing Bureau will appear on the certificate in black and white. If the certificate is returned by mail, then it will be printed on certificate paper which contains a gold seal and a blue watermark in the shape of the State of Michigan. The certificates are legally equivalent and both formats are admissible in a court of law.

Also, it is important for an entity to be mindful of its annual filing requirement in order to remain in good standing on the records of the Corporations Division. The annual report for nonprofit corporations is due by October 1 of each year. The annual
Dissolution

If a nonprofit corporation faces a situation in which it needs to dissolve or withdraw its authority to conduct affairs in Michigan, the corporation may dissolve or withdraw by using one of the following methods:

1. Filing a Certificate of Dissolution (form CSCL/CD-530 or CSCL/CD-531) for domestic corporations or an Application for Certificate of Withdrawal (form CSCL/CD-561) for foreign corporations.

Please note, the Certificate of Dissolution form CSCD/CL-530 may only be used if the corporation meets all of the following conditions and the dissolution is approved by a majority of incorporators or directors:

1) Has not commenced business
2) Has not issued any shares and has no members entitled to vote on dissolution
3) Has no debts or other liabilities
4) Has received no payments on subscriptions for its shares or memberships, contributions or other funds from members or third parties, or, if it has received payments, has returned them to those entitled to them, subtracting any part disbursed for expenses

2. Filing a Certificate of Amendment (form CSCL/CD-515) is an option for domestic corporations only. A Certificate of Amendment can be used to change the corporation’s term of existence to a specific date for dissolution. To allow for processing of the Certificate of Amendment by the Corporations Division, the date for dissolution should be at least 15 days in the future.

Also, while it is not an active approach, section 922 of the Nonprofit Corporation Act, indicates that if an annual report is not filed within two years of the annual report due date, a domestic corporation is automatically dissolved. Foreign corporations have one year before automatic revocation occurs.

All nonprofit corporations, unless organized for religious purposes, must obtain consent to the dissolution, withdrawal, or amendment changing its term to a specific date, or a written statement that consent is not required, from the Michigan Attorney General’s Office and submit the approval to the Corporations Division with the document. To obtain this approval, contact the Michigan Department of Attorney General, Charitable Trust Section, PO Box 30214, Lansing, MI 48909 or by calling (517) 373-1152. Additional information is available on its website at www.michigan.gov/agcharity. The documents listed above cannot be filed unless it is accompanied by either the written consent of the Attorney General or an affidavit attesting to the submission of a written request to the Attorney General for consent to the filing and the failure of the Attorney General to respond within 120 days.

Each of the domestic entity forms listed above can be completed online at www.michigan.gov/corpfileonline. A Visa, MasterCard, or Discover credit card may be used to pay the filing fees. The Certificate of Dissolution online forms include the ability to upload the approval letter from the Attorney General’s Office.

Conclusion

In closing, as we are all adapting to the challenges of a changing landscape, many nonprofit corporations are also responding to critical needs. The Corporations Division and the Department of Licensing and Regulatory Affairs remain committed to helping and serving nonprofit corporations and the business community by focusing on our mission to protect people and promote business in Michigan through transparent and accessible regulatory solutions.

NOTES

1. MCL 450.2405 and 450.2521.
3. MCL 450.2525.
4. MCL 450.2421.
5. The requirements for action by shareholders are generally the same as action by members. Since only a small minority of Michigan nonprofit corporations are stock-based, this column focuses on action by members.
6. MCL 450.2407(3)-(4).
7. MCL 450.2407(1).
8. MCL 450.2408 and 450.2421.
10. 8.3n, R.S. 1846 and MCL 24.406.
11. MCL 450.2922.

Alexis Derrossett is the Corporations Division Director in the State of Michigan’s Corporations, Securities & Commercial Licensing Bureau.

Ms. Derrossett is a graduate of Purdue University and Western Michigan University Cooley Law School. She serves on the State Bar of Michigan’s Character & Fitness Committee, and she is a member of the Business Law Section.
Tax Compliance Practice During Covid-19

The Covid-19 pandemic and the resultant impact upon tax practice and compliance cannot be overstated. Seemingly, every day for several weeks, new legislation and/or agency announcements and other administrative or executive pronouncements changed filing dates, payment dates, contribution rules and the like. The IRS effectively suspended most examination and collection work except in limited circumstances. Millions of tax returns piled-up as did countless correspondence. In over 30 years of practice, I have never experienced anything as wide-ranging, or as profound, to our work as tax practitioners.

Now, as government and the private-sector resume activities in the new “normal,” the IRS and Michigan Treasury are expected to resume their enforcement functions in examination, collection, and criminal investigation and enforcement. Recently, there have been some developments that should be an interest to business lawyers.

IRS Enhances Fraud Enforcement

Following up on enhanced enforcement efforts, the IRS announced the selection of a veteran in offshore compliance as legal advisor to the newly formed fraud enforcement office. Carolyn Schenck will serve as national fraud counsel. The fraud enforcement program will be part of the Small Business/Self-Employed Division of the IRS and IRS Chief Counsel. It is not a coincidence that the IRS is looking at the small-business and self-employed sectors, as studies have shown a significant tax gap in this sector of the economy. Given the program’s emphasis on fraud, IRS examinations in particular should be approached carefully as patterns of understated income and/or overstated expenses could quickly devolve into a criminal investigation or at least the serious consideration of the civil fraud penalty which is 75 percent of the understated tax.

Self-Employed Draw Attention

In keeping with the theme of self-employed workers, or “Gig Workers,” in a rare bi-partisan approach, both the House and Senate tax-writing committees are reviewing proposals to tighten the requirements for the issuance of Form 1099-K or 1099-MISC. One proposal would impose a five percent tax withholding requirement for certain self-employed workers, thus blurring the line between employees and independent contractors. A significant part of the tax gap is the underreporting of income and the corresponding tax obligations of self-employed workers. On the flip-side, the increased reporting of income would open the door for more benefit eligibility for such workers.

Virtual Trials

The United States Tax Court announced that the fall trial calendar will be conducted using remote procedures. The Tax Court had cancelled trials since March because of Covid-19. The virtual court sessions have also ushered in changes to certain trial deadlines; such as, the submission of trial memos being submitted 21 days before trial instead of 14. Please consult the Tax Court website for the latest announcements.

Lawyers and City Taxes

On May 18, 2020, the Michigan Supreme Court released its opinion in Honigman Miller Schwartz and Cohn LLP v City of Detroit, Docket No. 157522. Oral arguments in this case occurred on October 2, 2019, and the court’s decision has been anticipated with great interest by taxpayers, tax professionals, and municipalities.

The key issue in this case was the proper calculation of the revenue factor for purposes of allocating the petitioner’s income to the city of Detroit. Pursuant to the Uniform City Income Tax Ordinance (UCITO), the numerator of the revenue factor must include “services rendered in the city.” Petitioner, a law firm, derived a significant amount of income from legal services performed by its attorneys within the city of Detroit but delivered to clients located outside Detroit. Revenue derived from such activity, argued Petitioner, was not generated by “services rendered in the city” and thus was not includable in the numerator of the revenue factor. The city disagreed and assessed more than $1 million in additional tax based on its position that “services rendered in the city” refers to the location where the services are performed, not where they are delivered.

The Michigan Tax Tribunal granted summary disposition to the city, finding that the statute was ambiguous but that “services rendered in the city” required calculating the revenue factor based upon where services were performed, not where they were delivered. The Michigan Court of Appeals reversed and remanded, concluding that the term “rendered” is different than the term “performed,” which is used elsewhere in the UCITO statute. The Court of Appeals reasoned that the legislature’s use of these two different terms indicated that they had two separate meanings, and that the calculation of the revenue factor should be based upon where the service is delivered to the client, not where it is performed by Petitioner.

Upon review of Michigan’s statutory history with respect to sourcing income from the sale of services and an examination of the use of the term “render” in the context of the UCITO specifically, the Michigan Supreme Court determined that “services rendered” focuses upon where services are done, not where they are delivered. In its analysis, the court particularly highlighted the contrast between the computation of the payroll factor (based upon total compensation paid to employees for work done or services performed within the city) and the revenue factor (calculated based upon the gross revenue of the taxpayer derived from sales made and
services rendered in the city), noting that “render” is used when referring to a taxpayer’s revenue derived from doing services for a customer or client, while “perform” is used in the context of an employee’s work for his or her employer.

In its conclusion, the court’s opinion noted that the Michigan legislature has adopted an origin test for the calculation of the revenue factor with respect to revenue derived from services. This is in contrast to the destination or market-based test that is customarily used to allocate revenue from the sale of goods. Based on this finding, the court reversed the Court of Appeals and remanded the case back to the Michigan Tax Tribunal.

Thank you to, Erin Haney, for assisting in drafting this column. The City of Detroit Income Tax article can be found at www.varnumlaw.com.

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Michigan Adopts Insurance Cybersecurity Law

By Michael S. Khoury and Paul F. Doyle

My co-author Paul Doyle read one of my earlier columns where I described cybersecurity and related compliance initiatives as a “mosaic” of laws and regulations. The lack of a robust, uniform regimen for data privacy and security has led to industry specific legislation and state laws that require our clients to address important issues of privacy and data security on an ad hoc basis or sometimes with industry guidance. We have seen this with the financial industry (Graham Leach Bliley) and the health sector (HIPAA and HITECH) as well as the state laws that have been discussed in prior columns such as the California Consumer Privacy Act. The most recent of these is based on the Insurance Data Security Model Law proposed by the National Association of Insurance Commissioners (NAIC) in 2017. Michigan was the second state to adopt a variation of the law, which takes effect on January 1, 2021.

Background

A series of high-profile breaches of personal information in the health care and governmental sectors led the NAIC to study the issue, offer guidance, and then model a law for the insurance industry. Interestingly, the state of South Carolina played a key role in this process, propelled by its own breach in 2012 of Department of Revenue data. The NAIC convened a task force to address cybersecurity issues and a key participant in the South Carolina investigation became the leader of that task force. Over several years, the NAIC published a number of work products, including a set of guiding principles recommended to be followed as well as the model law.

2015 Principles for Effective Cybersecurity: Insurance Regulatory Guidance

The first set of guidance was published by the NAIC in 2015 and offered twelve guiding “principles” for state regulators to follow. Some of the key points were:

- State insurance regulators should ensure that personally identifiable consumer information held by insurers, producers, and other regulated entities is protected from cybersecurity risks and should mandate that notification protocols are in place to alert consumers in the event of a cybersecurity breach.
- Confident and/or personally identifiable information that is collected, stored, and transferred should be appropriately safeguarded, and state insurance regulators have a responsibility to protect information that they collect, store, and transfer.
- Guidance and oversight for the industry should be flexible, scalable, practical, and consistent with national efforts such as the NIST framework. Regulatory guidance must be risk-based and must consider the resources of the regulated entities.
- Incidence response planning is an essential component to an effective cybersecurity program.
- Regulated entities and state insurance regulators should take appropriate steps to ensure that third parties and service providers have controls in place to protect personally identifiable information and incorporate cybersecurity as part of the entity’s enterprise risk management process, making it clear that cybersecurity is not just an information technology department issue.
- Information, threat assessments, audit findings, and analysis should be shared to prepare organizations for emerging threats and vulnerabilities.
- Training and testing are essential.

The Insurance Data Security Model Law

Another prong of the NAIC efforts was to draft a model law for states to adopt. This was released in 2017. In the press release announcing the model law, the NAIC said:

The model law . . . creates rules for insurers, agents and other licensed entities covering data security, investigation and notification of breach. This includes maintaining an information security program based on ongoing risk assessment, overseeing third-party service providers, investigating data breaches and notifying regulators of a cybersecurity event.

South Carolina was the first to adopt the law, and Michigan’s version was more recent. Interestingly, the federal government was also looking at the issue of cybersecurity in the insurance industry. As NAIC wrapped up and ratified the model law, the U.S. Department of Treasury, through the Federal Insurance Office, was completing its own report on the state of the insurance industry. The treasury report commended NAIC on their creation of the model law and encouraged all states to adopt it. Treasury said that if the states did not adopt the model law, then within a five-year time frame, it would ask Congress to preempt the states.

The key elements of the model law can be summarized as follows:

- Insurers and other entities licensed by a state department of insurance must develop, implement, and maintain an information security program based on its risk assessment, with a designated employee or third-party in charge of the information security program.
- Compliance can be phased in, especially for oversight of third-party service providers.
- Licensees must determine the
appropriate security measures to implement based on careful, ongoing risk assessment for internal and external threats.

- Each cybersecurity event must be investigated, and the state insurance commissioner notified of a cybersecurity event.
- Insurance commissioners have the power to examine and investigate licensees to determine compliance with the law and to require remediation of data security deficiencies.
- The model exempts smaller licensees and those subject to existing regulatory oversight.
- The model does not create a private cause of action, nor does it limit an already-existing private right of action.

Michigan’s version of the Insurance Data Security Law\(^8\) varies from the model law by exempting additional smaller companies (less than 25 employees) and requiring notification to the regulator of the breach within 10 days from the date the breach is determined to have occurred (as compared to 72 hours as specified in the model law). Michigan’s version also includes specific notification requirements to affected consumers and credit reporting agencies with fines if notice is not given.

**Conclusions**

Michigan entities in the insurance industry have until the end of 2020 to get compliant with the new law. As this industry touches so many others, the new law may also result in the need to tightened compliance by those that rely on the insurance industry and business in general. This risk management analysis may result in other industries seeing the benefit in good cybersecurity practices that can be put into place without the need for legislative or regulatory impetus.

**NOTES**


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Introduction
Traditionally, litigation has been handled in person, with attorneys physically present for status conferences, motion hearings, depositions, mediations, settlement conferences, arbitrations, and trials. Over the past several years, various courts have begun to conduct status conferences by telephone, as well as motion hearings by telephone or occasionally by videoconference. Thus, prior to the COVID-19 pandemic, courts were moving to greater electronic access. The pandemic accelerated these efforts almost overnight. The Michigan Business Court Judges we interviewed were unanimous on this point: Court proceedings by videoconferencing are here to stay. This then promises time and cost savings for the parties and counsel along with greater efficiency for the courts.

These technological changes are consistent with the purposes of the business court statute and the Michigan Court Rules. The statute encourages efficient resolution of business disputes with the “expertise, technology, and efficiency required by the information age economy.” MCL 600.8033(3). Likewise, MCR 1.105 states, “These rules are to be construed, administered, and employed by the parties and the court to secure the just, speedy, and economical determination of every action and to avoid the consequences of error that does not affect the substantial rights of the parties.”

Today, business litigation is regularly conducted via Zoom, WebEx, or other video technologies. Michigan courts are holding hearings through Zoom and status conferences via telephone or Zoom.1

At least one judge has tried a bench trial using Zoom, and other judges expect to do so in the near future. Mediations and arbitrations are also being conducted by Zoom or WebEx, and depositions are being scheduled in the same fashion.

Michigan Supreme Court Orders
When the COVID-19 pandemic hit, court access became severely limited for public health reasons. To allow justice to proceed, the business courts had to react quickly. To facilitate this, the Michigan Supreme Court issued various Administrative Orders and provided every judge in Michigan a private Zoom room with its own unique password. As a result, videoconferencing in the business courts (and other courts) has rapidly become commonplace.

Issued on March 15, 2020, Administrative Order 2020-1 provides that, “In civil cases, trial courts should maximize the use of technology to enable and/or require parties to participate remotely.”

Then, on April 7, 2020, the court issued Administrative Order 2020-6.3 This authorized and required a good faith effort of judicial officers to conduct proceedings remotely (whether physically present in the courtroom or elsewhere), using two-way interactive videoconferencing technology or other remote participation tools, wherever possible.

Virtual and remote proceedings have resulted in their own set of procedures and issues. The State Court Administrative Office released the Michigan Trial Courts Virtual Courtroom Standards and Guidelines on April 7, 2020 (revised April 17, 2020).4 This resource contains various standards and best practices. These include the following.

Official Records
“Proceedings conducted via videoconferencing technology must be recorded by the court, except for those hearings that are not required to be recorded.”5 The recording must be “sufficient to produce a verbatim written transcript as if the hearing were held in person in the courtroom.”6

Attorney/Client Communications
The court “must provide a method to enable confidential communication between a party and the party’s counsel.”7 Specifically, in Zoom, courts can allow attorneys to meet with their client in a breakout room.8

Public and Press Access
“Access to proceedings must be provided to the public either during the proceeding or immediately after via access to a video recording of the proceeding, unless the proceeding is closed or access would otherwise be limited by statute or rule.”9 There is also a guideline that courts should create a YouTube live stream channel.10 This is in furtherance of the ideal of open and transparent courts accessible to the public.

How Courts Are Using Remote Technology
Kalamazoo County Business Court
Judge Alexander C. Lipsey presides over the Kalamazoo County Business Court. (Like most other business court judges, he also has a mix of other civil and criminal cases.) Judge Lipsey has been conducting conferences and motion hearings (including a preliminary injunction hearing without witnesses) via Zoom. He also uses Zoom to conduct settlement conferences. Overall, Judge Lipsey is “very satisfied” with conducting settlement conferences via Zoom except for an occasional technical issue (probably unrelated to Zoom’s platform).

Kent County Business Court
Judge Christopher P. Yates and Judge T.J. Ackert have continued to conduct routine case conferences by Zoom as well as conference calls. In addition, both Judge Ackert and Judge Yates have maintained busy motion dockets using Zoom and conference calls, so only trials and complex evidentiary hearings have been significantly delayed by the pandemic. Significantly, both judges have had ample time to write opinions, so the Kent County Specialized Business Docket website contains a whole host of new opinions, and the backlog of motions under advisement has been reduced to almost zero. Judge Yates notes that virtual motion hearings are more
structured and tend to be shorter. He observed that the pandemic has “forced us to think about things in a new way.” He states that court proceedings by videoconferencing “will make the practice of law much more efficient.”

Finally, the Kent County Specialized Business Docket intends to resume in-person bench trials in July 2020.

Macomb County Business Court
Judge Richard L. Caretti and Judge Kathryn A. Viviano report that their courts run largely the same as pre-COVID, but virtually. No trials have occurred via videoconferencing yet, but all motions and hearings are on the record through Zoom and are livestreamed on YouTube for public access. Judge Viviano and Judge Caretti each have specific COVID-19 protocols. The Macomb County Circuit Court conducts case evaluations telephonically but may move to Zoom in the future.

Oakland County Business Court
Like many other courts, Oakland County Circuit Court is conducting almost everything by Zoom, including bench trials. In fact, Judge Martha D. Anderson recently concluded a bench trial by Zoom. She noted that it was particularly helpful to have all the exhibits in advance. Judge Anderson mentioned that during the bench trial, one person’s screen occasionally froze, but everyone was able to work around this. Judge James M. Alexander noted that virtual trials pose many unanswered problems, from constitutional issues (generally, in criminal cases) to sharing exhibits, to prompting witnesses off-screen. With respect to virtual technology in general, Judge Alexander reflected that “in 90 days, we have come a million miles.” He expects using technology in the courtroom to continue as the new normal. Judge Alexander also observed that this “saves lawyers time and clients money and is more efficient for the court.” The Oakland County Circuit Court uses Zoom to conduct case evaluations.

Saginaw County Business Court
Judge M. Randall Jurrens has “tried to accommodate some business court matters during these extraordinary times. Particularly, things like case management conferences, status conferences, and motions (i.e., non-evidentiary hearings) can be successfully held by Zoom.”

Wayne County Business Court
Judge David J. Allen, Judge Edward Ewell Jr., Judge Muriel D. Hughes, Judge Lita M. Popke, and Judge Brian R. Sullivan believe that court proceedings by videoconferencing are here to stay. They each conduct settlement conferences and motion hearings using videoconferencing. Wayne County Circuit Court also uses videoconferencing to conduct case evaluations.

Issues with videoconferencing, according to Judge Ewell, include an occasional bad connection, poor lighting, or improper attire. These are the exceptions, however. As to the last, Judge Hughes recommends that parties and counsel dress for mediation the same way as they would dress for court. Furthermore, Judge Popke reminds counsel that “when the oral arguments are on YouTube, we are presenting to the public the judicial system, and it should appear as such.”

Judge Sullivan noted that certain hearings by videoconferencing work well, while others, especially those with witnesses, may not. He believes that there is no substitute for in-person interactions. However, as Judge Sullivan noted, to provide service and to be effective, courts will need to continue to allow remote access. Judge Sullivan added that the pre-COVID-19 trend to decide motions on the briefs is continuing.

Like Judge Sullivan, Judge Hughes decides many of her motions on the briefs, although she sets hearing dates for more complex motions or motions seeking an injunction. Emphasizing that “time is money,” Judge Hughes observed that virtual hearings save time and money. Judge Popke stated, “I have conducted nu-

merous business court status conferences by Zoom and have found them to be efficient. Attorneys and the court are always prompt and generally conclude the matters in less than 30 minutes, with the exception of complex cases.” Moreover, with hearings by videoconferencing, attorneys can be in multiple courts (Wayne County then Kent County, for example) on the same morning. In general, she reports, judges and attorneys like hearings by videoconferencing.

As for scheduling, Judge Ewell notes that courts will experience a backlog on trials. He thus encourages settlement conferences, mediation, and arbitration to resolve cases earlier. Judge Hughes agrees. She added that bench trials are another option. Judge Allen concurs with and supports the observations of his Wayne County colleagues.

Overall
A number of judges observed that hearings by videoconferencing were shorter. The judges generally like the efficiency of videoconferencing for the parties and counsel (resulting in saving considerable time and expense by avoiding travel) and for the courts themselves.

At a recent meeting of the Michigan Business Court Judges, the judges indicated they were conducting virtual (Zoom) pretrial conferences, status conferences, and evidentiary hearings and are planning to hold virtual bench trials.

Virtual ADR
Overall, the consensus seems to be that ADR has hardly skipped a beat due to COVID-19. (All Community Dispute Resolution Programs provide mediation via Zoom.) Generally, mediators and arbitrators report that they continue to provide mediation and arbitration services by videoconferencing.

In his article, “Thoughts About My First Zoom Arbitration,” Jonathan Frank observed that virtual arbitration is efficient because nobody has to travel. However, there are differences. Frank noted that emotion from parties was generally lost,
which can be both good and bad. Objections are hard to manage, as there is a slight delay in the transmission of the live stream. Frank suggested using a “visual stop sign” to make objections easier. He also noted that it was much harder to communicate with his client because they were not sitting next to each other in the same room; text messaging was an imperfect solution. Attorney Ian M. Williamson13 also recently handled an arbitration hearing via Zoom and found that while live testimony may often be preferable, witness examinations were more effective than he had anticipated. However, Williamson found the format more tiring than in-person proceedings due to the need to remain seated and focused on a screen for extended periods. He also experienced occasional issues with screens of witnesses or opposing counsel freezing up.

Regarding mediation by videoconferencing, the results appear mixed. Judge Alexander has heard that some attorneys like it, but others do not. There are benefits to in-person mediation, of course. Indeed, it is easier to get to “yes” when everyone is in the same room (or in nearby rooms). Conversely, it is easier for a party who is alone to say “no.” (This is presumably why judges have often required that parties with settlement authority personally attend settlement conferences.) In other cases, sometimes people just want to be heard. This may favor in-person mediation. But Judge Sullivan noted that in his experience, most parties have not found virtual mediation to be significantly different such that they would forego mediation if it were conducted by videoconferencing. Still, he believes the preference is for in-person mediation, if possible.

Retired Wayne County Business Court Judge Daniel P. Ryan has successfully used WebEx for years in mediations with people who live out of state or internationally. That said, Judge Ryan also noted some problems with videoconferencing, including web connection/camera problems, the fact that it is easier for parties to say “no,” and lack of formality in how parties dress and conduct themselves (which may lead to a view that the proceedings are not as serious as they would be for an in-person mediation.) Judge Ryan also spoke to another COVID-19-related issue on settlements. As a result of COVID-19-related delays, some parties are delaying settlements (to allow them to delay payment); other parties use the uncertainty of COVID-19 as a negotiating tool (“Settle now, or your case will be delayed due to COVID”).

Going Forward

COVID-19 has moved the legal world to integrate today’s technology into all aspects of business litigation, with the possible exception of jury trials. Video technology will still be used to conduct status conferences, motion hearings, evidentiary hearings, and bench trials after the pandemic is over. This will not be true in every case, of course. But it may well be that virtual court proceedings will become the rule rather than the exception post-COVID-19. Indeed, Michigan Supreme Court Chief Justice Bridget M. McCormack recently testified virtually to a United States House Judiciary Subcommittee. She observed that “this pandemic was not the disruption that any of us wanted, but it may be the disruption we needed to transform our judiciary into a more accessible, transparent, efficient, and customer-friendly branch of government.”14

In general, virtual court proceedings are going very well. Whether jury trials can be conducted virtually remains to be seen; many judges are skeptical. Virtual ADR is here to stay as well, although time will tell whether mediation is more successful in person than by video. ADR in general will be high in demand, as trials are backlogged due to COVID-19-related delays.

Judge Jurrens summed it up, “As to the future, I fully anticipate that while some matters will eventually return to the courthouse proper (particularly [jury] trials), the pandemic has afforded us an opportunity to experience and appreciate the utility and efficiency of virtual meetings; so I feel confident this new way of conducting some court proceedings is here to stay.”

The use of technology, albeit accelerated by COVID-19, helps fulfill the mandate in the business court statute to resolve business disputes efficiently with technology. (As many judges observed, the jury is out on whether jury trials can be effectively conducted by videoconferencing.) Regardless of what the future holds, technology such as videoconferencing in the courtroom (as well as in mediation and arbitration in certain circumstances) will be the new normal. Making litigation more efficient and inexpensive is a good thing.

NOTES

1. This column is not an endorsement of Zoom over any other technology or a critique of Zoom or any other technology. The emphasis on Zoom in this column is simply because Michigan’s state court judges each have a private Zoom room.
5. Id. at p. 2, ¶ A(2).
6. Id.
7. Id. at p. 4, ¶ B(1).
8. Id.
9. Id. at p. 4, ¶ C(1).
10. Id.
11. Judge Hughes cited a recent poll of attorneys at a recent negligence-related webinar. Of the 55 attendees, 74% plan to argue motions by Zoom after the COVID-19 pandemic is over if that option is available.
13. Williamson is a partner of the authors.
14. Testimony of Michigan Supreme Court Chief Justice Bridget M. McCormack before the Michigan State Senate Judiciary Subcommittee. She observed that “this pandemic was not the disruption that any of us wanted, but it may be the disruption we needed to transform our judiciary into a more accessible, transparent, efficient, and customer-friendly branch of government.”
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Legal Best Practices for Nonprofits in the COVID-19 Era

As COVID-19 continues to upend business as usual, nonprofit organizations must recognize and cope with the ongoing impact the disease has had on their mission. Self-isolation, social distancing, event cancellation and a decrease in funding are all on the minds of nonprofit leaders. Nonprofit directors must now begin asking questions about how the disease will affect their beneficiaries, employees and volunteers, management, work cultures, programs, fundraising, events, investments, and operations. As nonprofit directors address these issues, they will inevitably turn to their counsel for guidance on what their legal obligations are to weigh COVID-19’s impact against the need to advance the nonprofit’s mission.

Counsel for nonprofits should be prepared to address three separate types of issues, (1) director’s duties during the crisis, (2) issues related to the nonprofit’s charitable mission, and (3) employee and other human resources issues.

Directors, Management, and Decision-Making Issues

Under the Michigan Nonprofit Corporation Act, nonprofit directors owe the organization the same essential fiduciary duties (among other things) as for-profit boards of directors, including the duty of care. Thus, much like the board of directors of a for-profit corporation, a board of directors for a nonprofit is responsible for implementing plans, policies, budgets, specific directives, and responsible leadership that upholds the mission, vision and value of the organization. Thus, as for a for-profit, the nonprofit duty of care requires that a director acts in a reasonable and informed manner under the given circumstances. The duty requires the same standard of care as a for-profit corporation, namely the director must act in a manner in which “an ordinarily prudent person in a like position would use under similar circumstances.”

However, COVID-19 has considerably changed the circumstances from just a few weeks ago, and directors must now consider how that changes the care and attention an ordinarily prudent director would provide to the organization. While director liability for breach of fiduciary duty may be rare at least in the nonprofit context (but not unheard of), the risk may be significant if, for example, directors ignore decision making limits and respond to the crisis without regard to proper chains of authority. Review bylaws and current policies before making policy decisions so that leadership is properly making decisions and the chain of command remains clear.

Event Cancellations and Mission-Related Issues

While the full effect of COVID-19 will not be known for some time, it is clear that the business world has slowed considerably. Fundraising (or other) events, which may have been crucial to a nonprofit’s budget, must be postponed or outright canceled. Counsel’s task here will likely be to identify the impacts of cancelled events or meetings and take swift action to minimize or recover unexpected costs. Thus, Counsel should pro-actively review event contracts to determine if deposits are refundable or other fees are avoidable. Counsel may be required to evaluate contractual obligations and any defense the organization may have for not performing under an existing contract, negotiations with other parties to a contract, and whether the organization is entitled to cancellation insurance benefits.

Hopefully event contracts contain a force majeure clause under which performance is excused and deposits returned. However, in the absence of a force majeure clause, the doctrine of frustration-of-purpose doctrine may similarly provide an excuse for nonperformance of a contractual obligation. Generally, the doctrine may be “asserted where ‘a change in circumstances makes one party’s performance virtually worthless to the other, frustrating his purpose in making the contract.’”

More formally, frustration-of-purpose may be applied where: “(1) the contract must be at least partially executory; (2) the frustrated party’s purpose in making the contract must have been known to both parties when the contract was made; (3) this purpose must have been basically frustrated by an event not reasonably foreseeable at the time the contract was made, the occurrence of which has not been due to the fault of the frustrated party and the risk of which was not assumed by him.” Thus, it may be possible to argue that stay-at-home orders frustrate the purpose of an event, warranting a full refund of a deposit. Again, careful reading of the contract is required.

Employees and Human Resources

Finally, while not a specific legal obligation, nonprofits, like all companies, and indeed, all Michiganders, should do their part to slow the spread of COVID-19 by adhering to the general health policies and advice of experts. Nonprofits are, after all, employers and like all other employers, they should comply with COVID-19 guidance provided by the Department of Labor (OSHA) and the Department of Health and Human Services and their state analogs. If possible, directors should also provide flexible opportunities for employees and volunteers to work from home and offer sick leave or encourage employees who are sick to stay home.

To effectively preserve the mission and principles of the organization, nonprofit leaders should address mitigation strategies with counsel and take initiatives to stay informed of ever-changing guidance and policies from agencies charged with COVID-19 tasks.
NOTES


2. MCL 450.2541; see also Takagi, supra.


5. Takagi, supra note 1.


8. Id. at 133-134, 676 NW2d 633, quoting Restatement Contracts, 2d, § 265, comment a, p. 335 (emphasis added).


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Charitable organizations and private foundations are often the first community stakeholders to step in to assist victims of natural disaster such as floods, hurricanes, and tornadoes as well as hardships on a more individual level, such as a fire devastating a local employer or a local family. So long as the class of potential recipients of the relief is large enough to be deemed an indefinite class of charitable individuals, and payments are structured appropriately, the relief will be deemed charitable—in other words, a proper activity for a 501(c)(3) organization and not taxable as income to the recipient under the federal tax laws. In addition, under changes to the federal tax code after the terrorist attacks of September 11, 2001, employers are permitted to establish funds to relieve employees in the event of a federally declared disaster or employee hardship that would otherwise be deemed income subject to income and employment taxes. However, in all cases of charitable payments to individuals—even in the event of a federally declared disaster or hardship relief—the rules requiring an indefinite class of charitable recipients and those against impermissible private benefit and private foundation self-dealing still apply.

Indefinite Charitable Class
Pursuant to the Treasury Regulations, the eligible class of charitable beneficiaries must be so large as to be indefinite—so that it is not as if donors are earmarking their contributions to particular individuals. A charitable class must be large enough or sufficiently indefinite that the community as a whole, rather than a pre-selected group of people, benefits when a charity provides assistance. When the group of eligible beneficiaries is limited to a smaller group, such as the employees of a particular employer, the group of persons eligible for assistance must be open-ended and include employees affected by the current disaster and those who may be affected by a future disaster. However, it may be the case that the group of eligible employees is so large as to warrant its own charitable class. As with many things in this area of the law, it is a facts and circumstances test that requires careful consideration.

The seminal case in the nature of what is an indefinite charitable class is *Wendy L Parker Rehab Found Inc v Commissioner*, 52 TCM. 51 (1986). Although the Parker family created a purported charity to aid a seemingly open-ended class of “victims of coma,” the organization intended to spend at least 30 percent of its income for the benefit of Wendy Parker, the daughter of the organization’s founders. The Internal Revenue Service (IRS) noted that significant contributions were made by the Parker family (thus attempting to secure charitable deductions for expenditures that may not otherwise have been deductible). The IRS denied tax-exempt status, finding that the benefits of the organization did not flow primarily to the public but rather to the Parker family, which decision was upheld by the tax court.

Needy or Distressed Individuals
Any charitable payments to individuals must target those financially or otherwise in need. Charitable funds cannot be distributed to individuals merely because they are victims of a disaster, and an organization’s decision about how its charitable funds will be distributed must be based on an objective evaluation of the victims’ needs at the time the grant is made. One exception is that in the immediate aftermath of a disaster, the IRS realizes that no matter what an individual’s financial resources, they may be equally in need of assistance. By way of IRS example, “A charity may provide crisis counseling, rescue services, or emergency aid such as blankets or hot meals in the immediate aftermath of a disaster without a showing of financial need. Providing such services to the distressed in the immediate aftermath of a disaster serves a charitable purpose regardless of the financial condition of the recipients. However, as time goes on and people are able to call upon their individual resources, it may become increasingly appropriate for charities to conduct individual financial needs assessments.”

It is important to note that the analysis discussed in this article is whether the activity in question is charitable. It is common for

*Disaster Relief Philanthropy*

By Jennifer Oertel
a community to rally support through donations for particular community members in need, such as when someone suffers a house fire or severe illness. While these activities are not charitable, they are not prohibited. Instead, the contributions are analyzed pursuant to gift tax doctrine (not taxable to the donor if falling within applicable limits) and are typically not taxable to the recipient. However, the provision of aid to a particular individual or family is not charitable in the view of the IRS.

**Support to Local Business**

Disaster relief to local businesses is scrutinized, just as it is for any purported charitable contribution to a for-profit entity. The IRS has become increasingly hostile to economic development as a charitable activity over the years and has taken the position in a plethora of rulings that simple job creation is not charitable—there must be something more.

In Publication 3833, the IRS stated that disaster assistance may be provided to businesses to aid individual business owners who are financially needy or otherwise distressed, to combat community deterioration, and, to lessen the burdens of government. However, that is the same analysis that applies to any charitable activity, not just in a time of disaster. The IRS further stated that disaster relief payments to local business are only charitable if the assistance is a reasonable means of accomplishing a charitable purpose, and any benefit to a private interest is incidental to the accomplishment of a charitable purpose. This standard is often contrary to the common understanding of citizens and charities of what is important to the health of their communities and which they believe “should” be charitable.

The IRS offers the following rather extreme example of permitted disaster relief of a business:

As a result of a tornado, the central business district of a community is severely damaged. Because of the devastation, the area has become blighted. No single business wants to begin restoration efforts until it can be assured that the whole business district will be restored. A charity may provide funds to begin rebuilding the infrastructure of the district, such as roads, sidewalks, parks, sewers and power lines. This type of assistance would accomplish a charitable purpose by combatting community deterioration. Any benefit to the business is incidental to the public purpose accomplished by the charity’s program of assistance to the community.

Many organizations provide significantly greater assistance to local business than demonstrated by the IRS’ example. Clearly, charities providing aid to a business should first scrutinize their proposed programs to ensure that they would meet the IRS’ definition of a charitable activity. If they pass that test, then they need to establish objective and nondiscriminatory selection criteria to determine when aid should be offered and when it should be discontinued. If a purported activity does not meet the IRS’ requirements, then a charitable entity may consider providing relief to a business (such as low-interest, patient capital loans) as a mission-related investment, utilizing a prudent portion of its investment portfolio.

**Employer Sponsored Disaster Relief**

Since the adoption of IRC 139, as amended (the IRC), employers may provide tax-advantaged assistance to their employees through several different avenues, the most flexible of which is through an independent, charitable entity. (This is the only option for employers to provide relief to employees for individual employee hardship that is not a federal disaster (a “Qualified Disaster”), as defined below.) As a result of President Trump’s declaration of a national emergency that warrants assistance by the federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act, the COVID-19 pandemic is treated as a Qualified Disaster for purposes of “qualified disaster relief payments” under IRC 139. More typically, a “disaster area” is declared by the President upon the request of the governor of a state in which a natural disaster has occurred, and qualified relief may be provided within a designated area affected by the natural disaster, but the COVID-19 pandemic applies nationwide. Invocation of IRC 139 requires a Qualified Disaster, not a disaster declared by a state or local authority, and state and local tax laws may not provide favorable tax treatment even in the event of a Qualified Disaster.

In a Qualified Disaster, payments that comply with the IRC will not result in taxable income to the recipient, are not subject
to employment taxes and withholding, and benefit from certain other exceptions to the federal tax rules.

Under IRC 139(c), a Qualified Disaster is defined as:

1) a disaster which results from a terroristic or military action (as defined in section 692(c)(2));
2) a federally declared disaster (as defined by section 165(i)(5)(A));
3) a disaster which results from an accident involving a common carrier, or from any other event, which is determined by the Secretary to be of a catastrophic nature; or
4) with respect to qualified disasters that an applicable Federal, State, or local authority (as determined by the Secretary) deems to warrant assistance from the Federal, State, or local government or agency or instrumentality thereof.

Under IRC 139, Qualified Disaster relief payments include the following types of payments:

1) to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a Qualified Disaster;
2) to reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence or repair or replacement of its contents to the extent that the need for such repair, rehabilitation, or replacement is attributable to a Qualified Disaster;
3) by a person engaged in the furnishing or sale of transportation as a common carrier by reason of the death or personal physical injuries incurred as a result of a Qualified Disaster; or
4) amounts by a Federal, State, or local government, or agency or instrumentality thereof, in connection with a Qualified Disaster, in order to promote the general welfare.

However, in all cases, the payments only qualify to the extent any expense compensated by such payment is not otherwise reimbursed by insurance or otherwise.

Qualified disaster relief payments do not include income replacement payments, such as payments of lost wages, lost business income, or unemployment compensation. Payments for things that would otherwise be the legal responsibility of an employer (including under a collective bargaining agreement) would also not qualify. Also, as noted above, a payment will not be qualified to the extent it covers an otherwise qualified expense for which the victim has already been compensated, such as through insurance or other relief payments (like government payments under the CARES Act). In addition, in order for any disaster or hardship relief to be deemed to be a charitable activity of the employer, the relief must be provided to an indefinite charitable class consisting of needy or distressed individuals, as previously discussed.

**Corporate Foundation**

Because of the IRS’ concern over private foundations aiding their related corporations in recruiting and retaining employees (which amounts to prohibited self-dealing under the private foundation rules), certain safeguards were enacted in an attempt to ensure that such assistance is serving charitable purposes rather than the business purposes of the related corporation. The IRS will presume that payments in response to a Qualified Disaster made by a private foundation to employees (or family members of employees) of an employer that is a disqualified person to the foundation (such as the related corporation) are consistent with the foundation’s charitable purposes if all of the following are satisfied: (i) the class of beneficiaries is large or indefinite (a “charitable class”), (ii) the recipients are selected based on an objective determination of need, and (iii) the selection is made using either an independent selection committee or adequate substitute procedures to ensure that any benefit to the employer is incidental and tenuous. In other words, at least a majority of the selection committee must not be in a position to exercise substantial influence over the affairs of the related corporation. Also, the related corporation should not promote the relief program as a means by which to attract employees.

Although IRC 139 provides significantly more leeway given that it clarifies that payments that meet the above-noted criteria are not deemed to be self-dealing merely because the recipient is an employee of the related corporation, that presumption does not apply to payments that would otherwise constitute self-dealing. For example, the pre-
Sometimes, employers sponsor the establishment of a separate public charity that is not subject to the same restrictive rules of private foundations and DAFs.

Employer-Sponsored Charities

Sometimes, employers sponsor the establishment of a separate public charity that is not subject to the same restrictive rules of private foundations and DAFs. For example, these charities may provide relief in the event of any type of disaster or qualified employee emergency hardship, so long as the related employer does not exert excessive control over the organization. In order to meet the public support test, these charities are typically funded by a large employee base, and those employees also serve on the charity’s board of directors. To ensure the program is not impermissibly serving the related employer, the same three requirements must be met as for employer-controlled private foundations: (i) the potential pool of recipients must consist of an indefinite charitable class; (ii) the recipients must be selected based on an objective determination of need; and (iii) the recipients must be selected by an independent selection committee, or adequate substitute procedures must be in place to ensure that any benefit to the employer is incidental and tenuous. The charity’s selection committee is independent if a majority of the members of the committee consists of persons who are not in a position to exercise substantial influence over the affairs of the employer. If these requirements are met, the public charity’s payments to the employer-sponsored employees and their family members in response to a disaster or emergency hardship are presumed (1) to be made for charitable purposes and (2) not to result in taxable compensation to the employee recipients. Employers may also contract with a local community foundation or one of the national charities that regularly offers employer-sponsored assistance programs tailored to the employer’s needs, within the boundaries of the tax regulations.

Direct Payments to Employees

Employers may also choose to make payments directly to employees, as opposed to indirectly through a tax-exempt entity. IRC 139 provides for special tax treatment of disaster relief payments made to victims of a Qualified Disaster, regardless of the source. Therefore, such relief payments will not be included in the income of recipients to the extent that any expenses covered by these payments are not otherwise compensated by insurance or other reimbursements. Qualifying payments are also not subject to income tax, self-employment tax, or employment taxes even though the payments are made directly from the employer, so long as they otherwise meet the eligibility criteria.

Employer Sponsored Donation of PTO/Leave/Vacation Time

Another way by which employers may support employees is by facilitating the donation of paid time off (including leave or vacation time) for use by other employees adversely affected by a Qualified Disaster. The plan may allow employees to donate accrued paid time
off to an employer-sponsored leave bank for use by other employees adversely affected by a Qualified Disaster. The donated leave is not taxable to the donor, although it is deemed income to the recipient. An employee is considered “adversely affected” by a Qualified Disaster if it has caused severe hardship to the employee or a family member of the employee that requires the employee to be absent from work.

In order for such a program to be exempt from taxation as income to the donating employee, the plan must be formalized in writing by the employer and must meet the following requirements:13

- The plan does not allow a leave donor to donate leave to a specific leave recipient.
- The amount of leave that a leave donor may donate in any year generally may not exceed the maximum amount of leave that he or she normally accrues during the year.
- A leave recipient may receive paid leave (at his or her normal rate of compensation) from the donated leave bank. Each leave recipient must use this leave for purposes related to the major disaster.
- The plan adopts a reasonable limit, based on the severity of the disaster, on the period of time after the major disaster occurs during which a leave donor may donate, and a leave recipient must use, the donated leave.
- A leave recipient may not convert leave received under the plan into cash in lieu of using the leave.

However, a leave recipient may use leave received under the plan to eliminate a negative leave balance that arose from leave advanced to the leave recipient because of the effects of the major disaster. A leave recipient also may substitute leave received under the plan for leave without pay used because of the major disaster.

- The employer must make a reasonable determination, based on need, as to how much leave each approved leave recipient may receive under the plan.
- Leave donated due to one Qualified Disaster be used only for employees affected by that disaster.

Except for an amount so small as to make accounting for it unreasonable or administratively impracticable, any leave donated under a major disaster leave-sharing plan not used by leave recipients by the end of the period specified in the plan must be returned within a reasonable period of time to the leave donors (or, at the employer’s option, to those leave donors still employed by the employer) so the donor can use the leave.

The IRS also created particular exceptions for employees to provide leave-based donations of cash to charitable organizations in past Qualified Disasters such as Hurricane Harvey, Hurricane Irma, and the Ebola virus.14 At the time of this writing, it is anticipated that similar relief would be granted for the COVID-19 pandemic, although that has not yet been enacted.

Books and Records

While charitable organizations are not the guarantors of how their charitable assets are used, they do have to take reasonable precautions to ensure that the grants they make are used for charitable purposes. As previously discussed, grants to individuals or for-profit business are especially scrutinized. An organization must maintain adequate records to show that the organization’s payments further the organization’s charitable purposes and that the recipients of grants are members of an indefinite charitable class that are needy or distressed. Records should demonstrate that the organization has made distributions to individuals after making appropriate needs assessments based on the recipients’ financial resources and their physical, mental, and emotional well-being. According to the IRS,15 generally, documentation should include: a complete description of the assistance provided; costs associated with providing the assistance; the purpose for which the aid was given; the charity’s objective criteria for disbursing assistance under each program; how the recipients were selected; the name, address, and amount distributed to each recipient; any relationship between a recipient and officers, directors, or key employees of, or substantial contributors to, the charitable organization; and, the composition of the selection committee approving the assistance. In the event that a charitable organization is distributing short-term emergency assistance, the records to be maintained may be less detailed, such as the type of assistance provided; criteria for disbursing assistance; date, place, estimated number of victims assisted (individual names and addresses are not required); charitable pur-
pose intended to be accomplished, and the cost of the aid. Examples of such short-term emergency aid would include the distribution of blankets, hot meals, heaters, electric fans, or coats, hats and gloves. The IRS recommends that an organization that is distributing longer-term aid should keep the more-detailed type of records described above.

Conclusion

IRC 139 makes it possible for employers to provide tax-advantaged assistance to employees in the event of a Qualified Disaster or in some cases of employee hardship that would otherwise be deemed income to the employee and subject to employment taxes. However, whether the assistance is employer-provided or provided by an independent charitable organization, the general IRC requirements as to the charitableness of an organization’s activities still apply even in the case of a Qualified Disaster.

NOTES

2. IRS Publication 3833, Disaster Relief: Providing Assistance Through Charitable Organizations.
4. See, for example, TAM 934002 (investment in hotel to aid unemployment in local economy not deemed charitable); and Priv Ltr Rul 7742062 (2007) (purchase of small business investment company to create jobs and alleviate unemployment not deemed charitable).
5. IRS Publication 3833.
6. Id.
8. IRC 139 provides federal income and employment tax exemption; state and local tax laws may differ. All references in this article to tax treatment refer to federal income and employment taxes unless otherwise noted.
9. The Robert T. Stafford Disaster Relief and Emergency Assistance Act (Pub L No 100-707), signed into law on November 23, 1988, amended the Disaster Relief Act of 1974 (Pub L No 93-288). The Stafford Act constitutes the statutory authority for most Federal disaster response activities especially as they pertain to the Federal Emergency Management Agency (FEMA) and FEMA programs.
10. See IRC 4941(d)(2)(B) and Treas. Reg. 53.4941(d)-2(c)(2).
11. IRC 4946.
12. Under the Pension Protection Act of 2006, the definition of Donor Advised Fund was added to the IRC as section 4966.
13. IRS Notice 2006-59; See also, Priv Ltr Rul 200720017 (May 18, 2007).
14. See IRS Notice 2017-48 (Hurricane Harvey); IRS Notice 2017-52 (Hurricane Irma); and IRS Notice 2014-65 (Ebola Virus).
15. IRS Publication 3833.
Managing Endowment Funds
During an Economic Downturn

By Celeste E. Arduino

During an economic downturn, many charities may consider invading the principal of their endowments. Others may consider borrowing from endowments, or pledging endowments as collateral for loans obtained by the charity. While endowments are intended to support a charity and even provide stability during uncertain economic times, a charity’s use of an endowment may be restricted by donor intent, contractual terms, and the law.¹

Identifying “True” Endowments
The Michigan Uniform Prudent Management of Institutional Funds Act (“UPMIFA”)² defines an “endowment fund” as a fund that, under the terms of a gift instrument, is not wholly expendable by the charity on a current basis. This means that a true endowment for legal purposes is one that has been restricted by a donor. A “gift instrument” is defined broadly under the law to include not only a written gift or donation agreement between the charity and a donor, but also solicitations and other records relating to the gift. Thus, a donation to a charity that is designated by the donor for endowment purposes, or made in response to a charity’s request for endowment funds, would be considered an endowment for legal purposes. Board-designated endowments (i.e., a board’s own designation of otherwise unrestricted funds as an endowment for its own use) are not endowments for legal purposes.

Expenditures of Income and Principal
Subject to the intent of the donor as expressed in a gift instrument, UPMIFA permits a charity to spend or accumulate as much of the endowment as the charity determines is prudent for the uses, benefits, purposes, and duration for which the endowment is established. In making such a determination, the charity must consider the following factors: the duration and preservation of the endowment fund; the purposes of the charity and the endowment fund; general economic conditions; the possible effect of inflation or deflation; the expected total return from income and the appreciation of investments; the charity’s other resources; and the charity’s investment policy. It is generally assumed, under UPMIFA, that charities should preserve principal by maintaining the purchasing power of amounts contributed and should spend income by making a distribution each year using a reasonable spending rate.

A charity must always consider donor intent in managing and using its endowment funds. UPMIFA imposes a couple rules of construction relating to the gift instruments creating an endowment. A gift instrument that simply designates a gift as an “endowment,” or that contains a direction or authorization to use only “income,” “interest,” “dividends,” “rents, issues, or profits,” or “to preserve the principal intact,” or uses words of similar import, does both of the following: (1) creates an endowment fund of permanent duration unless other language in the gift instrument limits the duration or purpose of the fund; and (2) does not otherwise limit the charity’s authority to spend or accumulate as much of the endowment as the charity determines is prudent. Thus, if a donor wishes to impose any specific restrictions or requirements on a charity’s spending (such as requiring all income to be spent each year or restricting a charity from making any expenditures if the endowment is underwater), then the donor should include an explicit provision in a written gift agreement with the charity.

Underwater Endowments
Before UPMIFA was enacted in 2009, charities were generally prohibited from spending endowments if the value of the endowment had fallen below its original gift value. This meant many charities, during the 2008 recession, were unable to utilize their endowments. Although UPMIFA (unlike the predecessor law) allows spending from underwater endowment funds, the charity must still determine that such spending is prudent,
A charity must always consider donor intent in managing and using its endowment funds.

**Borrowing from Endowments**

Particularly during an economic downturn, charities may be tempted to “borrow” from their endowments, by using the endowment funds for a different charitable purpose or spending more than is prudent, with the intent to repay or replenish the endowment when donations pick back up or the economy rebounds. Unless specifically authorized by the terms of a gift instrument, borrowing from an endowment is not permitted unless the amount to be borrowed and the purpose for which the borrowed funds will be used would otherwise be a permissible expenditure from the endowment fund if spent by the charity, taking into consideration the factors set forth above.

**Pledge of Endowment Assets**

Charities may also seek to pledge assets in an endowment fund as security for a loan obtained by the charity. The Michigan Nonprofit Corporation Act generally permits charities to pledge or create a security interest in any of its property. However, unless specifically permitted by a gift instrument, UPMIFA and donor intent restrict the pledge of endowment assets unless the use of such assets to satisfy the debt would be a permissible expenditure from the endowment fund. In other words, a pledge of endowment assets is subject to the same analysis as borrowing from an endowment.

**Release or Modification of Restrictions**

A charity that wishes to use an endowment fund for a different purpose, or take an action with respect to an endowment fund that is contrary to the terms of the gift instrument or UPMIFA, may always seek the donor’s (or donors’ if multiple donors have contributed to the endowment fund) written consent to a release or modification of the restrictions. A donor may give prior consent, in a gift instrument, to the charity’s release or modification of a restriction or stated charitable purpose of an endowment. UPMIFA also provides a mechanism for a charity to seek court approval of a release or modification if certain requirements are met. Of course, any release or modification must be consistent with the charity’s charitable purposes and 501(c)(3) requirements.

**Variance Power**

Although UPMIFA sets forth the methods for releasing or modifying the restrictions imposed upon endowment funds, it is not intended to affect the right of a charity’s board to exercise any power to modify restrictions contained in a gift instrument as conferred by the charity’s governing instruments or by a gift instrument. Such a power is often referred to as the charity’s “variance power” and may be reserved by any charity, including community foundations which may be required to retain a variance power to qualify to be treated as a single charitable organization, despite holding multiple funds. Thus, a variance power that exists in a charity’s articles of incorporation (which is a public document) at the time a gift is made, should control unless a donor includes a specific restriction on the variance power in a gift instrument. Query, though, how a variance power aligns with donor intent if the donor was unaware the variance power existed.

**Conclusion**

Spending and borrowing from endowment funds is subject to both donor intent and applicable law. The emphasis on donor intent underscores the importance of a charity maintaining detailed records relating to its endowment funds and gift instruments. Care should also be taken when soliciting donations as the words used by a charity in its solicitation materials can impose restrictions on its use of the donated funds for many years to come.

**NOTES**

1. This article addresses only certain legal considerations of managing endowment funds and does not address the application of accounting standards to the use and management of endowments. A certified public accountant should be consulted to determine the applicability of accounting standards.

2. UPMIFA generally applies to charities organized as nonprofit corporations. Charities organized as trusts are governed by the relevant terms of the Michigan Estates and Protected Individuals Code.
Celeste E. Arduino is Co-Chair of the Exempt Organizations and Impact Investing Practice Group at Bodman PLC in Troy, Michigan. Celeste represents community and family foundations, public charities, religious organizations, and other tax-exempt and charitable organizations in securing and retaining exempt status, advising on corporate governance issues, and counseling on general operational matters.
Program-Related Investments: Are They Too Risky?

By Jay Long

Impact Investing

Organizations are moving towards placing their investment assets into what they deem socially impactful investments.1 “Impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return.”2 There are many forms of these investment strategies that consider non-financial factors such as program-related investments (“PRIs”); mission related investments (“MRIs”); socially responsible investments (“SRIs”); sustainable investments, investments that consider environmental, social and governance (“ESG”) factors; and economically targeted investments (“ETIs”).3 This article focuses on the response of the Internal Revenue Service (“IRS”) to program-related investments, specifically, when these investments are deemed invalid; thus subject to the excise tax on “jeopardizing investments.”

The practice of impact investing is inhibited by fear that foundations will face IRS scrutiny for failure of a PRI, yet a scan of federal caselaw and IRS private letter rulings found only six cases (excluding for failure to meet expenditure responsibility) in which foundations were penalized for failure to meet the PRI requirements, examples of which are discussed herein.

Section 4944 (Jeopardizing Investments)

Section 4944 provides for an excise tax on any private foundation investments that jeopardize the performance of exempt purposes of the foundation. Although section 4944 does not describe jeopardizing transactions, the regulations, with certain exceptions, provide:

an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. In the exercise of the requisite standard of care and prudence the foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk and potential for return). The determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation’s portfolio as a whole.5

Although the regulations do not list a category of investments that are per se violations of section 4944, the U.S. Department of Treasury goes on to provide examples of investments that are closely scrutinized: (1) trading in securities on margin, (2) trading in commodity futures, (3) investments in working interests in oil and gas wells, (4) the purchase of “puts,” “calls,” and “straddles,” and (5) the purchase of warrants, and selling short.6

If it is determined that a private foundation made a jeopardizing investment, the IRS imposes a two-tier excise tax. The first tier of tax is 10 percent of the amount so invested for each year or part thereof in the taxable period;7 followed by a second tax of 10 percent of the amount invested on the participation of any foundation manager in the making of the investment.8 The second tier tax is 25 percent of the investment by the private foundation and 5 percent of the investment by the foundation manager if the jeopardizing investment is not removed from jeopardy within the specified period.9
Program-Related Investments—An Exception to Jeopardizing Investments

Under section 4944(c), program-related investments are excluded from the definition of jeopardizing investments. Treasury Regulations § 53.4944-3(a) state that PRIs are investments that meet the following tests:

- **Primary Purpose Test**—The primary purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(B). “An investment shall be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) if it significantly furthers the accomplishment of the private foundation’s exempt activities and if the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation’s exempt activities.” This requirement is illustrated in the regulations, including Example 11 (primary purpose is furthering scientific research), and Example 12 (primary purpose is combatting environmental deterioration).

- **No Significant Investment Purpose Test**—No significant purpose of the investment is the production of income or the appreciation of property. “In determining whether a significant purpose of an investment is the production of income or the appreciation of property, it shall be relevant whether investors solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation. However, the fact that an investment produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.”

- **No Political or Legislative Purpose Test**—The purpose of the investment must not be to accomplish the purpose of attempting to influence legislation or to attempt to participate in, or intervene in, any political campaign on behalf of any candidate for public office.

The regulations provide many examples of investments that qualify as program-related under section 4944.

Program-Related Investments Held Invalid

This section summarizes cases and rulings that have declared a PRI invalid. As shown below, PRIs have been declared invalid in only limited circumstances. Many of these circumstances surround when a foundation asserts economic development as the primary purpose of the PRI, for which the IRS has become increasingly hostile.

**Failure to Satisfy the Primary Purpose Test**

As stated above, for an investment to be a PRI it must significantly further the accomplishment of the private foundation’s exempt activities. Only five cases/rulings where a PRI was deemed to be invalid due to the foundation’s failure to meet the primary purpose test were found, those examples are discussed below.

**TAM 200218038**

- **Facts**—L is a private foundation and is exempt from federal income tax under section 501(c)(3). M is a public charity and is exempt from federal income tax under section 501(c)(3). M’s charitable program is to provide entrepreneurship training and mentoring to at-risk youths. N was established by M to create an endowment fund for M. N is the general partner of O, a limited partnership, which was established to provide funding to M. O trades in commodities and futures.

- **Investment**—L invested in O, a limited partnership.

- **Analysis/Ruling**—The IRS found that L’s investments in the futures and commodities markets were solely a way to produce investment returns to be used by L in accomplishing its exempt purposes. The IRS compared the facts to Example 7 of Treasury Regulations § 53.4944-3(b) where there was no relationship between the investments per se and the accomplishment of exempt purposes except for producing a return. Although the foundation’s investment did not qualify for the program-related investment exception, the IRS ultimately ruled that the investment was not a jeopardizing investment.

**PLR 201017066**

- **Facts**—A section 501(c)(3) corpora-
If it is determined that a private foundation made a jeopardizing investment, the IRS imposes a two-tier excise tax.

TAM 93400025

- **Facts**—The private foundation is exempt from federal income tax under section 501(c)(3). Its stated purposes include, among other things, to preserve, create, and/or promote the architectural heritage of the town and to aid in the continuing improvements of the county for the betterment of its citizens via direct or indirect assistance and financial aid to any agencies of local government or to any community project that has such aims and such purposes.
- **Investment**—To stimulate tourism, aid the economy in general, and relieve unemployment, the foundation purchased 100 percent stock of a for-profit corporation. This corporation had been created to construct and operate a hotel.
- **Analysis/Ruling**—The foundation’s argument that the hotel stimulated the economy via employment opportunities did not change the fact that the ownership of the hotel was not in furtherance of an exempt purpose. Thus, the IRS ruled that the purchase of the hotel is not a program-related investment.

PLR 820105016

- **Facts**—X is a charitable foundation that carries out charitable activities relating to the promotion of the arts, theatre, culture, and education.
- **Investment**—X is the residuary beneficiary of the assets of the Y estate, which assets include nearly all of the outstanding shares of stock entitled to vote on Z and A, corporations which operate pari-mutuel horse racing facilities (a racetrack and associated facilities), year-round.
- **Analysis/Ruling**—The IRS found that all the charitable endeavors of X were located in other states and no current or past activity of X involved the operation of horse racing, breeding, or stabling facilities. The IRS found that fostering horse racing and the “equine arts” was not similar to X’s sponsorship of programs in the arts, humanities, and public media because the organizations currently benefited by X were in public television stations, drama and dance companies, and also symphony and chamber orchestras (not horse racing, which were commercial endeavors). The IRS found that investing in the horse racing was not a PRI although the foundation argued that the closing of the track would lead to the loss of state revenue and jobs.

PLR 774206217

- **Facts**—The private foundation is exempt from federal income tax under section 501(c)(3).
- **Investment**—The private foundation proposed to purchase $100,000 of nonvoting stock in a small business investment company.
- **Analysis/Ruling**—The IRS found that the private foundation’s purchase of the nonvoting stock was not a PRI, despite the foundation’s claim that the purchase would create employment opportunities.

**No Significant Investment Purpose Test**

TAM 802300518

- **Facts**—Y is not classified as a pri-
Private foundations are increasingly looking at PRIs as a means by which to make their philanthropic capital stretch further.
of the federal tax laws governing private foundations. However, as demonstrated by a scan of IRS private letter rulings and tax court cases spanning over 50 years (since enactment of the private foundation rules in the Internal Revenue Code of 1969), there have been few occurrences of such issues, and they could have been remedied by compliance with the expenditure responsibility rules and assurance of the charitable nature of the activity being funded.

NOTES


4. Unless otherwise indicated, all “section” references in this summary are to the U.S. Internal Revenue Code of 1986, as amended, and all “§” references are to the Treasury regulations promulgated thereunder.


6. Id.

7. IRC 4944(a)(1).

8. IRC 4944(a)(2). This tax is paid by the participating managers and is subject, under IRC 4944(d)(2), to a maximum of $10,000 for all managers with respect to any one investment.

9. IRC 4944(b).


12. Treas. Reg. 53.4944-3(b).


14. Priv Ltr Rul 201017066 (Feb 2, 2010).

15. TAM 9340002 (June 16, 1993).


17. Priv Ltr Rul 7742062 (Jan 1, 1977).

18. TAM 8023005 (Jan 1, 1980).


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Community Foundations and Variance Power: A View from the Inside

By Brett Hunkins

In May 2018, two significant things happened to me. First, I joined the Community Foundation of Greater Flint and became aware of the concept of variance power. Second, I had a mild heart attack.

In the two years since, my understanding of the heart and how to care for it has expanded in ways I could not have imagined, and now I have great clarity about how the steps I take contribute to or detract from my health.

In parallel, my understanding of variance power has expanded in ways I could not have imagined, but with less clarity about how the steps we take organizationally contribute to or detract from our effective use of variance power.

Something seems amiss in that picture.

I can report that there is good news for anyone attempting to find greater clarity about what variance power is, what it requires, what it allows, and how community foundations apply it—there are many definitions and legal principles available to sort through.

The not so good news is that those definitions exist in multiple individual spheres, and it is unclear how, or whether, those spheres intersect in the operating decisions of a community foundation.

Furthermore, to the extent those spheres are deemed to intersect, it raises important questions about a community foundation’s ability to maximize its effectiveness in its area of influence while operating within confines of legal parameters that were not designed for other purposes. This can be especially true in times of greatest need for charitable resources, as illustrated through the COVID-19 pandemic.

Background and Review

The Community Foundation of Greater Flint operates as a single entity not-for-profit corporation with authority vested in a board of trustees, rather than as a holder of accumulated component funds. Accordingly, the discussion of variance power and how it applies will bypass the review of treasury regulations that often is used as a frame.

The governing body of any community foundation organized similarly must have the power:

(1) To modify any restriction or condition on the distribution of funds for any specified charitable purposes or to specified organizations if in the sole judgment of the governing body (without the necessity of the approval of any participating trustee, custodian, or agent), such restriction or condition becomes, in effect, unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community or area served;

(2) To replace any participating trustee, custodian, or agent for breach of fiduciary duty under State law; and

(3) To replace any participating trustee, custodian, or agent for failure to produce a reasonable (as determined by the governing body) return of net income (within the meaning of paragraph (f)(11)(v)(F) of this section) over a reasonable period of time (as determined by the governing body).”

The ability for the community foundation to modify restrictions as described in (1) above is referred to as its variance power. Beyond merely having the variance power, however, the governing body must “commit itself by resolution or otherwise to exercise that power.”

In carrying out the powers it is committed to exercise, the governing board must also operate within parameters imposed by state law. Treasury regulations provide a framework for resolving potential inconsistencies between any actions the governing body may take under (1)-(3) and applicable state law, as follows:

If a power described in such a provision is inconsistent with State law… the community trust will be treated
There seems to be little doubt that part of what makes a community foundation a powerful channel for philanthropy is its ability to be knitted into the fabric of the community it serves.

In order to provide further guidance, an example is provided with reference to the power to modify under paragraph (1) above. If the power to modify is inconsistent with State law, but the power to institute proceedings to modify would be consistent with State law, the community trust will be treated as meeting such requirements to the fullest extent possible if the governing body has the power (in the governing instrument or otherwise) to institute proceedings to modify a condition or restriction. On the other hand, if in such a case the community trust has only the power to cause proceedings to be instituted to modify a condition or restriction, it will not be treated as meeting such requirements to the fullest extent possible.

Evidently not content with simply raising the potential for confusion by having offered an example, the drafters doubled down by offering another:

In addition...if the power to modify and the power to institute proceedings to modify a condition or restriction is inconsistent with State law, but the power to cause such proceedings to be instituted would be consistent with State law, it were expressly granted in the governing instrument and if the approval of the State Attorney General were obtained, then the community trust will be treated as meeting such requirements to the fullest extent possible if it has the power (in the governing instrument or otherwise) to cause such proceedings to be instituted, even if such proceedings can be instituted only with the approval of the State Attorney General.

In Michigan, the Uniform Prudent Management of Institutional Funds Act (UPMIFA) provides that a donor can give consent through a gift instrument accompanying the gift for a community foundation to exercise its variance power at points in the future. If such a modification is made by the community foundation, the funds modified must still be used for a charitable purpose.

Discussion
There seems to be little doubt that part of what makes a community foundation a powerful channel for philanthropy is its ability to be knitted into the fabric of the community it serves. One way it achieves this connection is by being responsive to the needs that emerge while continuing to address those that already exist.

Treasury regulations provide the flexibility for that responsiveness by requiring a transfer of control in order to create a completed gift to the community foundation. That is, in order for the donor’s gift to qualify for a full deduction, the donor must cede control of the gift in the first place. It is also worth remembering that the “full deduction” available to the donor was “fuller” than the donor could receive by making a gift to a private foundation because the treasury regulations recognized that a community foundation’s unique philanthropic niche created a clear charitable outcome for any gifts it would receive under the regulation.

In summary, in exchange for the enhanced deductibility of a donor’s gift to a community foundation, the donor cedes control of the use of the gift, at which point the community foundation also gains variance power over the gift.

It is worth pausing a moment here to acknowledge a pragmatic peculiarity to the transaction insofar as the donor’s gift, if accompanied by the relinquishment of control, is to be administered by the community foundation in pursuit of its charitable purposes; this at least logically raises the question of what created a more specific charitable purpose that might raise the possibility of future modification.

The answer seems to come from trust law principles related to the doctrine of cy pres, though there is not a great deal of clarity about the extent to which a community foundation operating as a single entity ameliorates, or obviates, the type of mischief cy pres sought to foreclose. Namely, a community foundation operating under the direction of a governing board naturally adds a dimension of charitable assurance that a single trustee may not.

Indeed, the legal compendium for community foundations seems to leave this question to a degree of interpretation. Moreover, revisiting Treas. Reg. 1.170A-9(f)(11)(v)(B) provides the reminder that the community foundation “governing body must be able to
modify the restriction without obtaining the approval of any participating trustee, custodian, or agent of the community foundation.” It is notable that the donor is not listed as a party from whom approval might need to be sought.12

There is an additional nuance to be mined relative to how a governing body might actually modify a charitable purpose, presuming for now that it has determined that such purpose is “inconsistent with the charitable needs of the community or area served.”13

The legal compendium notes that the hallmark of community foundations is “the ability of the governing body to exercise the function of cy pres without having to first obtain court approval.”14 The compendium continues:

Under cy pres, a court will change the purpose of a charitable trust to the nearest similar purpose when the trustor’s purpose cannot be achieved because it is impossible, impracticable or illegal. The standards which the regulations set forth for when a governing body should exercise the variance power are slightly broader than the standards that a court would use when exercising the doctrine of cy pres. An advantage of allowing a community foundation to make the changes is that it, unlike a probate judge, is a charitable specialist and it is better able to identify the best charitable use of the funds for the community.15

Given the community foundation’s operation as a single entity, the application of trust law makes for a somewhat murky picture. It at least allows for ambiguity in evaluating the question of what the law allows as compared to what the law requires.

In effect, the introduction of cy pres could be construed to impose a limit, or at least a kind of conditioning of the governing body, on the very gift treasury regulations required to be received free of material conditions. This creates a pattern where the donor relinquishes control in exchange for the original tax deduction, then seems to receive some of it back through the attachment of donor intent.

A similar conflict arises with the introduction of Michigan law, which also creates a standard of donor intent at a higher level than treasury regulations may have intended. In addition to the overarching conflict, there is also inconsistency in practical application given the circumstances to justify a possible change of purpose.

The Michigan UPMIFA statute provides for modifications to an alternative charitable purpose where:

- the restriction has become impracticable or wasteful;
- the restriction impairs the management or investment of the fund; or
- modification will further the purposes of the fund due to circumstances not anticipated by the donor.16

An additional consideration exists because any modification must be made in accordance with the donor’s probable intention.17

These modifications seem to run parallel with the treasury approach of “unnecessary” and “incapable of fulfillment,” but they do not provide the broader opportunity for modification through a finding that a purpose is “inconsistent with the charitable needs of the community or area served.”

This difference then requires an evaluation of the community foundation’s compliance with state law “to the fullest extent possible” in order to be found to be following the treasury regulations under the guidance those regulations establish.18

The Michigan UPMIFA statute enabling a donor to, in effect, pre-approve a future modification of purpose through the community foundation’s variance power seems intended to provide the mechanism that would enable the governing body to modify based on a finding of inconsistency with charitable need while avoiding the court approval required by most state statutes to exercise such variance power.19

The fact that the legal landscape contains these conflicts muddies the water for a community foundation’s governing body who, by virtue of the treasury regulations, must be committed to exercising the powers.20

So to recap, I had the heart attack before I learned all of this, it was not caused by learning it.

**Practical Implications**

**Purpose and Complexity**

In navigating the legal framework pertinent to understanding and interpreting a community foundation’s variance power, it is at times hard not to wonder if there is not a simpler version that could be achieved.
At a minimum, the treasury regulations regarding transfer of control free of material condition works clumsily in conjunction with the insertion of donor intent principles from trust law. The more overt potential conflict between treasury regulations and state law also can make for a confusing picture. There is further potential for a blurred line within trust and state law given that Michigan UMPIFA notes that it can be superseded by donor intent.

This confusing legal landscape also creates operational tension because of its overlap with the tendency toward donor deference that exists in community foundations, as it does in many charitable organizations. As a consequence, there can be misunderstandings of whether, or when, interactions with donors are raising legal considerations and when they are more about donor stewardship.

Stewardship and Responsiveness

Because a community foundation stands at the intersection between its donor base and the community it serves, it must achieve consistent and thoughtful stewardship of its donor base while constantly evaluating the ongoing, evolving, and emerging needs of the community.
Concluding Thoughts

From a purely pragmatic standpoint, a community foundation can achieve needed clarity about its variance power through shepherding new donors and the gift agreement that memorializes the transactions.

It is also true that a community foundation’s choice to operate toward the donor deference end of its stewardship continuum cannot all be blamed on a complicated legal environment.

However, a clearer and less fraught legal environment would enable the community foundation greater operational certainty in determining how it can best provide leadership and financial resources within the community it serves. Attorneys advising clients about charitable giving and estate planning can also be a great resource to lessen the surrounding legal and relational complexity by helping them understand the benefits of placing reliance on the philanthropic experts within a community foundation.

NOTES

2. The need to modify a restriction or condition of course indicates that the community foundation accepted a gift subject to such a limitation in the first place. There can be added complexity in evaluating gifts from private foundations because of the requirement that any restriction or condition not rise to the level of a material restriction or condition. Factors to be used in any evaluation are found in Treas. Reg. 1.507-2(a)(7).

7. MCL 451.926(5).
8. MCL 451.926(1).

11. Hoyt, Legal Compendium for Community Foundations, Chapter 1, citing Priv Ltr Rul 82225165 (Mar 29, 1985) where the IRS approved a donor-imposed restriction that a community foundation had to obtain the consent of the advisory committee before changing the charitable purpose of a fund, while commenting that the restriction may have been moot since “outer <sic> provisions of the agreement may have granted the governing body of the community foundation the authority to override any act of the advisory committee.

12. There is a parallel consideration raised as to how the application of a Trust standard to a governing body’s variance power influences the less stringent “business judgment” kind of standard it might otherwise be held to, and the relative public policy questions that could emerge from such a consideration.


15. Id., including citation to 15 Am Jur 2d Charities Sections 133, 137 and 142; Restatement of Trusts 2d Section 399.
16. S.B. 411, 6(2).
17. Id.
19. Pause for author’s commentary that this point is uncomfortably close to circular reasoning given that the additional finding of “inconsistent with charitable purpose” is arguably at odds with Michigan law given that there is not a clear requirement in Treasury regulations that a modification would need to be to a similar purpose. It would again raise the matter of the donor releasing control in exchange for a deduction, but then regaining some manner of it by application of State law.

21. Id.
22. This is another example of the legal frame seeming to make sense within one sphere but not in another. The CF’s ability to exercise variance power is an outcome, or the rationale, of the enhanced deductibility over what a private foundation would achieve, but arguably any charitable organization could achieve a similar power through drafting it into a gift agreement. As a result, there seems to be a fair bit of wrangling, particularly when mixed with donor deference, to almost preemptively avoid a negative outcome that in another setting would not be thought of as negative.
Senior Secured Bank v. MCA: A Recurrent Financial Feud and How to Better Control the Damage Done

By Stephen J. Brown

In the last ten years, hundreds of entrepreneurial financiers calling themselves Merchant Cash Advancers or “MCAs” have entered the middle and small cap credit markets. MCAs are aggressive competitors. Traditional regulated financial service providers, banks especially, tend to look down on MCAs. MCAs can often advance financing within a few days or weeks of meeting their potential new clients, they do so with minimal underwriting or handwringing, and they are none-too-shy about doing business with entities that already have fully collateralized loans with a bank. These disruptive tactics have allowed MCAs to gain significant market share at the expense of more traditional competitors. MCAs claim that this is what capitalism is all about.

Much of the demand for MCA financial products comes from entities that are already near insolvency either because they are fragile startups or because they are in turnaround situations. Many of these entities do not survive. This means that insolvency and turnaround specialists will be dealing with MCA products for years to come. MCA products and MCAs themselves are already appearing regularly in published bankruptcy and state court insolvency cases. We discuss certain salient cases below.

Traditional financial service providers are inclined to think that MCAs are unprofessional “corporate loan sharks” whose very business model is an invitation to litigation. That invitation has often been accepted. MCAs, of course, give as much criticism as they get, and accuse the banks of (among other things) failing to serve wide sectors of the economy. The author takes no side in the matter—his particular clients, whether banks, factors, or MCAs, being entirely innocent and always in the right—and has friends and clients on both sides of the dispute.

Article 9 of the Uniform Commercial Code (“UCC”) has become the usual legal battleground in these fights between MCAs and more senior financial service providers, including banks and factors. Factors, like MCAs, claim to buy their clients’ accounts receivable rather than make loans. Factors differ from MCAs in that they are older and more familiar organizations, and in that they buy existing accounts, whereas MCAs claim to buy percentage interests of all future accounts. Critically, both factors and MCAs insist that they do not lend money to anyone. However, Section 109 of UCC-9 provides that UCC-9 applies to the purchase of accounts receivable. This means that UCC-9 applies both to a classical asset-based loan provided by a bank, and the more purchase-based financing provided by factors and MCAs.

The central thesis of this article is that, at first glimpse anyway, there appears to be an irreconcilable conflict between two of the most important legal concepts in the UCC-9. One such concept favors traditional secured lenders due to the first-in-time UCC-1 filings that they make, while the second concept shields MCAs from attacks so long as the MCAs tap cash from a client’s checking account. Litigation is similar to poker in that a good player must try to predict how long opponents will accept risk and stay in a fight. If two competing poker players each believes that he or she holds a winning hand and that the other guy is bluffing, then escalation becomes the name of the game. This creates outcomes that are dangerous for everyone.

This conflict found in the UCC makes litigation between banks and MCAs particularly expensive, surprisingly emotional, and highly destructive of value for all parties concerned. The risk inherent in litigation is compounded because some judges at the trial court level may not be familiar with the more complex provisions of the UCC, which is no doubt a dense and challenging legal read. Personalities, biases, and pure luck can unduly influence a lawsuit and make predicting outcomes all the more difficult in this charged environment. The author has considerable experience with this litigation on
both sides, and with the factoring, MCA and secured lending sectors generally.

This article first describes the legal issues and then offers a legal conclusion of which of the two conflicting concepts should prevail all else being equal, which of course it never is. The article ends with a few suggestions for making these conflicts less destructive and fraught with risk for all parties concerned.

The Confusing Conflict Between Two Powerful UCC-9 Positions

By way of background, MCAs generally make a single initial lump sum advance of cash to their clients. MCAs then make a contractually enumerated series of identical daily ACH cash withdrawals from the client’s checking account. It is therefore a tell-tale indication that a company has contracted with an MCA when one sees, for example, 25 consecutive daily withdrawals of the same inexplicably precise amount—say $2,117.52—made by an entity whose name indicates that it is a financing company of some sort.

MCAs often start doing business with a client only after the client has already exhausted its credit lines with an existing secured lender and some cash flow emergency has arisen. While actual documentation varies widely, the client’s existing bank loan documentation may prohibit the client from doing an MCA transaction, but the client, desperate for cash, proceeds with the MCA transaction. This fact pattern is called “stacking” because the client-borrower has stacked one lender’s position upon another in order to effectively double finance the same assets. “Stacking” scenarios likely occur thousands of times each year in the United States, and they put the interests of MCAs and other secured lenders on a direct collision course, especially if the shared client-borrower, in other words the stacker, then fails.

The two UCC-9 positions colliding with each other are (1) the rule generally awarding a first priority position to first-in-time UCC-1 filers on all collateral and proceeds thereof and (2) the rule that cash is special and must be particularly well guarded by secured lenders. A second set of related rules protects those who take cash or other cash-like assets, such as purchasers of checks, holders in due course, and (most relevant here) transferees from checking accounts.

The Typical Position of a Hypothetical Senior Secured Bank

The UCC-9 establishes a clear order of priority of rights in the assets of a borrower among competing secured lenders. The UCC-9 achieves this goal using a publicly searchable filing system that allows a lender to announce that it has taken a lien on a borrower’s assets, much like a child might publicly call “dibs” on an attractive toy that other children would like to play with. Section 9-322(a) gives first priority to any party that files its claim (called a UCC-1 financing statement) before anybody else files or otherwise perfects their own liens. The “first to file” rule leaves no room for ambiguity, and any person seeking to know who has a first lien on a given borrower’s assets need only conduct a public search to see whose UCC-1 financing statement is “first in time.” The UCC affords a party filing first the right to prime a competing lender who claims to have lent first. By making the UCC-1 filing date a trump card, the UCC avoids messy disputes about who lent money first, which would lead to a slew of other definitional issues and likely require resort to evidence. Instead, the matter is kept objectively verifiable and simple. First to lend does not win, first to file a UCC-1 does.

Sections 9-315(c), 9-315(d), and 9-322(b) also provide that a secured party holding a first-priority lien on collateral also enjoys a first-priority lien on the “identifiable” cash proceeds of such collateral. It is therefore relatively easy for a bank or secured lender holding the oldest UCC-1, which often perfects a “blanket” security interest on “all assets,” to create a strong argument that it holds a first position on all proceeds of such assets, which would include all cash paid by a borrower’s customers to pay off accounts receivable. Once an entity holds a first-lien on everything, every new dollar that a borrower earns looks like “proceeds.” For those instances where cash is not traceable back to the bank’s original collateral, the so-called 21-day rule applies, which requires the bank to have taken alternative or additional measures to ensure continuing priority and perfection over its collateral as that collateral changed forms from accounts receivable to cash. See section 9-315(d).

Bankers have been (incorrectly) taught from the beginning of their careers that they hold a first place lien on all borrower assets once they hold the oldest UCC-1 then in ef-
They get angry when they learn that long after the bank made a loan to Company XYZ and filed the earliest UCC-1, an MCA has been withdrawing cash from Company XYZ's checking account. And if that borrower later fails and the bankers are already looking around for creative ways of recovering losses, bankers tend to think of MCAs as relatively deep-pocketed targets who have stolen the bank's collateral and need to give it back. For banks and other more traditional secured lenders, collateral is sacred and something that they will fight to defend.

**The Typical MCA Position**

MCAs live in a world in which collateral is important but not a primary concern. For them, cash flow is king. MCA transactions typically last only a few months, although they are often extended or rolled over. MCAs therefore do not dwell like banks do on the long term viability of their clients in deciding to do a deal. As described above, MCAs recover their investments in a client with daily ACH withdrawals of cash from a client's corporate checking account. They therefore focus on short term cash flow in their underwriting. A common corporate checking or operating account is called a “deposit” account in the language of the UCC-9. See definition found at Section 9-102(29). This “deposit account,” it turns out, is often the point of the banks’ greatest weakness.

What bankers often fail to remember is that a UCC-1 financing statement cannot perfect a lien against absolutely all forms of collateral. Under Section 9-312, the UCC-1 financing statement is powerless to perfect a lien against a “deposit” account, which happens to be the receptacle where most of a borrower’s free cash is held. Rather, the only way to perfect a lien on a deposit account is through “control.” Section 9-312(b). Moreover, and this is critical, perfection of a lien by effect of “control” lasts only “while the secured party retains control.” Section 9-314(b).

Control and the exercise of control require would-be senior secured lenders to do more than simply make a filing. They must instead normally enter into three-way control agreements, called deposit account control agreements (DACA), with their borrower and with the bank that acts as the depository for the borrower’s corporate checking account.

DACAs, in turn, normally require certain actions to be taken before the control theoretically provided for in their terms can be exercised. Daily monitoring of the borrower’s checking account is required to do this job right, so that any offending payments that a borrower might otherwise want to make (such as to an MCA) can be prevented by a senior lender using payment veto rights created by a DACA. Banks very often fail to pay proper attention to their DACAs. After making the shocking discovery that somebody else has been siphoning off their borrowers’ cash, their most precious collateral, bankers demand repayment from MCAs or threaten litigation. By that time, their borrowers have long ago signed an MCA agreement and have been allowing daily withdrawals by an MCA to go on for weeks, months, or years.

The MCA response to a banker’s accusation is typically aggressive: If you controlled your borrower’s cash, then how come we have it? To the MCAs anyway, the fact that MCAs withdrew the cash from a client’s checking account is, *ipso facto* dispositive evidence that the bank did not continually “retain” control over its borrower’s checking accounts and accordingly did not hold a perfected lien on cash under Section 9-314(b).

At this point, the debate tends to devolve into a now-familiar and somewhat futile exchange of prefabricated talking points. With money, careers, and reputations on the line, nobody volunteers to be persuaded by the other side’s arguments. Bankers argue that they are not in a position to monitor where every last cent of their borrower’s cash is sent, and, moreover, they would be precluded from vetoing cash disbursements due to lender liability concerns. Bankers accuse MCAs of teaching borrowers how to violate their contracts with banks, control of cash or no control of cash. Bankers also argue that Section 9-312(b) creates an exception to the general rule that a lien against cash can only be perfected through control, an exception that allows liens on cash that is the “proceeds” of the bank’s collateral. MCAs respond that it is not clear that any given dollar is truly the identifiable proceeds of the bank’s collateral, which is a condition to qualify for the clearest exception to Section 9-312(b). See Section 9-315(d). MCAs ask banks why they did not better tend to their clients’ capital needs, such that the clients had to come to MCAs to begin with.

It is normally at this point in the exchange of fire that MCAs roll out their heaviest cannon: Section 9-332(b). This section — much like the holder-in-due-course rule, the good
faith purchaser rule, and a slew of similar legal doctrines—is intended to protect the free flow of assets and money in the American economy. It would be difficult or impossible to conduct business having to wonder what hidden liens might be attached to every dollar one receives from a counterparty. For this reason, many lawyers believe that Section 9-332(b) strips the liens off of every dollar leaving a borrower’s checking account. The language of Section 9-332(b) is short and direct by UCC standards:

A transferee of funds from a deposit account takes the funds free of a security interest in the deposit account unless the transferee acts in collusion with the debtor in violating the rights of the secured party.

At first glance, the language might appear to offer some hope to a jilted bank that thought it has first priority in everything, including borrower cash. Was not the transaction between the MCA and the borrower, which converted the bank’s collateral, a form of “collusion”? The answer is likely not. Article 9 of the UCC borrows the word “collusion” from Article 8, which makes clear that “collusion” requires a lot of wrongdoing and requires active “complicity” in tort-like behavior. Indeed, the official comments to article 8 make clear that knowing that a given action is wrongful is not enough to satisfy the collusion test. See official comment 5 to Section 8-115 of the UCC. For an unpublished opinion analyzing the issue of whether collusion exists, see Small Bus Fin Sols, LLC v Pearl Beta Funding, LLC, No 411478-V (Md Cir Ct Sept 29, 2017). MCAs who might suspect or know that a client who signs an MCA contract is violating its already existing obligations to its bank are not necessarily “colluding” with the client. The issue depends very much on the facts, which makes summary judgment on this issue difficult.

The Author’s Experiences in Litigation

Most courts have viewed Section 9-332(b) as a game-winner, with the Fifth Circuit Court of Appeals being a notable exception. Section 9-332(b) leaves little room for maneuver to a bank claiming that the funds that an MCA took from a borrower’s deposit account came with a bank lien still attached. MCAs are without question “transferees” of funds from their clients’ deposit accounts. While traditional secured lenders are able to show that they once had a lien under Section 9-315 on funds if those funds are identifiable proceeds of their collateral, most caselaw holds that the lien on funds is stripped away when the funds are transferred from a checking account into the possession of the MCAs.

This leaves the banks with no lien-based theory of recovery against MCAs, which could otherwise be their most direct route to a recovery. They can still resort, and often do, to standard tort theories such as “tortious interference with a contract.” These tort theories, however, are weak because the banks were in a position to prevent their losses from happening in the first place if they had just paid attention to their borrowers’ deposit accounts. Banks are frequently viewed by courts as sophisticated actors who “should have known better” and apparently preferred not to expend the resources necessary to take control over their borrowers’ cash. At times, the very bank claiming to have been cheated was also the depository institution where the borrower maintained its checking account, making the bank’s constructive knowledge of what was happening easy to prove. Even when the checking account is maintained at a third-party bank, at times it appears banks were aware of their borrowers’ dealings with MCAs and allowed those financings to happen because the extra money kept their borrowers from operational collapse.

If a client’s music stops at the wrong moment from the MCAs’ point of view, they can also demonstrate in litigation that they put more money into a company than they took out. This leaves banks with challenges in proving damages. Sometimes banks allege that the MCA “ruined” their client, thereby indirectly causing financial losses. Proving that complex causal argument at trial is difficult. MCAs can answer bank lawsuits with general denials and a slew of affirmative defenses such as estoppel, waiver, failure to mitigate, and the like. A bank’s tort-based attacks on MCAs can easily become bogged down in a hilly and swampy factual terrain favoring the defense.

Salient Caselaw

The UCC-based debate generally described above has dominated the discussions found in various fairly recent cases concerning Section 9-332(b). Section 9-332(b) is a relatively recent addition to the UCC and replaces an older but similar provision once given the number 9-306. Accordingly, there is still not
Most courts have viewed Section 9-332(b) as a game-winner, with the Fifth Circuit Court of Appeals being a notable exception.

- In *Stierwalt v Associated Third Party Adm’rs*, No 16-mc-80059, 2016 US Dist LEXIS 68744 (ND Cal May 25, 2016), a judgment creditor receiving funds out of a checking account by effect of a writ of execution trumped the claims of an earlier existing creditor who claimed that the money in the checking account was “proceeds” of its collateral. Id. at **15-25. The court rejected the argument that a party taking funds from an account through a writ of execution was not a “transferee” for purposes of 9-332(b). Id. at *23.

- In *In re Delano Retail Partners*, No 11-37711-B-7, 2017 Bankr LEXIS 2397 (Bankr ED Cal Aug 14, 2017), a previously existing secured creditor claimed that a Chapter 7 bankruptcy trustee had no right to take funds held in a debtor’s checking account that were subject to a lien as the proceeds of the creditor’s collateral. Notably, the trustee had taken the funds using Bankruptcy Code Section 544 strong-arm powers, because no creditor had exercised prepetition control over the checking account, and accordingly no lien had been perfected. Id. at *24. The court ruled that Section 9-332(b) stripped any proceeds-based lien from the funds held in the checking account. Id. at **25-29. The ruling in *Delano* is at direct odds with the *Garner* decision from the Fifth Circuit, discussed in detail below, because the *Delano* court ruled that all liens, not just liens focusing on deposit accounts themselves, were stripped by Section 9-332(b). Id. at *20. This included the funds held in a deposit account on which a third party had claimed a proceeds lien. Id.

- In *In re Charleston Assocs, LLC*, No 13-10449-MKN, 2017 Bankr LEXIS 4581 (Bankr D Nev Dec 12, 2017), a senior secured bank (U.S. Bank) obtained an agreement from a depository bank that supposedly gave it control over an account’s contents. Actual “control,” however, apparently was not exercised because funds still left the account in question and were transferred to City Bank. The *Charleston Assocs* court ruled that Section 9-332 protected City Bank (the recipient of the funds), trumping U.S. Bank’s security interest. Id. at **12-15.

- In *Orix Fin Servs, Inc v Kovacs*, 167 Cal App 4th 242 (2008), the court considered the terms of current Section 9-332 and compared it to a similar (and less stringent) analogue that previously existed as Section 9-306. That court determined that Section 9-332(b) was intentionally written to impose an even higher burden on secured parties attempting to disgorge cash from any third party who receives cash from a debtor’s checking account. Id. at 249.

- In *VendorPass, Inc v Texo Sols, LLC*, No A-4015-14T2, 2017 NJ Unpub LEXIS 256 (NJ Super Ct Feb 2, 2017), a court ruled that the receipt by a creditor of funds from an account served as an effective affirmative defense to the claims of a competing creditor, even though the plaintiff admitted that it held no lien whatsoever on the funds or deposit account in question. Id. at *14. Section 9-332(b) would clearly seem irrelevant to this case, given the absence of any lien in the fact pattern, and yet the court notably used it to shield the funds in question from competing “claims” by the transferee/defendant. The case is therefore strange and an arguable misuse of Section 9-332(b) in that it was used here to clear away claims and not liens, an expansion on its text.

- In *Heartland Bank & Trust Co v Letter Grp*, 2014 IL App (3d) 130498, a usurping junior creditor took certain checks from the debtor’s clients that were already subject to a senior bank’s lien, and then deposited those checks into its own checking account by effect of a writ of execution. Id. at *21-22. The court ruled that the funds were not “proceeds” of the checks, and accordingly no lien had been perfected. Id. at *22. The court then considered Section 9-332(b) and held that it did not apply because the funds were not taken from a checking account. Id. at *23. The court’s holding was directly contrary to the *In re Delano Retail Partners* decision, discussed in detail below, because the *In re Delano Retail Partners* court ruled that Section 9-332 stripped any proceeds-based lien from funds held in a checking account. Id. at **25-29. The court in *Heartland Bank & Trust Co v Letter Grp* then considered the question of whether the funds were subject to a lien, and held that they were because the senior secured bank had exercised prepetition control over the funds. Id. at *23-24.

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A bank’s tort-based attacks on MCAs can easily become bogged down in a hilly and swampy factual terrain favoring the defense.
electricity, tables, chairs, etc. might find themselves called upon to return ordinary payments (from a commingled account) to a debtor’s secured creditor….


The Garner Case

One powerful federal court has taken a position contrary to the cases above. See Garner v Knoll, Inc (In re Tusa-Expo Holdings, Inc), 811 F3d 786 (5th Cir 2016). In Garner, the Fifth Circuit Court of Appeals confronted a bankruptcy preference action in which a key supplier and creditor of a bankrupt furniture retailer was accused of receiving a multi-million dollar preference by a bankruptcy trustee. Id. at 790. Preference defendant Knoll was the actual maker of the furniture and found itself exposed to a potential multi-million dollar loss through no real fault of its own, a fact which the author believes heavily influenced the court. The question of whether Knoll had received a preference turned on whether the cash Knoll had received from the debtor was Knoll’s own collateral anyway.

The appellate court in Garner ruled that the money that Knoll had received was the proceeds of Knoll’s collateral, and that Knoll’s cash collateral that was still the subject of Knoll’s own perfected lien even when Knoll received it from the debtor’s deposit account. Accordingly, Knoll received no preference despite receiving funds from a deposit account, the language of Section 9-332(b) notwithstanding. For Knoll anyway, the humble furniture maker whose labor made the debtor’s business possible, this result seems intuitively fair, albeit at odds with the text of the UCC. The court’s decision in Garner rescued the furniture maker from a $4.5 million preference action.

To arrive at this conclusion, the court took a decidedly narrow textualist approach that drew a distinction between (A) a lien on funds held in a deposit account and (B) a lien on the deposit account itself. The court ruled that under the plain meaning of Section 9-332(b), only liens on the deposit account were stripped by Section 9-332(b), and thus a lender’s Section 9-315(c) lien would continue to attach to the funds as they exited the account. The court found that closely comparing the language of Sections 9-332(b) with 9-332(a), which applies to paper “money” as opposed to “funds,” compelled this result. Id. at 795-96.

To the author, at least, the Garner decision appears incorrect and in open conflict with other provisions of the UCC. The word “funds” is not defined by the UCC, nor does any provision of the UCC speak of how to perfect a security interest in “funds.” It therefore seems strange that the Garnet court assumed that the security interest in funds, which is nowhere directly contemplated by the UCC, was distinct and separate from the security interest in the deposit account where these funds reside.

It is also unclear why the UCC would create different rules for “funds” and for “money,” as the Fifth Circuit insists must exist. Id. at 796. It is equally unclear why a person wanting to take a lien on a deposit account must exercise control at all times or lose the lien under Section 9-314(b), and yet a different creditor holding a lien on cash “proceeds” can apparently take no care whatsoever as it concerns “funds” and still be safe, even though these funds are often held in a deposit account. It is the very essence of accounts receivable, after all, that they usually change in form and become cash when account debtors pay their bills. Creditors or buyers taking a lien in accounts receivable know that the collateral will eventually convert to cash. No gentler standard of care as it pertains to cash need apply to them.

To the author, at least, the UCC has intended “funds” to simply mean non-paper money, electronically held money, that can really only exist or be transferred so long as it is credited to and held within a deposit account or some other similar abstract and often electronic receptacle. There is, therefore, no meaningful distinction between “funds” and “funds held in a deposit account,” which is why the author believes that the language of Sections 9-332(a) and 9-332(b) differ as they do without intending or commanding the result in Garner. To the author, the phrase “held in a deposit account” was placed in Section 9-332(b) merely to add more information as to what the otherwise undefined “funds” might be, not to redirect Section 9-332(b) so that it no longer removed liens from “funds.” Indeed, the official comment 2 to Section 9-315 expressly contemplates that Section 9-332 would strip a lien from “funds,” which also contradicts Garner. The Fifth Circuit’s rigid textualist approach,
in other words, finds and heeds a distinction that does not exist.

Regardless of the legal merits, Garner would allow money to enter the stream of American commerce with invisible liens attached to every dollar, which is contrary to the policy so aptly described above by now Supreme Court Justice Breyer. Those liens, in turn, could arguably still exist when the money passes still further downstream in commerce to subsequent transferees. “Arguably” is an apt word, because somebody will eventually make this troubling argument, once money is on the line. (See generally Sections 9-201(a) and 9-315(a), which provide for lien survival upon transfers of collateral, subject to various exceptions and defenses.)

The best ruling concerning Section 9-332(b), albeit one that will at times lead to harsh results for incompetent creditors, would demand that holders of liens on funds in deposit accounts take all steps to ensure continuing liens on these funds using control and monitoring. These chronic fights between MCAs and other lenders would be prevented if the exit of cash from the relevant accounts was itself prevented through bank control. Section 9-332(b) should be given the broadest reading possible for the benefit of all parties concerned. This would give banks and other secured lenders that do their jobs as secured lenders properly a decided competitive advantage, and it would allow them to prevent MCA usurpation of their positions without anybody having to litigate. This same clear rule also helps MCAs tremendously, who will no longer be sued or treated as retroactive guarantors or insurers for bank loans that go bad. Clarity helps everyone.

Some Suggestions for Improvement (or Can’t We All Get Along?)

Both sides would be considerably aided by a better understanding of the law. MCAs appear at times oblivious to the fact that, if a potential client already has a UCC-1 filing against all of its assets, then a third party considers accounts receivable to be spoken for. It makes no difference if the MCA is a true sale buyer, since the UCC effectively does not recognize a difference between buying a receivable and lending against it. See Section 9-109. It also makes no difference if the MCA is only buying interest in future accounts, since any previously existing lender can still claim future or “after-acquired” collateral as its own. See Section 9-204. Thus, choosing to do business with a company whose assets are already covered by a third party’s UCC-1 filing is asking for trouble, even if there are colorable legal justifications for doing so.

Senior secured lenders appear at times to be equally oblivious to the amount of monitoring and administration that is required to truly have a watertight security interest on cash. As discussed above, they often fail to take steps to control cash, and as a result, they lose their most important and liquid collateral. That first loss, in turn, compels them to the often unwise decision to take a second loss in the form of protracted and cost-ineffective litigation.

If MCAs were to contact senior lenders and seek to make arrangements with them prior to advancing funds, this would greatly reduce the tension. Banks are indeed helped when third parties help to keep their more fragile borrowers alive. The two sides could then negotiate a suitable intercreditor agreement that would provide stability and predictability for both sides.

Even when a full conflict is inevitable, both sides would be well served by dialing down the institutional contempt they claim to have for the other. MCAs are here to stay, and they provide valuable survival money to hundreds of companies every year. Many MCA managers are ex-bankers. Yes, MCA money can be more expensive than most bank loans, but bank loans are not always available to startups and turnarounds. Startups and turnarounds employ millions of Americans and provide this society with valuable products, and they do it with the help of MCAs. MCA clients are not fools and should not be patronized. If signing the MCA contracts did not make sophisticated corporate clients better off, they presumably would not sign.

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lar that they ever received. This tactic arguably seeks a windfall and ensures a long legal fight. As the UCC already recognizes in its provisions pertaining to purchase money security interests, senior lenders are not materially harmed when junior creditors inject new capital into a company. This approach would leave the litigants fighting only about the excess money that the MCAs took from a borrower, rather than every last dollar that left the borrower’s account in route to an MCA.

In sum, this pattern of ignoring realities on the front end and then fighting to the death on the back end is not working for anybody.3

NOTES

1. UCC section citations are commonly referred to with the applicable UCC Article number preceding them, such that Section 109 of Article 9 of the UCC is called “Section 9-109.” Due to slight variations and modifications made to the generic UCC enacted by each state, this article will specifically refer to the UCC in effect in Illinois.

2. While this article describes litigation between banks and MCAs, which is indeed the classic scenario, any financial service provider with a “first in time” UCC-1 filing is apt to file a lawsuit if it feels its position has been wrongfully usurped by a competitor and there are losses to be mitigated in so doing. Substantively identical litigation can take place between MCAs, between banks, or between factors and MCAs.

3. The author thanks senior associate Matthew Schmidt for his research assistance in writing this article. The author also thanks his partner Bevin Brennan for her edits and comments.

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Comerica, Inc, v Department of Treasury, No 344754, ___ Mich App ___, ___ NW2d ___ (Apr 16, 2020)

This case arose from the Department of Treasury’s calculation of the franchise tax for a unitary business group (UBG) under the Michigan Business Tax Act (MBTA) and the forwarding of tax credits under the Single Business Tax Act when two UBG entities merge into one. Originally, petitioner was a bank holding corporation called “Comerica-Michigan” that eventually converted itself into a Texas banking association. First, petitioner created Comerica-Texas in October 8, 2007. Then, on October 31, 2017, Comerica-Michigan merged into Comerica Texas. With this merger, Comerica-Michigan ceased to exist. Earlier in 2013, respondent audited petitioner’s 2008-2011 MBT returns and reduced petitioner’s refund. This adjustment was because of respondent’s calculation of petitioner’s net capital and claimed tax credits. Specifically, respondent treated petitioner’s two entities as separate entities with their own net capital because the MBTA required an accounting for the years before the merger. Respondent argued that the tax credits earned by Comerica-Michigan could not be reassigned to Comerica-Texas because these tax credits were assigned by a limited liability company in 2005 and that these credits could not be reassigned more than once under the SBTA.

Petitioner disputed the refund reduction before the Michigan Tax Tribunal. Petitioner argued that respondent both double counted petitioner’s net capital and wrongfully disallowed the tax credits because the tax credits were not assigned, but rather transferred by operation of law because of the merger. The tax tribunal agreed that respondent improperly calculated petitioner’s net capital, but affirm respondent’s disallowance of the tax credits “because the merger was not unintentional or involuntary” and was therefore not a transfer by operation of law.

Both sides appealed to the Michigan Court of Appeals. The court held that respondent erred in its interpretation of petitioner’s base tax. However, the court reversed the tribunals holding that the tax credits could not be transferred. The fundamental dispute between the parties was whether the SBTA permitted the credits to transfer by a means other than an assignment. The SBTA specifically limited the number of times that tax credits could be assigned to a single assignment. However, because the tax credits here were not assigned, but rather transferred according to the merger, they were not subject to the single-assignment limitation. The Court of Appeals determined that the term assignment was not synonymous to a transfer of the tax credits under a merger. In light of this, the Michigan Court of Appeals reversed the tax tribunal in part.

Goodman v JP Morgan Inv Mgmt, Inc, 954 F3d 852 (6th Cir 2020)

This case began as a result of allegations that J.P. Morgan Investment Management Company (JPMIM) breached its fiduciary duty under the Investment Company Act (ICA). Nancy Goodman and the Campbell Family Trust, plaintiffs, were shareholders in mutual funds (the Funds). J.P. Morgan provided certain investment advisory services in managing the funds. Plaintiffs sued J.P. Morgan as shareholders arguing that JPMIM charged excessive fees for these services under section 36(b) of the ICA.

In order to impose liability under section 36(b), a shareholder must show that the challenged fees were disproportionately high considering all relevant factors. The district court considered these factors and determined that they favored JPMIM. The plaintiffs argued that the district court should compare the fees JPMIM charged to other funds for its different role as a subadvisor to the fees it charged to the funds as an advisor, and that the difference in these charges supported its argument that JPMIM was charging excessive fees. The district court declined to do this and granted summary disposition toward defendants. Plaintiff then appealed to the Sixth Circuit.

Plaintiff’s argument on appeals was identical: “that the comparative fee structures and services provided to the Funds can be aptly compared to the Subadvised Funds.” This, plaintiff’s argued, created a genuine issue of fact regarding whether JPMIM’s disproportionately large advisory fee could be explained by arm’s-length bargaining. JPMIM countered that the funds and subadvised funds were not comparable. The Sixth Circuit agreed and held that “the Funds are not comparable to the Subadvised Funds but are comparable to certain other mutual funds that realized similar performance.” The difference in fees between the funds and subadvised funds was sufficiently explained by a number of factors that made the subadvised funds both riskier and more complex. Moreover, the balance of factors in this case caused the Sixth Circuit to conclude that the other factors under the Gartenberg test supported the district court’s ruling. Because the district court did not clearly err, the Sixth Circuit affirmed.
Index of Articles
(vol 30 and succeeding issues)*

ADR
ADR provisions in business agreements, 36 No 2, p. 18

Affordable Care Act, business of medicine for independent practitioner, 33 No 2, p. 46

American Taxpayer Relief Act of 2012, 33 No 1, p. 7

Automotive acquisitions, current risks, 33 No 2, p. 36

Automotive suppliers
dual-source requirements contracts, 32 No 3, p. 19

Bankruptcy. See also Preferences
Bankruptcy Court Rules, amendments to Rule 3001 and 3002.1, 33 No 1, p. 18
expert witnesses, avoiding traps for the unwary, 34 No 2, p. 18
foreclosure, bankruptcy forum to resolve disputes 30 No 1, p. 17
fraudulent transfers and In re Tousa, reasonably equivalent value, 33 No 1, p. 31
proof of claim, whether and how to file, 30 No 1, p. 10
rental property, 37 No 2, p. 37
Stern v Marshall and bankruptcy court authority, 33 No 1, p. 12
tenancy by the entireties, 39 No 2, p. 35
trustees and fraud, 38 No 1, p. 17
tuition, 38 No 1, p. 59

Banks. See Financial institutions
Benefit corporation and constituency statutes, 35 No 2, p. 35

Bitcoin and the future of currency, 34 No 2, p. 25
Builders Trust Fund Act debts, conversion as basis for nondischargeability, 33 No 1, p. 25

Business Court in Michigan
arbitration and pre-suit mediation 35 No 3, p. 21
Business Court Act presents opportunities and challenges 33 No 2, p. 11
insurance coverage disputes and early expert evaluation 32 No 3, p. 26

Business identity theft, 34 No 3, p. 36
CFIUS annual report, 33 No 2, p. 40

Charities. See Nonprofit corporations or organizations
China
doing business in China, 34 No 2, p. 13
set up a wholly-owned enterprise, how to, 36 No 2, p. 34
unique registered numbers, operation of business licenses in China, 35 No 2, p. 51

Commercial litigation
claim preclusion in Michigan, call for clarity, 36 No 1, p. 38
common-interest or joint defense agreements, 32 No 1, p. 11; 36 No 1, p. 32
diversity jurisdiction and LLCs, 32 No 1, p. 21
jury trial, 39 No 1, p. 31

Competitor communications, avoiding sting of the unbridled tongue, 18 No 1, p. 18

Computers. See Technology Corner.
Confidential supervisory information, 39 No 3, p. 31
Consumer protection claims
Dodd-Frank Wall Street Reform and Consumer Protection Act and the Consumer Financial Protection Bureau, 20 No 2, p. 13
Fair Credit Reporting Act of 1970, plaintiff’s standing under Article III of the Fair, 36 No 2, p. 39

Contracts. See also Automotive suppliers
agreements to agree, drafting tips, 32 No 1, p. 25
dual-source requirements contracts, automotive suppliers, 32 No 3, p. 19
electronic contracting, 31 No 2, p. 9
exclusivity and requirements contracts, automotive suppliers, 32 No 1, p. 44
indefinite duration contracts, risks and strategies, 32 No 3, p. 13

Conversions of entities, 31 No 1, p. 7; 32 No 2, p. 6
Copyrighs, tax treatment of protected property, 32 No 3, p. 37
Corporate counsel. See In-house counsel
Corporations. See also Nonprofit corporations; Securities benefit corporation and constituency statutes, 35 No 2, p. 35
Business Corporation Act amendments, 33 No 2, p. 18;
37 No 3, p. 17
corporate governance, 31 No 3, p. 29
Delaware and Michigan incorporation, choosing between, 34 No 3, p. 13
director and officer liability insurance fundamentals, 31 No 3, p. 17
dissolution agreements, 36 No 2, p. 44
dissolution, corporate existence after, 32 No 3, p. 5
fiduciary duties in corporate and LLC context 36 No 1, p. 48; 38 No 2, p. 32; 38 No 3, p. 16
S corporations, 31 No 2, p. 7
Section 488 revisited, opportunities for flexible governance, 31 No 3, p. 10

Creditors’ rights. See also Bankruptcy; Judgment lien statute
Builders Trust Fund Act debts, conversion as basis for nondischargeability, 33 No 1, p. 55
debtor exemptions, history and future, 30 No 2, p. 57;
31 No 2, p. 14
garnishment, growing menace for Michigan employers, 31 No 2, p. 17
plaintiff’s standing under Article III of the Fair Credit Reporting Act of 1970, 36 No 2, p. 39
Crowdfunding, 34 No 1, p. 5; 34 No 3, p. 28; 36 No 1, p. 5
Cyberinsurance, 32 No 3, p. 9
Cybersecurity risks and disclosure, 32 No 2, p. 10; 35 No 1, p. 9; 35 No 2, p. 26; 35 No 3, p. 41
Data breach legislation, 31 No 3, p. 9

*For cumulative index from volume 16, go to http://connect.michbar.org/businesslaw/newsletter.
Delaware and Michigan incorporation, choosing between 34 No 3, p. 13

Did You Know?
  Corporate Division information, 33 No 2, p. 5
corporate existence after dissolution, 32 No 3, p. 5
crowdfunding, 34 No 1, p. 5
dissolution of nonprofit corporation, 33 No 3, p. 5
electronic seals, 34 No 1, p. 5
entity conversions, 31 No 1, p. 7
intrastate offering exemption, 34 No 2, p. 5
medical marijuana, 31 No 2, p. 5; 31 No 3, p. 5
nonprofit corporations amendments, 33 No 3, p. 5
professional corporations, 33 No 1, p. 5
Regulatory Boards and Commissions Ethics Act, 34 No 3, p. 5
service of process on business entities and other parties, 30 No 1, p. 5
summer resort associations, 35 No 1, p. 5
what’s in a name, 32 No 1, p. 5
Discovery amendments, 39 No 2, p. 15
Dissolution
corporate existence after dissolution, 32 No 3, p. 5
dissolution agreements, 36 No 2, p. 44
Diversity jurisdiction and LLCs, 32 No 1, p. 21
Dodd-Frank Wall Street Reform and Consumer Protection Act and the Consumer Financial Protection Bureau, 30 No 3, p. 13
Electronic Shares, 37 No 3, p. 56
Emergency Financial Manager Law and impact on creditors, 32 No 1, p. 52
Employment. See also Noncompetition agreements
  ICE audit campaign, 30 No 2, p. 63
  restrictive employment agreements, 39 No 1, p. 24
  social networking, management of legal risks, 30 No 2, p. 44
Estate tax uncertainty in 2010, 30 No 1, p. 8
Exclusivity and requirements contracts, automotive suppliers, 32 No 1, p. 44
Federal government
  acquisition of federal government contractor, avoiding pitfalls, 32 No 3, p. 30
  selling goods and services with reduced risk through commercial item contracting, 31 No 1, p. 41
Fiduciary duties
  fiduciary duties in corporate and LLC context, 36 No 1, p. 20
  officers and managers, 38 No 1, p. 64
Financial institutions
  disparate impact and its effect on financial services, 33 No 3, p. 22
  Dodd-Frank Wall Street Reform and Consumer Protection Act and the Consumer Financial Protection Bureau, 30 No 3, p. 13
  good faith approach to lender liability, 33 No 3, p. 29
  insolvent counterparty, strategies for dealing with, 33 No 3, p. 11
loan modification procedures and exclusive statutory remedy, 33 No 3, p. 17
mapping fall from troubled company to bank fraud, 33 No 1, p. 42
troubled banks mean trouble for bank directors, 30 No 3, p. 22
Financial technology, 39 No 3, p. 18
Foreclosure, use of receiver or bankruptcy as alternative to, 30 No 1, p. 17
Foreign defendants, serving in Michigan courts, 30 No 1, p. 49
Forum selection clauses, enforceability of international clauses, 30 No 3, p. 40
Franchises
  Introduction to franchising law, 35 No 3, p. 46
Fraudulent transfers
  Janvey v Golf Channel, 38 No 1, p. 54
  reasonably equivalent value, 33 No 1, p. 31
Garnishment, growing menace for Michigan employers, 31 No 2, p. 17
Health Care Law, 37 No 2, p. 28
Identity theft, 31 No 1, p. 11; 34 No 3, p. 36
Immigration
  ICE employer audit campaign, 30 No 2, p. 63
Indemnification clauses, 32 No 1, p. 31
In-house counsel
  careers in compliance, 37 No 3, p. 15
  consulting, 26 No 3, p. 11
  how to be a successful in-house counsel, 38 No 1, p. 14
  law firm partnership, 38 No 3, p. 10
  from law school to in-house counsel, 35 No 3, p. 12
  leveraging public section skills, 35 No 2, p. 11
  make yourself marketable for other jobs, 36 No 2, p. 12
  new job considerations, 36 No 1, p. 11
  nondisclosure agreements, 39 No 2, p. 13
  overseas insight, 37 No 2, p. 11
  professional development plan, 36 No 3, p. 29
  small legal department but big job, 35 No 1, p. 11
  transitioning from law firm to in-house, 34 No 2, p. 11
  transforming a career from legal office to business office, 34 No 3, p. 11
Upjohn warnings, 40 No 1, p. 16
Insurance
  business courts, coverage disputes, and early expert evaluation, 32 No 3, p. 26
  cyberinsurance, 32 No 3, p. 9
Intellectual property
  IP license rights in mergers & acquisitions, 33 No 2, p. 9
  RICO and theft of trade secrets, 31 No 2, p. 23
Internal affairs doctrine, foreign corporations, 37 No 3, p. 23
International Trade Commission
  preventing importation of goods, 32 No 1, p. 39
  unfair trade relief actions (ITC Sec. 337), 36 No 2, p. 9
International transactions
  forum selection clauses, enforceability, 30 No 3, p. 40
  unfair trade relief actions (ITC Sec. 337), 36 No 2, p. 9

INDEX OF ARTICLES
Internet. See also E-mail; Privacy; Technology Corner.

Michigan Internet Privacy Protection Act, 33 No 1, p. 10
Investigations by federal government, 40 No 1, p. 29
Investing by law firms in clients, benefits and risks, 22 No 1, p. 25
Judgment lien statute
shortcomings of judgment lien statute, 31 No 1, p. 48
Lawyers and the economy, greasing the gears of commerce, 32 No 2, p. 46
Limited liability companies (LLCs)
2010 LLC Act Amendments, 31 No 2, p. 10
dissolution agreements, 36 No 2, p. 44
diversity jurisdiction and LLCs, 32 No 1, p. 21
fiduciary duties and standards of conduct of members, 36 No 1, p. 20
limitations on transfer of membership interests, 31 No 1, p. 31
meaning of operating agreement, 30 No 2, p. 2
single-members LLCs, 30 No 2, p. 20
Litigation. See Commercial litigation
Marijuana business, 39 No 3, p. 25
Medical marijuana, 31 No 2, p. 5
Mergers and acquisitions
automotive acquisitions, 33 No 2, p. 36
class action settlements, 37 No 1, p. 26
federal government contractor, avoiding pitfalls when acquiring, 32 No 3, p. 30
personal goodwill in sales of closely-held businesses, 33 No 3, p. 37
Michigan Domestic Asset Protection Trust Statute, 38 No 1, p. 24
Michigan Sales Representative Commission Act, 37 No 2, p. 14
Michigan Uniform Voidable Transactions Act, 38 No 1, p. 31
Minority oppression
Existence and scope of claims, 36 No 2, p. 25
Naked licenses, trademark abandonment, 32 No 1, p. 35
National Highway Traffic Safety Administration, the regulatory era, 26 No 3, p. 17
Noncompetition agreements
choice of law, 36 No 1, p. 26
enforceability, reasonableness, and court’s discretion to “blue pencil,” 31 No 3, p. 38
protecting competitive business interests, 30 No 2, p. 40
recent cases (2015), 35 No 2, p. 56
trade secrets and noncompetition agreements, impact of murky definitions, 36 No 1, p. 12
Nonprofit corporations or organizations
2015 amendments to Nonprofit Corporation Act, 35 No 2, p. 13
avoiding pitfalls in nonprofit practice, 32 No 2, p. 12
benefit corporation and constituency statutes, 35 No 2, p. 35; 37 No 3, p. 30
blockchains and charities, 38 No 2, p. 26
Charitable Institution Exemption, 38 No 2, p. 44
Cooperative Entities, 38 No 2, p. 50
cybersecurity responsibilities of nonprofit officers and directors, 35 No 2, p. 26
electronic voting, 38 No 2, p. 21
political activity by nonprofits, 32 No 2, p. 19
protecting charitable assets, new model act, 32 No 2, p. 25
review of federal and state requirements affecting tax-exempt organizations, 35 No 2, p. 20
social enterprise structures in tax-exempt public charities, 35 No 2, p. 29
tax reform, 38 No 2, p. 14
youth camp programs, assessment of risks for nonprofits, 32 No 2, p. 31
Partnerships
dissolution agreements, 36 No 2, p. 44
partner liability, 39 No 2, p. 23
revision of the Uniform Partnership Act, 39 No 2, p. 27
tax audit procedures, changes to agreements in light of, 36 No 2, p. 14
unintended partnerships, 33 No 2, p. 24
Personal property liens, secret liens in need of repair, 35 No 3, p. 31
Physicians, business of medicine under the Affordable Care Act, 33 No 2, p. 46
Political activity limitations, 38 No 2, p. 37
Preferences
earmarking defense, gradual demise in Sixth Circuit, 30 No 1, p. 25
minimizing manufacturer’s exposure by asserting PMSI and special tools liens, 30 No 1, p. 41
ordinary terms defense, 30 No 1, p. 34
Privacy
workplace, clarification by US Supreme Court, 30 No 2, p. 11
Professional corporations, 33 No 1, p. 5; 33 No 2, p. 18
Proof of claim, whether and how to file, 30 No 1, p. 10
Public debt securities, restructuring, 22 No 1, p. 36
Public records, using technology for, 19 No 2, p. 1
Public welfare investments, 39 No 3, p. 12
Receiverships
appointment, 35 No 1, pp. 19, 30, 32; 36 No 3, p. 13
commercial real estate, 38 No 3, p. 22
flexibility of receiverships vs. certainty of bankruptcy, 35 No 1, p. 32
forms, 35 No 1, p. 13; 36 No 1, p. 44
overview, 35 No 1, p. 13
payment of receiver, 35 No 1, p. 24
qualifications under MCR 2.622, 35 No 1, p. 27
standing under MUVTA, 38 No 1, p. 34
statutory and court rule requirements for appointment, 35 No 1, p. 30
view from the bench, 35 No 1, p. 37
Requirements contracts, 39 No 3, p. 43
Retirement plan assets to fund start-up company, 30 No 2, p. 34
RICO and theft of trade secrets, 31 No 2, p. 23
ROBS transaction to fund start-up company, 30 No 2, p. 34
S corporations
- synthetic equity, avoiding tax traps when planning for key employees, 35 No 1, p. 64
- Sandbagging provisions, 39 No 1, p. 12

Securities
- caselaw regarding Michigan’s Uniform Securities Act, 37 No 1, p. 13
- crowdfunding for small businesses in Michigan, 34 No 3, p. 28
- enforcement trends under Michigan Securities Act, 40 No 1, p. 6
- fairness hearing procedures, 36 No 1, p. 5
- going public is not merely the S-1 registration statement, 34 No 1, p. 28
- intrastate offering exemption, 34 No 2, p. 5
- investment securities, revised UCC Article 8, 19 No 1, p. 30
- overview of Michigan securities regulation, 31 No 1, p. 12
- Plain English movement of SEC, FINRA, and OFIR, 31 No 1, p. 19
- SEC whistleblower program, what employers need to know, 34 No 1, p. 13
- secondary liability and “selling away,” 30 No 2, p. 49
- short selling regulation, alternative uptick rule, 30 No 3, p. 32
- simplifying securities regulation of M&A brokers, 34 No 1, p. 21
- Sixth Circuit opinions concerning securities, 31 No 3, p. 29

Service of process
- business entities and other parties, 30 No 1, p. 5
- foreign defendants, 30 No 1, p. 49

Shareholders
- *Franks v Franks*, business judgment and specific intent, 40 No 1, p. 23
- *Madugala v Taub*, clarification by Michigan Supreme Court, 34 No 3, p. 20
- minority shareholder oppression suits, 36 No 2, p. 25; 37 No 3, p. 45; 39 No 1, p. 18
- recent cases addressing oppression, 31 No 3, p. 25; 34 No 3, p. 23
- use of bylaws to shape proceedings for shareholder claims, 35 No 2, p. 40

Short selling regulation, alternative uptick rule, 30 No 3, p. 1

Single-member LLCs, 30 No 2, p. 20; 37 No 3, p. 51

Small Business Reorganization Act, 39 No 3, p. 38

Social networking, management of legal risks, 30 No 2, p. 44

Standing under Article III
- Article III standing in the Sixth Circuit, 40 No 1, p. 18
- Fair Credit Reporting Act of 1970, plaintiff’s standing under Article III, 36 No 2, p. 39

Taking care of business

Corporations Online Filing System (COFS), 36 No 1, p. 5; 36 No 2, p. 5; 38 No 1, p. 5

Corporations, Securities & Commercial Licensing Bureau, 36 No 3, p. 5; 37 No 3, p. 6

LARA organizational changes, 35 No 2, p. 5

Prepaid Funeral and Cemetery Sales Act, 37 No 2, p. 5

State Authorization Reciprocity Agreement, 35 No 3, p. 5

Securities Law in Michigan, 38 No 1, p. 5

Transportation, 37 No 1, p. 5

Taxation and tax matters
- 2012 year-end tax planning, 32 No 3, p. 7
- 2018 Tax Cuts and Jobs Act, 38 No 1, p. 7
- American Taxpayer Relief Act of 2012, 33 No 1, p. 7
- audit procedures for state taxes, 34 No 1, p. 32
- Brownfield Project State Sales and Income Taxes, 36 No 3, p. 7
- budget cuts at IRS, practical impacts, 35 No 1, p. 7
- cash deposits and suspicious activity reports, 33 No 3, p. 8
- clearance procedure for state taxes, 34 No 1, p. 32
- collections update, 37 No 2, p. 7
- copyright-protected property, tax treatment of, 32 No 3, p. 37
- corporate income tax, 31 No 3, p. 7; 32 No 3, p. 6
- COVID-19 crisis, 40 No 1, p. 9
- cryptocurrency guidance, 39 No 3, p. 5; 40 No 1, p. 10
- disclosure requirements for uncertain tax positions, 30 No 3, p. 34
- enforcement priorities, 34 No 1, p. 8; 38 No 3, p. 5
- estate tax planning after 2010 Tax Act, 31 No 1, p. 9
- estate tax uncertainty in 2010, 30 No 1, p. 8
- global outreach, 39 No 2, p. 5
- goodwill in sale of closely-held businesses, 33 No 3, p. 37
- identity thefts and other scams, 34 No 3, p. 7
- IRS Organizational Changes, 37 No 1, p. 9
- late filing, practical solutions, 33 No 2, p. 7
- Michigan Business Tax, 30 No 2, p. 27
- offshore accounts, 32 No 1, p. 7
- Panama Papers, 40 No 1, p. 9
- partnership audit procedures, 36 No 1, p. 8; 36 No 2, p. 14
- passports and tax delinquencies, 36 No 1, p. 8
- political uncertainty, advising clients in times of, 36 No 2, p. 7
- property and transfer tax considerations for business entities, 30 No 2, p. 27
- recent litigation in tax court, 37 No 3, p. 8
- reclassification of property by State Tax Commission threatens loss of tax incentives, 30 No 3, p. 28
- refund procedures for state taxes, 34 No 1, p. 32
- S corporations, 31 No 2, p. 7
- state taxes, 38 No 2, p. 9
- statutes of limitations and filing dates, 35 No 3, p. 8
- sunset for tax cuts (2010), 30 No 2, p. 9
- Swiss bank accounts disclosures, 34 No 2, p. 9
Tax Court and Caselaw Update, 39 No 1, p. 5
Unpaid Federal Insurance Contributions Act tax, 38 No 1, p. 42
U.S. citizenship and taxation, 35 No 2, p. 7
zappers, automated sales suppression devices, 32 No 2, p. 8
Technology Corner. See also Internet
Blockchain, 37 No 3, p. 10
business in cyberspace, 31 No 2, p. 9
California Consumer Privacy Act, 39 No 3, p. 7
compliance, 37 No 1, p. 11
contracts, liability, 31 No 2, p. 9
cyber incident response planning, 37 No 2, p. 8
cyberinsurance, 32 No 3, p. 9
cyber risk obligations, 39 No 2, p. 7
cybersecurity, 34 No 1, p. 10; 35 No 1, p. 9
data breach legislation, 31 No 3, p. 9
developing policies—the forest and the trees, 33 No 3, p. 10
electronic voting, 38 No 2, p. 10
escrows of technology, relevance, 30 No 3, p. 10
European Union, 32 No 1, p. 9; 36 No 2, p. 9; 36 No 3, p. 9
identity management, 39 No 1, p. 7
identity theft protection act amendments, 31 No 1, p. 11
international trade, IP, and unfair trade practices, 36 No 2, p. 9
Internet of things, 35 No 3, p. 10
Internet Privacy Protection Act, 33 No 1, p. 10
IP license rights in context of mergers and acquisitions, 33 No 2, p. 9
IT project management, 35 No 2, p. 9
ITC Section 337 actions for relief from unfair trade, 36 No 2, p. 9
Privacy and Data Security Update: 2019, 40 No 1, p. 12
privacy in the workplace, 30 No 2, p. 11
SEC guidelines on cybersecurity risks and disclosure, 32 No 2, p. 10
Spam and scamming, 38 No 3, p. 6
technology M&A due diligence, 38 No 1, p. 9
trademark and business names, 34 No 3, p. 9
Touring the Business Courts
2017 amendments to the business court statute, 37 No 3, p. 13
Genesee County Business Court judges, 39 No 2, p. 11
Ingham County Business Court judges, 39 No 3, p. 10
Kalamazoo County Business Court judges, 39 No 3, p. 10
Kent County Business Court Judge, 40 No 1, p. 13
Macomb County Business Court judges, 39 No 2, p. 11
Oakland County Business Court’s case management protocol, 38 No 1, p. 12
Oakland County Business Court judges, 39 No 1, p. 9
Ottawa County Business Court judges, 39 No 3, p. 10
Wayne County Business Court, 38 No 3, p. 8
Trade secrets
International Trade Commission, misappropriated trade secrets, 32 No 1, p. 39
noncompetition agreements and trade secrets, impact of murky definitions, 36 No 1, p. 12
RICO, 31 No 2, p. 23
Trademark abandonments, naked licenses, 32 No 1, p. 55
Transfer tax considerations for business entities, 30 No 2, p. 20
Uniform Commercial Code
filing system reform, 38 No 3, p. 11
Model Administrative Rules and UCC filings, 35 No 3, p. 13
“only if” naming of debtor under MCL 440.9503, 33 No 1, p. 38
Youth camp programs, assessment of risks for nonprofits, 32 No 2, p. 31
Zappers, automated sales suppression devices, 32 No 2, p. 8
Books

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