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CONTENTS

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The editorial staff of the *Michigan Business Law Journal* welcomes suggested topics of general interest to the Section members, which may be the subject of future articles. Proposed topics may be submitted through the Publications Director, D. Richard McDonald, The Michigan Business Law Journal, 39577 Woodward Ave., Ste. 300, Bloomfield Hills, Michigan 48304, (248) 203-0859, drmcdonald@dykema.com, or through Daniel D. Kopka, Senior Publications Attorney, the Institute of Continuing Legal Education, 1020 Greene Street, Ann Arbor, Michigan, 48109-1444, (734) 936-3432, dan@icle.org.

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

Issue	Primary Theme/Committee	Article Deadline
Fall 2012	Uniform Commercial Code Committee	July 31, 2012
Spring 2013	Debtor/Creditors Rights Committee	November 30, 2012
Summer 2013	Unincorporated Enterprises Committee	March 31, 2013
Fall 2013	Financial Institutions Committee	July 31, 2013

ADVERTISING

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

MISSION STATEMENT

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

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

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From the Desk of the Chairperson

By Edwin J. Lukas

This latest issue of the *Michigan Business Law Journal* focuses on business litigation, which is undoubtedly a timely theme. New pilot projects and proposed legislation related to business litigation continue to be hot topics for Michigan business lawyers. Specifically, circuit courts in Macomb County and Kent County recently initiated specialized business dockets designed to reduce the time and costs associated with certain business cases while improving the efficiency associated with their administration. State legislators also proposed a bill that would create a statewide business court system on a regional basis enabling counties that establish their own business dockets to "opt out" of the statewide system. We anticipate substantial developments associated with these efforts in the forthcoming year.

The Business Law Section recently reconstituted its ad hoc committee to study the benefits and risks associated with such a system. The committee is analyzing the legislation in pursuit of our goal of establishing dispute resolution procedures that are in the best interests of business litigants, our members and the state of Michigan. The Section invites you to share your thoughts on these matters. What is your reaction to the proposed legislation? How would it affect business litigation in your region? If you are willing to share your views on the proposed legislation and dispute resolution for businesses, please contact the chair of the Section's ad hoc committee on business courts, Diane Akers, at dakers@bodmanlaw.com.

In this issue of the *Journal*, the Section offers a variety of articles associated with commercial litigation. Dan Sharkey and Brent Warner share their thoughts on the enforceability of certain requirements contracts in the automotive industry. Dan Linna and Jessica Warren explore the risks and best practices associated with common interest or joint defense agreements. Gavin Fleming and Eric Parzianello offer their perspective on diversity jurisdiction and limited liability companies in light of recent caselaw. Dan Quick and Jonathan Redway provide an overview of proceedings before the International Trade Commission and how such proceedings can be an effective tool in preventing the importation of goods utilizing misappropriated trade secrets. Michael Callahan examines indemnification clauses and the manner in which they have been enforced in Michigan. Not to be outdone, T.L. Summerville, who played a key role in recruiting authors for this issue, discusses the enforceability of "agreements to agree" and offers techniques for protecting clients from liability.

Outside the realm of business litigation, Beverly Griffor provides advice on avoiding the abandonment of a trademark due to naked licensing. No, naked licensing is not a reference to a salacious act; rather, it occurs when a trademark owner licenses a mark to another without the owner retaining the right to approve the licensee's use of the mark in connection with the licensee's goods or services. Regardless, Beverly's tips will certainly be useful to your clients.

Finally, please note that the Section's 24th Annual Business Law Institute and Mid-Year Meeting will be held on May 4 and 5 at the Amway Grand Plaza Hotel in Grand Rapids. We believe that the Institute is an indispensable component of your annual Section membership. The Institute delivers expert advice on the best ways to respond to the changing landscape of business practice and today's economy. In addition to updates on recent developments in business legislation and caselaw, this year's compelling agenda includes sessions addressing the following topics:

- *International Financial Reporting Standards (IFRS)*. The Securities and Exchange Commission will likely adopt regulations in 2012 converging U.S. generally accepted accounting principles with IFRS. Given that most privately held companies will likely adopt IFRS over time, learn how these regulations will affect all of your clients and draft language in documents to address IFRS.
- *Social Media and Technology: Protecting Your Clients*. Social networking and technology present unique privacy and confidentiality considerations. Understand the implications of sharing information on social networking sites and learn how to draft policies that successfully address electronic communications.
- *Basics of Structured Finance*. Experts in venture capital and private equity will share their insights on subordinated debt and preferred equity financing. Discover the interplay of commonly used affirmative and negative covenants in sophisticated finance transactions.
- *Business Issues under the Michigan Corporate Income Tax*. The new Michigan Corporate Income Tax will impact Michigan business clients in numerous ways. Explore how the new tax affects choice of entity decisions and conversions to or from C corporations.
- *Employment Law for Business Lawyers*. Transactional attorneys are often asked questions on a variety of labor and employment law topics. Understand the complex relationship of federal, state, and local laws that govern employment law and other aspects of workforce management.

More importantly, the Institute presents networking opportunities to catch up with your Section colleagues. Join us in Grand Rapids to share your stories and ask questions of faculty, council members, and fellow business lawyers during the reception and annual Section dinner. We look forward to seeing you there!

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What's in a Name?

The online Business Entity Search (www.michigan.gov/entitysearch) can be useful for checking whether a business is organized as a corporation or limited liability company and, if so, its current status. It may also be used to determine if a formation document, application for certificate of authority, certificate of assumed name, or other document involving a new name has been received by the Department of Licensing and Regulatory Affairs. For a received but unfiled document for a new name, a Business Entity Search result will indicate "Filing Pending." If a subsequent document changes the entity name or adds a new assumed name, the results of a search conducted under the new name will indicate "Filing Pending."

Business Entity Search permits a search by the "Name" using the same sequence of letters as appears at the beginning of the entity name. Entering the complete name will provide a narrow search to locate the specific entity. However, entering the first word or two of a name may be sufficient to locate a list of entities that have that same first word or first two words in the name. A search may also be conducted by keyword by entering one or more words contained anywhere in the name. A search may also be conducted using the six-digit file number assigned by the Corporation Division, if known.

Creativity may be required when you only have part of a name. *American Legion Post 267 v Township of Lyon,*[1] an unpublished opinion of the Michigan Court of Appeals, states "Petitioner, a Michigan corporation, owns a post in Davison." A Business Entity Search for "American Legion Post 267" produces no results. A name search for just the first two words "American Legion" produces 145 results but no match to American Legion Post 267. A key word search for "American Legion" anywhere in the name produces 320 results but no match to American Legion Post 267. A keyword search for "Post No. 267" produces result of "Charles N. Skellenger Post No. 267, Memorial Building of Davison, Michigan," file number 787 003.

The facts in *Jeffrey Harrell Builder, Inc. v Christopher Wolff*[2] describe a situation in which the plaintiff used several different names. The Wolffs contracted with Fulton Construction Company in 2006 to build a home. They terminated the agreement with Fulton, did not pay, and Fulton recorded a claim of lien on the property on January 15, 2008. The Wolffs hired plaintiff to complete the construction, and the contract with the Wolffs was in name of Jeff G. Harrell Builder, Inc. In interactions with the Wolffs, plaintiff used stationary reading H B Harrell Building Co., Jeff Harrell Building Co., and Harrell Building Co. and cited Jeffrey G. Harrell Builder, Inc. as the licensed builder on the project. Plaintiff recorded a claim of lien against the property in the name of Harrell Building Company.

A Business Entity Search for Jeff G. Harrell Builder, Inc. produces no results. Searches for Jeff Harrell Building Co. and H B Harrell Building Co. also produce no results. A search for Harrell Building Company locates an assumed name filed October 7, 2009, for Jeffrey Harrell Builder, Inc., file number 027256.

Plaintiff filed a lawsuit July 16, 2009, to foreclose on the claim of lien on Wolffs' property using the name Harrell Building Company. Fulton was named a defendant because of its recorded claim of lien. Fulton "moved to dismiss on ground that Harrell Building Company was neither a recognized business nor a licensed builder in Michigan, and as such was barred from using the Construction Lien Act…to recover for improvements to real property. Prior to the hearing on the defendant's motion, the suit was dismissed with prejudice by stipulation of the parties on October 9, 2009."

Fulton was also named as a party in second suit, filed by plaintiff under the name Jeffrey G. Harrell Builder, Inc., to foreclose on the claim of lien. Fulton moved to dismiss on the basis that Jeffrey G. Harrell Builder, Inc. had not recorded a claim of lien and the trial court granted the motion.

A name must be distinguishable on the records of the administrator. Basically, if the name is a different sequence of letters, numbers, or letters and numbers from other active names, it is available for use. In addition to availability, section 212 of the Business Corporation Act,[3] section 212 of the Nonprofit Corporation Act,[4] and section 204 of the Limited Liability Company Act [5] prohibit the use of a name that indicates or implies the entity was formed for a purpose other than the purpose or purposes permitted by the articles.

For example, if the name selected indicates or implies that the profit corporation or limited liability company is rendering services within the learned professions, a different name may need to be selected. However, the identical name may be permissible if the entity is a nonprofit corporation, professional service corporation, or professional limited liability company formed for purposes consistent with the name. The same rules apply to assumed names and subsequent name changes for an entity. In addition, state or federal law may limit the use of certain words. A list of some of these restricted words is available on the Corporation Division's Web site.[6]

Section 21712 of the Public Health Code[7] permits nursing homes to use "health care center," "health center," "rehabilitation center," or a term conveying a meaning substantially similar to those terms, so long as the name does not conflict with terms prohibited by section 21712. The Business Corporation Act and Limited Liability Company Act contain similar language to permit profit corporations and limited liability companies that are licensed as nursing homes to use "health care center," "health center," or "rehabilitation center" in their names.[8] Although these changes permit the use of these words in the name of a nursing home, if the

nursing home provides services in a learned profession, it will be subject to the requirements of the professional service corporation act and article 9 of the LLC act.

No substantive rights, however, are acquired in a name when the document is filed. A person may acquire rights in a name by using the name. Rights may be determined under federal trademark law, state trademark law, or common law.

In addition, there are a few statutes that provide some name protections for specific types of entities. For example, PA 269 of 1929 protects the use of names and emblems of benevolent, humane, fraternal, or charitable organizations. Section 1 of the act[9] provides in case of conflict that the organization that first incorporated is entitled to exclusive use of the name. Section 1 of PA 304 of 1919[10] contains a similar provision.

Marks that are used only in intrastate may be registered with the Corporation Division under the Trademark and Service Mark Act, PA 242 of 1969. Marks used in interstate commerce may be registered with the U.S. Patent and Trademark Office. To avoid infringing the rights of another entity, a search of names of sole proprietorships, partnerships, corporations, limited partnerships, and limited liability companies and a search of registered marks should be done before selecting a name for use. Marks, however, are not required to be adopted as assumed names, and it is not necessary to file a Certificate of Assumed Name for a mark.

Use of an accurate and complete name can be essential to business transactions and to protecting rights in a name. The difference of spelling by one letter can determine name availability and may also result in unanticipated consequences. There is no requirement for any entity to adopt or use an assumed name. However, if business is to be transacted under other than the entity's true name, it is essential to ensure that a Certificate of Assumed Name is filed for each name under which the entity does business.

NOTES

1. No 300613, 2011 Mich App LEXIS 2083 (Nov 22, 2011).
2. No 299270, 2011 Mich App LEXIS 2125 (Nov 29, 2011).
3. MCL 450.1212.
4. MCL 450.2212.
5. MCL 450.4204.
6. http://www.cis.state.mi.us/bcsc/forms/corp/pub/restrict.pdf.
7. MCL 333.21712.
8. See MCL 450.1213(2) and MCL 450.4204a.
9. MCL 430.51.
10. MCL 430.101.

G. Ann Baker is Deputy Director of the Bureau of Commercial Services, Department of Energy, Labor & Economic Growth. Ms. Baker routinely works with the department, legislature, and State Bar of Michigan's Business Law Section to review legislation. She is a past chair of Business Law Section and is the 2008 recipient of the Stephen H. Schulman Outstanding Business Lawyer Award.

By Paul L.B. McKenney

Your Clients' Pesky Offshore Accounts, Again…

Background

Many practitioners have clients with offshore financial and bank accounts. In addition to reporting any income from such accounts, there is also a separate and independent disclosure reporting regime administered by the Internal Revenue Service (IRS). If the accounts, in aggregate, exceed $10,000, then:

1. Individuals must check the "yes" box on Schedule B of their Forms 1040 and make appropriate disclosures, and
2. Individuals, trusts and business entities must file a U.S. Department of Treasury "Report of Foreign Bank and Financial Accounts," ("FBAR") on Form TD F 90-22.1.

Offshore accounts have been the oft-stated IRS number one enforcement priority for the last few years. The government has devoted considerable resources, both here and abroad, toward enforcement. The penalties for non-disclosure are draconian. In addition to criminal exposure, the taxpayer faces a penalty of 50 percent of the principal balance of the account per year. Obviously, after many years of non-disclosure, that will be a multiple of the account balance. There are additional penalties, but this article is far too short to go into the FBAR regime in detail.

Prior Amnesties

In 2009 the IRS announced an offshore voluntary disclosure program, or amnesty. In return for payment of 20 percent of the highest balance over six years and the payment of all income tax due, plus a 20% penalty on the income tax, the taxpayer would not be criminally prosecuted and would not be subject to the much higher statutory penalty regime. That brought the IRS $3.4 billion and over 17,000 taxpayers into the reporting system. The IRS conducted a similar offshore voluntary disclosure program that closed last fall. Over $1 billion has been paid under that program to date.[1]

The problem that tax practitioners keep hearing is that after the prior programs have terminated, more taxpayers surface. We can broadly break these taxpayers down into two groups.

1. The numerically far-larger group has either inherited money, had some in the old country, had an account in Canada that then paid higher interest, and other benign and/or relatively small dollar amounts. Since they did not come in under either amnesty program, they were looking at draconian penalties with 50 percent of the principal balance per year of nondisclosure, etc.
3. The second numerically smaller group, but far larger in dollar amount, were people who had offshore accounts, had not reported the income, and were playing "hide the ball" with Uncle Sam. Such individuals should not take comfort in the fact that the IRS has not found them yet. One of the requirements for those in the 2009 and 2011 amnesties was full cooperation with the IRS, including who introduced them to the offshore accounts and how they functioned. Unlike the situation in 2009, the IRS has since learned much about the network and identities of the promoters and referral sources and has negotiated disclosures with many foreign governments that feared their institutions being frozen out of U.S. financial markets if they did not furnish information to the IRS. Perhaps a better operating assumption, reflecting the facts on the ground today for those hiding assets, is: The IRS will find me, sooner or later.

Third Chance (or Strike Three!)

On January 9, 2012, the IRS announced a third offshore voluntary disclosure program.[2] Unlike the prior two programs, which came with termination dates measured in months, this "would be open for an indefinite period, unless otherwise announced." The maximum penalty is 27.5 percent, which is higher than the prior two amnesties. However, there is a sliding scale for relatively-smaller dollar amounts. They may qualify for five percent or 12.5 percent of the balance penalty. Many taxpayers for whom noncompliance may be fairly described as "inadvertent" qualify for the five percent penalty. This offers a wonderful opportunity for them to make an expensive, ongoing, "gets worse every year" problem disappear cheaply. To qualify for the five percent penalty, the taxpayer must meet the following criteria:

1. Did not open or cause the account to be opened,
2. Minimal or infrequent contact with the account,
3. Except for withdrawing funds, closing the account, and transferring funds to the United States, did not withdraw more than $1,000 from the account in any one year, and
4. Can establish that all applicable U.S. tax has been paid on funds deposited to the account (only account earnings that escape U.S. taxation).

From many who have inherited funds or otherwise qualify, this represents a wonderful solution. Other taxpayers can qualify for the relative bargain 12.5 percent offshore penalty rate if, for each of the years, there was less than $75,000 in the offshore account.

Every taxpayer's situation is different, and the rules regarding the latest IRS offshore voluntary disclosure initiative are certainly not simple. However, for any client who has an undisclosed offshore account, they need to seriously explore whether they wish to pursue what, for many, will be a proper and relatively less expensive path.

NOTES

1. IRS News Release 2012-5.
2. *Id.*

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 By Michael S. Khoury

How European Union Changes May Affect American Business

In prior columns I have written about worldwide legal developments and how they impact U.S. businesses. Among the most significant of those regulations is the European Union Privacy Directive and the subsequent safe harbor agreement that was worked out between the United States and the European Union ("EU").

There have been two new directives enacted by the EU and one proposed regulation that may significantly impact those who do business in the EU, including electronic commerce sites that sell to businesses and consumers in the EU on the Internet.

An excellent resource on global privacy issues, including ongoing developments, by the EU can be found in materials published by Françoise Gilbert, the founder of the IT Law Group.[1] You can also find frequent articles and other resources about privacy, as well as information about her excellent treatise on global privacy rules.

The "Cookie" Regulation

Technically called Directive 2002/58/EC,[2] this rule impacts the collection and processing of personal data and the protection of privacy in electronic communications. The most significant aspect of the directive, which had an initial effective date of May 26, 2011, applies to electronic cookies used to collect information by users of Web sites. For example, if you visit a Web site, it may automatically collect information such as the IP (internet protocol) address of the computer or network you are accessing the site from, as well as other generally anonymous data about your visit to the site. If you register with the site, it will also collect other information such as passwords and preferences. The new cookie rule requires that the visitor to the site give affirmative consent before the Web site may collect *any* data. This has been a significant issue for operators of Web sites who have approached the problem in various ways.

Perhaps the most common way in which operators of Web sites have dealt with the issue is to use either a splash screen or a banner that would be the first screen the user would see. In this approach, users would be faced with an initial screen or a banner on top of the main Web site, which would require the user to specifically accept that the Web site will collect information from them. By clicking on that screen or banner, the user is then taken to the main Web site. If the user does not accept, then no access is allowed to the Web site. This seems the simplest and most logical approach, although other entities are using different approaches.

The directive also implements rules related to the security and confidentiality of data and communications, imposes new rules on disclosures to users about how the data will be used, and requires that terms of use and privacy policies conform to the directive. This will impact every U.S. company that sells products or services to EU citizens. Web site policies and procedures will need to be reviewed to ensure conformance.

EU Directive on Consumer Rights

The second directive is the EU Consumer Rights Directive adopted by the EU in October 2011. The intended scope is related to consumers (natural persons) but excludes individuals who are acting on behalf of their business in undertaking a transaction on a Web site. The effect on this directive for U.S. companies is similar to the cookie rule discussed above, but specifically relates to how a Web site must interact with the user.

In addition to rules on transparency and disclosure, there are two very material changes from the directive. The first deals with the practice of pre-accepting the terms on a site. For example, if you are registering with the site to purchase products, you are typically required to accept the terms of use and privacy policy by checking (or ticking) the box. There is apparently a practice among some sites of pre-ticking the box, and this practice will be banned.

The other significant change will be related to refund rights. Consumers that purchase goods can change their mind on the transaction within fourteen calendar days, which is a seven-day extension of current practice. If the Web site does not clearly explain to the customer about this right, then the right to return the products is extended to one year. All these dates start from the time of receipt by the consumer, not shipment by the seller.

The directive is to be adopted by member states within two years, although member states have notoriously been slow to adopt some of the directives of the EU.

EU Data of Privacy Reform

The EU has proposed some sweeping changes to the data privacy and protection regimen. These will not be new directives, but they will be "regulations" that will affect all member states that have adopted the initial EU privacy directive. Member states will apparently have some discretion in the adoption of the regulations.

The initial proposal identifies a number of concepts related to data privacy, generally focusing on the requirements that Web sites can no longer rely on implicit consent, but the site owner must receive explicit consent to its privacy and data protection practices. New and expanded data protection principles are also applicable, but the actual implementation of these may become a serious problem.

An example of the problem with the proposed regulation that is relevant to those in the state of Michigan and the automotive industry relates to event data recorders on a vehicle. Most vehicles have several electronic control modules that govern the operation of various components of the vehicle, such as air bag deployment, anti-lock brakes, or any other operation that must happen automatically

without specific driver intervention. These event data recorders collect data on the vehicle, and a plain reading of the initial proposals would require the manufacturer of the vehicle to obtain explicit consent from the driver for the collection of the data. How would that happen? Can the owner withdraw consent?

On January 25, 2012, the EU published extensive information on the proposed reform,[3] and this developing reform must be watched very closely by U.S. companies.

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NOTES

1. http://www.itlawgroup.com.
2. http://www.ec.europa.ec.
3. See http://ec.europa.eu/justice/newsroom/data-protection/news/120125_en.htm.

Common-Interest or Joint-Defense Agreements: Legal Requirements, Potential Pitfalls, and Best Practices

By Daniel W. Linna Jr. and Jessica M. Warren*

Introduction

Parties that share a common legal interest may find it advantageous to coordinate their efforts and share information, including attorney-client privileged communications. For example, co-plaintiffs or co-defendants in a lawsuit may want to work collaboratively to conduct factual investigations, perform legal research, and develop legal strategies. Parties considering a merger may want to share analyses regarding pending or future litigation. A potential purchaser of intellectual property may request that the seller furnish a copy of a privileged intellectual-property opinion. However, each of these scenarios presents a significant risk: the possibility that the disclosure of privileged communications will result in the waiver of the attorney-client privilege.[1] Further, the waiver likely extends not only to the communications disclosed, but to all privileged communications on the same subject matter.[2]

Under the right circumstances, the common-interest privilege provides an exception to the waiver rule. When privileged communications are disclosed to a party sharing a common legal interest, and the disclosure is in furtherance of the common interest, the common-interest privilege generally preserves the right to assert the *underlying* privilege against other parties. Unfortunately, common-interest privilege law is "complicated and contradictory."[3] As a threshold matter, while there is little question that co-defendants may invoke the common-interest privilege upon satisfying its requirements, the status of the privilege is far less certain outside of actual or imminent litigation. Beyond this, nuances in the law and differences across jurisdictions raise the risk that a party's reliance on the common-interest privilege will result in a waiver.

To mitigate the risk of a waiver, parties that intend to invoke the common-interest privilege often enter into a "joint defense" or "common interest" agreement.[4] If done well, a common-interest agreement establishes the foundational facts to assert the common-interest privilege and protects a party against waiver. Done poorly, the agreement can lead not only to waiver of the underlying attorney-client privilege, but also to unintended attorney-client relationships, conflicts of interest, expanded malpractice exposure, and the inability to extricate yourself or remove an uncooperative party from a group, among other things.

In this article, we discuss the requirements for invoking the common-interest privilege, pitfalls and potential problems, and provisions that counsel should consider including in a common-interest agreement.

Ordinary Common-Interest Scenario

An ordinary common-interest scenario arises when parties that are each represented by their own counsel wish to share privileged communications, as depicted in Figure A.

Figure A

Lawyer A	Lawyer B	Lawyer C
|	|	|
Client A	Client B	Client C

In this scenario, can Lawyer A disclose privileged communications between Lawyer A and Client A to Lawyer B without waiving the privilege? Ordinarily, such disclosure would result in a waiver, destroying Client A's ability to assert the privilege against other parties. But if the common-interest privilege applies, it provides an exception to the general waiver rule.

The Distinct Co-Client Scenario

Some of the confusion regarding the scope and applicability of the common-interest privilege is due to the failure to distinguish it from the co-client privilege.[5] The co-client privilege applies where one lawyer represents multiple clients, as depicted in Figure B.

*We would like to recognize the contributions of Matthew P. Allen, Kevin A. Fanning, and Richard E. Zuckerman, each of whom, with Daniel W. Linna Jr., was a presenter at the Commercial Litigation Committee's webinar on Joint Defense Agreements on May 31, 2011.

Figure B

The co-client privilege generally protects communications between the Lawyer and Client A that are disclosed to Client B or Client C.[6] The focus of this article is scenarios where each client has its own counsel. The potentially applicable privilege in those scenarios is the common-interest privilege.

What is a Common-Interest Agreement?

A common-interest agreement is essentially an agreement to assert and preserve the common-interest privilege. Generally, it is:

1. an agreement amongst persons sharing a common legal interest that;
2. information protected by the attorney-client privilege or work-product doctrine;
3. that is communicated in the presence of, or shared amongst them;
4. will not result in a waiver of those protections.

Common-Interest Privilege Requirements

Generally speaking, a party invoking the common-interest privilege has the burden of showing:

1. an underlying privilege such as the attorney-client privilege protects the communication;
2. the parties disclosed the communication at a time when they shared a common interest;
3. the parties shared the communication in furtherance of the common interest; and
4. the parties have not waived the privilege.[7]

A significant problem for parties that intend to rely on the common-interest privilege, however, is that there is a lack of uniform law.[8] Indeed, as the federal district court for the Eastern District of Michigan observed, "[t]he law on the so-called common interest privilege or joint defense privilege is complicated and contradictory."[9]

A significant problem for parties that intend to rely on the common-interest privilege, however, is that there is a lack of uniform law.

Because the law varies greatly across jurisdictions, it is extremely important that practitioners research the specific law of the jurisdiction that governs any potential assertion of the common-interest privilege. Below, we summarize three Michigan cases that apply the common-interest privilege—one applying Michigan law, the other two applying federal common law.[10] Following these case summaries, we discuss common issues that arise when determining the scope of the common-interest privilege.

Michigan Courts' Application of the Common-Interest Privilege

There appear to be no publically available Michigan state-court opinions addressing the availability of the common-interest privilege under Michigan law.[11] When presented with this issue, the federal district court for the Eastern District of Michigan held that the Michigan Supreme Court would adopt a narrow version of the common-interest privilege.[12] This court has also recognized the common-interest privilege when applying federal common law in federal-question cases.[13]

State Farm v Hawkins—*Common-Interest Privilege Under Michigan Law*

In *State Farm Mut Auto Ins Co v Hawkins*, the federal district court for the Eastern District of Michigan held that the Michigan Supreme Court would likely adopt a narrow version of the common-interest privilege. In *Hawkins*, the plaintiff sued the defendant for fraudulently claiming reimbursement for health-care services that she never provided.[14] The plaintiff issued subpoenas to the defendant's former law firm and to an attorney within that law firm.[15] Among the documents requested were communications between the attorney and the defendant's new attorney.[16] The attorney asserted a common-interest "arrangement" between the defendant's former law firm and the defendant, and refused to produce the documents.[17] The attorney argued that the firm and the defendant shared a common interest because the plaintiff had suggested that the firm may have played a role in the defendant's fraud.[18]

The court's first task was to determine whether Michigan law recognized the common-interest privilege.[19] The court held that "[t]he wide acceptance of [the] common interest exception, and the absence of its rejection, suggests that the Michigan Supreme Court would recognize it."[20] But given "Michigan's clear directive to construe the attorney-client privilege narrowly," the court held that "the Michigan Supreme Court would likely adopt

the narrow version of the common interest privilege as described in the Restatement."[21]

The court cited Restatement § 76:

> If two or more clients with a common interest in a litigated or nonlitigated matter are represented by separate lawyers and they agree to exchange information concerning the matter, a communication of any such client that otherwise qualifies as privileged under §§ 68-72 that relates to the matter is privileged as against third persons. Any such client may invoke the privilege, unless it has been waived by the client who made the communication.[22]

"Under the Restatement," the court held:

> [P]rivileged communications between an attorney and client are not waived when they are revealed to an allied lawyer, provided that the person asserting the privilege shows that the attorney-client privilege applied to the underlying attorney-client communication…. [The] other requirements must [also] be met, e.g., the communication must be related to a common litigation interest.[23]

The court also held that, under the Restatement, the common-interest privilege applies to both actual and potential litigants.[24]

Applying this standard, the court held that the firm (represented by the attorney within the firm who had received the subpoena) and the defendant (represented by her new counsel) could participate in a common-interest arrangement.[25] The attorney for the firm communicated with the attorney for the defendant in an effort to address the firm's potential liability to the plaintiff with regard to defendant's fraudulent acts.[26] Thus, the court held that "the attorneys were representing clients with a common litigation interest."[27] But the court also held that the common-interest privilege "may only be claimed if the communications are being shared between the clients' attorneys."[28] Therefore, the court ordered the production of an updated privilege log and held that only communications made by the firm's attorneys or agents of the firm's attorneys to the defendant's new counsel could be withheld under the common-interest privilege.[29]

Dura Global v Magna—*Common-Interest Privilege Under Federal Common Law*

In *Dura Global, Techs, Inc v Magna Donnelly Corp*, the Eastern District of Michigan, applying federal common law, held that an auto supplier had properly invoked the common-interest privilege and had not waived the attorney-client privilege when it disclosed patent opinion letters to its OEM customer.[30] Magna's patent counsel had disclosed two opinion letters to Toyota's intellectual property counsel.[31] The opinion letters related to two patents held by Dura and a window that Magna had proposed for Toyota.[32] Magna later agreed to indemnify Toyota for claims by Dura related to Toyota's use of Magna's window.[33]

Dura subsequently sued Magna for patent infringement and misappropriation of trade secrets. Dura issued a subpoena to nonparty Toyota, and Toyota produced the opinion letters to Dura, allegedly without notifying Magna.[34] Dura argued that Magna, by disclosing the opinion letters to Toyota, waived the attorney-client privilege as to the subject matter of communications between Magna and Toyota.[35] The court disagreed.

The court, unable to find controlling Sixth Circuit authority, decided the issues as it believed the Sixth Circuit would.[36] The court recited a statement of the common-interest privilege to which it stated the "parties agree."

> The parties agree that the common interest privilege permits the disclosure of privileged communication without waiving the privilege, provided that the parties have "'an identical legal interest with respect to the subject matter of the communication.'"[37]

The court noted that, if the privilege survived disclosure to Toyota, "the later unauthorized disclosure by Toyota to [Dura] did not waive that privilege."[38] The "privileged status of communications falling within the common interest doctrine cannot be waived without the consent of all of the parties."[39]

The court rejected Dura's argument that Magna and Toyota were negotiating a business strategy, not formulating a common legal strategy.[40] First, the court noted the steps Magna took to ensure the confidentiality of the opinion letters. Magna had (1) marked the opinion letters and a cover letter "confidential and privileged," (2) asked for confidentiality concurrently with the disclosure, (3) stated in the cover letter that sharing of the opinion was "strictly on the basis of a joint defense privilege," and (4) requested in the cover letter that Toyota contact Magna if the need arises for Toyota to disclose the

[U]nder the Restatement, the common-interest privilege applies to both actual and potential litigants.

opinion to a third party.[41] Additionally, the communications were between intellectual property lawyers, not non-attorney employees.[42] The court held that Magna's counsel could reasonably expect Toyota's counsel to maintain the confidentiality of the opinion letters.[43] The court held that these steps, even if Magna could have taken more, were sufficient to prevent waiver of the privilege.[44]

Second, the court found that the disclosures were made in connection with a common legal strategy, not merely a "joint commercial venture."[45] The court distinguished *Libbey Glass*,[46] a case where disclosure was made by and to non-attorney employees who "had concerns" about legal issues, but did not understand the significance of maintaining the confidentiality of legal opinions. In contrast, the communications between counsel for Magna and Toyota dealt exclusively with legal issues relating to Toyota's purchase of windows, not business matters.[47] Additionally, the parties' correspondence about the indemnification agreement, the court held, showed that the disclosure of the opinion letters was due to a common legal interest: avoiding any liability for Magna's window infringing upon Dura's patents.[48] The court concluded that, although there was some overlap between the legal issues and the larger business venture between the parties, that overlap did not "negate the effect of the legal interest in establishing a community of interest."[49] Finally, the court stated that "[t]he weight of authority holds that litigation need not be actual or imminent for communications to be within the common-interest doctrine."[50] Accordingly, the court upheld Magna's claim of the common-interest privilege.

The court stated that, "[i]n order to be considered a 'common interest' within the meaning of the common interest doctrine, the interest must be 'identical' and it must be a 'legal' interest as perhaps contrasted to a mere business interest."

Cozzens v City of Lincoln Park—*Common-Interest Privilege Under Federal Common Law*

In *Cozzens v City of Lincoln Park*, the court, citing federal law, rejected a nonparty's reliance on the common-interest privilege after he had disclosed privileged communications to another nonparty who had only a pecuniary interest in the outcome of a different lawsuit.

Cozzens began as a constitutional challenge to a city ordinance.[51] After the defendants were awarded summary judgment, they moved for sanctions against certain of the plaintiffs and nonparties and their respective attorneys.[52] In response to a subpoena issued by the plaintiffs, nonparty Bednarski invoked the attorney-client and common-interest privileges for documents that had previously been disclosed to nonparty Seagraves.[53] The communications largely consisted of communications between Bednarski and his counsel, on which Seagraves was copied, and some communications from Bednarski's counsel to Seagraves.[54] Bednarski and his counsel argued that the "common interest" linking Bednarski and Seagraves to the communications with Bednarski's counsel was a state-court lawsuit to which Bednarski was a party and for which Seagraves was paying Bednarski's legal fees.[55] But Seagraves' only interest in the state-court lawsuit was that the lawsuit represented a potential source of funds that Bednarski could use to pay a loan Seagraves had made to Bednarski.[56]

The court held that there was "too much of a disparity in the nature of the interests in the state court litigation" between Bednarski and Seagraves.[57] The court stated that, "[i]n order to be considered a 'common interest' within the meaning of the common interest doctrine, the interest must be 'identical' and it must be a 'legal' interest as perhaps contrasted to a mere business interest."[58] The court cited *Reed v Baxter*, in which the Sixth Circuit held that the common-interest doctrine did not apply when a city attorney met with two city employees to discuss a promotion decision, and two city councilmen attended the meeting.[59] Because only the city employees were involved in the underlying litigation, the Sixth Circuit held there was a disparity of interest between the employees and councilmen and therefore the common-interest doctrine did not apply.[60] Similarly, the *Cozzens* court concluded that Bednarski's disclosure to Seagraves resulted in a waiver of the attorney-client privilege.[61]

Common Issues When Determining the Scope of the Common-Interest Privilege

Several key issues emerge when attempting to determine the circumstances under which a party may invoke the common-interest privilege. Below, we generally discuss five of these issues.[62]

How Common Must the Interest Be?

Courts across jurisdictions generally require a common interest that is legal and not solely commercial.[63] Beyond this, courts vary on a spectrum of requiring (1) mere commonality of interests, (2) substantially similar legal

interests, (3) nearly identical legal interests, or (4) identical legal interests. In some jurisdictions, courts have recognized the common-interest privilege in business transactions.[64] But other courts have refused to find a common legal interest in business transactions sufficient to invoke the common-interest privilege.[65]

What is required under Michigan law is not clear. Although whether the parties shared a common interest was not at issue in *Hawkins*, the court adopted the privilege as described in the Restatement.[66] Notably, the Restatement provides that the "common interest…may be either legal, factual, or strategic in character" and that the interests "need not be entirely congruent."[67] But the *Hawkins* court also expressly stated that the communication must be related to a "common litigation interest."[68] Further, the court said it was adopting a narrow version of the common-interest privilege given the "narrow scope" of the attorney-client privilege under Michigan law.[69] Therefore, *Hawkins* does not shed much light on this question.

In both *Cozzens* and *Dura Global*, the court, applying federal common law, held that the common interest must be identical and legal as contrasted to a mere business interest.[70] In *Dura Global*, the court upheld the common-interest privilege because it found that the disclosure was made in connection with a common legal strategy, as opposed to a "joint commercial venture."[71]

Must Litigation Be Actual or Imminent?

Some jurisdictions require anticipated or actual litigation to assert the common-interest privilege. For example, the Fifth Circuit requires a "palpable" threat of litigation.[72] Many jurisdictions, however, recognize the possibility of a common-interest privilege before any threat of litigation.[73]

In *Hawkins*, the court, applying Michigan law, looked to the Restatement and applied the common-interest privilege to "potential litigants in a case as well as actual litigants."[74] Likewise, in *Dura Global*, the court, applying federal common law, recognized that the majority rule is that litigation need not be actual or imminent to invoke the common-interest privilege.[75]

Which Communications Are Protected?

It is important to know that even in the context of a valid common-interest arrangement there is uncertainty regarding which communications qualify for protection. Referring to Figure A above, it is clear that communications between the lawyers of separate clients (for example, between Lawyer A and Lawyer B) are protected.[76]

It is less clear whether communications from Client A to Lawyer B would be protected. Under the Restatement approach, which *Hawkins* held the Michigan Supreme Court would adopt, they would be covered. Indeed, the Restatement's comments provide that "any member of a client set—a client, the client's agent for communication, the client's lawyer, and the lawyer's agent (*see* § 70)—can exchange communications with members of a similar client set. However, a communication directly among the clients is not privileged unless made for the purpose of communicating with a privileged person as defined in § 70."[77] Nevertheless, *Hawkins* states that the common-interest privilege "may only be claimed if the communications are being shared between the clients' attorneys."[78]

Some of the courts that hold that communications from Client A to Lawyer B are protected[79] do so based on finding an implied attorney-client relationship. Note that such a finding could cause conflict issues for the lawyer. In other courts, the answer is unclear, but it may be that such communications are not protected.[80] Under proposed Federal Rule of Evidence 503(b)(3)—which has been incorporated in several states, but not Michigan—the client's privilege extends to communications "by him or his lawyer to a lawyer representing another in a matter of common interest."[81] Thus, a communication from Client A to Lawyer B would be protected, but a communication from Lawyer B to Client A would not. Some courts have suggested, without reference to Proposed Federal Rule of Evidence 503(6)(3), that communications from Lawyer B to Client A might not be protected.[82]

It is not clear whether communications between clients that include their counsel are protected. Under proposed Federal Rule of Evidence 503(b)(3) and many court opinions, such communications would not be protected. But it would seem that the context of such communications may make a difference, including if the communication can be classified as one involving or between the clients' counsel.[83] In comparison, it is noteworthy that communications between clients without counsel present are probably not protected.[84] As a threshold matter, there may be no

Some jurisdictions require anticipated or actual litigation to assert the common-interest privilege.

basis for asserting an underlying privilege. Notably, the *Hawkins* court observed that under the Restatement an unrepresented person who is not a lawyer cannot participate in a common-interest arrangement.[85] But again, for most of these scenarios the law is simply not clear.

Who Can Waive the Privilege?

If an underlying privilege is preserved in a valid common-interest arrangement, who can thereafter waive the privilege? Generally, the privilege is preserved unless all parties agree to waive the privilege.[86] Unauthorized waiver is generally a waiver only as to the party committing the unauthorized disclosure.[87] Under the Restatement, participants to a common-interest arrangement may unilaterally waive the privilege for their own communications.[88] If there is subsequent litigation between former parties to a common-interest agreement, the general rule is that, absent agreement to the contrary, the common-interest privilege will not prevent the parties from using disclosed communications against each other, but the privilege will still apply as to third parties.[89] In *Dura Global*, the court, applying federal common law, held that the common-interest privilege cannot be waived without the consent of all parties.[90]

Courts generally do not require a writing to assert the common-interest privilege, but it is normally recommended.

Is a Writing Required?

Courts generally do not require a writing to assert the common-interest privilege,[91] but it is ordinarily recommended. A writing will help the parties meet their burden of proving that an agreement exists, and memorializes the parties to, terms of, and date of the agreement. Done properly, a writing will make it clear that all communications were made in confidence and between only those who are evidenced as parties to the agreement. The federal district court for the Western District of Michigan has said that "[i]n determining whether the particular facts of a case establish the existence of an attorney-client relationship in a joint defense situation, the federal courts rely heavily on the provisions of any written joint defense agreement establishing the rights and duties of the parties and their counsel."[92]

Potential Pitfalls and Problems

Notwithstanding the potential benefits, entering into a common-interest arrangement is not without potential pitfalls and problems. Below are some of the issues that counsel should consider before entering into a common-interest arrangement.

- **Waiver—**The obvious risk of disclosing privileged materials in reliance on a common-interest agreement is the possibility of waiving the privilege. If, for some reason, the common-interest privilege does not apply, the underlying attorney-client privilege likely has been waived.
- **Unintended attorney-client relationships—**Absent adequate safeguards, a common-interest agreement could lead to a finding of unintended attorney-client, implied attorney-client, fiduciary, or third-party beneficiary relationships between counsel for one party to the agreement and the other parties, which counsel did not intend to represent.[93]
- **Current, future, and potential conflicts—**The attorney's receipt of confidential information from non-client parties could result in a conflict that would preclude the attorney and the attorney's firm from being adverse to the non-client party.
- **Discoverability—**In some jurisdictions, the agreement itself is not considered privileged. Further, courts generally require the identification of group members.[94]
- **Reduced freedom to control your defense—**In addition to losing some control, the parties in a litigation scenario may need to spend time resolving strategic differences. This is especially problematic if one party's best strategy (for example, introducing certain evidence or witnesses) is detrimental to other parties to the agreement.
- **A co-party may settle without you.**
- **A co-party may sue you.**
- **Malpractice exposure—**If an attorney for one party to the common-interest agreement makes a mistake (for example, failing to timely file a dispositive motion on behalf of the group), all of the parties to the common-interest agreement might pursue a claim, arguing that the attorney owed each of them a duty under the common-interest agreement.

Provisions to Consider Including in a Common-Interest Agreement

Below are some of the provisions that counsel should *consider* including in a writing memorializing a common-interest agreement:

- A detailed description of the parties' common legal interest(s).
- When the common-interest privilege arose.
- The agreement applies to all information, whether written or oral, shared pursuant to the agreement.
- The parties intend for the common-interest privilege to apply to communications predating the written agreement. (This, of course, does not excuse the parties from showing that the privilege otherwise applies.)
- Each party agrees to assert the common-interest doctrine and all other applicable privileges when responding to any discovery request.
- Information shared will not be disclosed to a third party without the consent of the party who provided the information absent court order.
- Parties will use information exchanged only for the purposes of furthering the parties' common interest.
- Confidentiality must be maintained after the lawsuit has ended.
- Materials disclosed pursuant to the agreement may not be used by one party against another in a legal proceeding.
- Waiver of the common-interest privilege cannot occur without the consent of all parties.
- A party is not prohibited from disclosing or otherwise using in any way information that originated from that party.
- Sharing of information shall not be the basis for a later attempt to disqualify another party's lawyer in a subsequent matter unless the subject matter is nearly identical.
- A process for the return of inadvertently produced privileged information, including a statement that inadvertent production does not waive the privilege.
- A definition of the scope and limits of the parties' relationship.
- A broad advance waiver, providing that the parties agree that nothing in the agreement, nor compliance with the terms of the agreement by any party, shall be used as a basis to seek to disqualify the respective counsel of such party in any future litigation.[95]
- A clear delineation of each lawyer's responsibilities and duties to avoid, as much as possible, creating implied attorney-client relationships. State that:
  - Each party is represented exclusively by its own attorney, and no attorney-client relationship is intended or created (either express or implied) between any party and counsel for another party.
  - Actions taken under the agreement are intended solely to benefit the attorney's individual client.
  - Nothing in the agreement is intended to interfere with each attorney's obligations to the attorney's client.
  - The agreement is not intended to make any party the agent of any other party for any purpose.
  - Each attorney has performed thorough conflict checks.
  - Each attorney has explained the agreement to his or her client and that client has agreed to be bound by the agreement's terms.
  - The parties and their counsel are not obligated under any duty to share information or materials.
- A process for removing uncooperative co-parties that includes a way to protect all disclosed confidences.
- Each party retains the right to independently settle, and must provide prompt notice of any settlement to the other parties.
- Any party may withdraw with notice to all parties, and upon doing so must return all confidential information it received.
- All modifications must be made in a signed writing.
- A merger clause specifying that all

Although common-interest agreements may result in lower litigation costs and other benefits from information sharing, they do not come without risks.

agreements are contained in the document.[96]

- Specific performance or injunctive relief are appropriate remedies to compel performance of the agreement.
- The writing should be signed by each attorney and each party.

Conclusion

Although common-interest agreements may result in lower litigation costs and other benefits through information sharing, these benefits do not come without risks. First, lawyers must understand the common-interest privilege law in their jurisdiction so that they do not unduly expose their clients to the risk of waiving the underlying attorney-client privilege. Second, lawyers must evaluate the other parties and counsel with whom the common interest is shared. A lack of trust amongst the group members ought to be a red flag. Additionally, lawyers should carefully consider current and potential future conflicts of interest. Third, in most circumstances, lawyers should insist on a written common-interest agreement with appropriate provisions to protect the lawyer and the lawyer's client. Finally, lawyers should carefully explain to clients both the benefits and risks of common-interest agreements.

NOTES

1. *See Leibel v GMC*, 250 Mich App 229, 242, 646 NW2d 179, 186-187 (2002) ("Once otherwise privileged information is disclosed to a third party by the person who holds the privilege, or if an otherwise confidential communication is necessarily intended to be disclosed to a third party, the privilege disappears."). Note, however, that "waiver of the attorney-client privilege will not necessarily constitute a waiver of work-product protection." Niehoff, Malone, Proctor, and Taylor, *The Attorney-Client Privilege and the Work-Product Doctrine in Michigan*, § 29, p 34. Generally, federal courts find a waiver if work product is disclosed to an adversary. *See id.*, § 30, p. 35.

2. Niehoff, Malone, Proctor, and Taylor, *The Attorney-Client Privilege and the Work-Product Doctrine in Michigan*, § 11, p 14 (2003) ("Although there is very little Michigan authority on point, most courts have recognized that, when the privilege is waived, that waiver extends to all communications on the same subject matter.").

3. *State Farm Mut Auto Ins Co v Hawkins*, No 08-10367, 2010 US Dist LEXIS 55260, at *6 (ED Mich June 4, 2010) (Cleland, J) (subsequent proceedings not included).

4. We submit that "common interest" agreement is more appropriate because it reflects the underlying common-interest privilege and the breadth of scenarios to which the privilege may apply. The common-interest privilege is also referred to as the joint-defense privilege, community-of-interest rule, and the allied lawyer doctrine, among other things. But it appears that "common interest" privilege is the most widely accepted.

5. *See Teleglobe Communications Corp v BCE, Inc (In re Teleglobe Communications Corp)*, 493 F3d 345, 365 (3rd Cir 2007).

6. Restatement (Third) of Law Governing Lawyers § 75.

7. Katherine Traylor Schaffzin, *An Uncertain Privilege: Why the Common Interest Doctrine Does Not Work and How Uniformity Can Fix It*, 15 B U Pub Int L J 49, 63 (Fall 2005) (hereinafter "An Uncertain Privilege").

8. *Id.* at 65.

9. *State Farm Mut Auto Ins Co v Hawkins*, No 08-10367, 2010 US Dist LEXIS 55260, at *6.

10. *Hawkins* is the only Michigan case we found that deals with the common-interest privilege under Michigan law. The other Michigan federal district court cases that we cite all expressly state that they are applying, or appear to be applying, federal common law.

11. *See Hawkins*, 2010 US Dist LEXIS 55260 at *7.

12. *Hawkins*, 2010 US Dist LEXIS 55260.

13. *See*, *e.g.*, *Dura Global, Techs, Inc v Magna Donnelly Corp*, No. 07-10945, 2008 US Dist LEXIS 41432 (ED Mich May 27, 2008) (Majzoub, Mag J) *adopted by* No. 07-10945, 2008 US Dist LEXIS 51095 (ED Mich July 2, 2008) (Cox, J) (subsequent proceedings not included); *In re Smirman*, 267 FRD 221 (ED Mich May 12, 2010) (Zatkoff, J).

14. *Hawkins*, 2010 US Dist LEXIS 55260, at *1.

15. *Id.*

16. *Id.* at *2.

17. *Id.* at *8.

18. *Id.*

19. *Id.* at *7. Because plaintiff's complaint alleged state-law claims, the court, under Federal Rule of Evidence 501, applied state privilege law.

20. *Id.*

21. *Id.*

22. *Id.* *7 (citing Restatement (Third) of the Law Governing Lawyers § 76).

23. *Id.*

24. *Id.* at *8.

25. *Id.*

26. *Id.*

27. *Id.*

28. *Id.*

29. *Id.*

30. *Dura Global,* 2008 US Dist LEXIS 41432.

31. *Id.* at *1.

32. *Id.*

33. *Id.* at *2.

34. *Id.*, n.2.

35. *Id.* at *1.

36. *Id.*

37. *Id.* (quoting *MPT, Inc v Marathon Labels, Inc*, No 1:04 CV 2357, 2006 US Dist LEXIS 4998slip copy at *6 (ND Ohio Feb 9, 2006) (quoting *Libbey Glass, Inc v Oneida, Ltd*, 197 FRD 342, 347 (ND Ohio 1999)).

38. *Id.* at *2.

39. *Id.* (quoting, *United States v BDO Seidman, LLP*, 492 F3d 806, 817 (7th Cir 2007)).

40. *Id.* at *3.

41. *Id.* at *1, *3.

42. *Id.* at *3.

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.* (citing 197 FRD at 347).

47. *Id.* at *3.

48. *Id.*

49. *Id.* (quoting *In re Regents of the Univ of California*, 101 F3d 1386, 1390 (Fed Cir 1996)).

50. *Id.* (quoting *United States v BDO Seidman, LLP*, 492 F3d 806, 816 n 6 (7th Cir 2007)).

51. *Id.* at *1.

52. *Id.* at *2.

53. *Id.*

54. *Id.*

55. *Id.* at *4.

56. *Id.*

57. *Id.*

58. *Cozzens v City of Lincoln Park*, No 08-11778, 2009 US Dist LEXIS 64112, at *4 (ED Mich July 24, 2009) (Hluchaniuk, Mag J) (subsequent history not included).

59. *Id.* at *4 (citing *Reed v Baxter*, 134 F3d 351, 357 (6th Cir 1998)).

60. *Id.*

61. *Id.* at *4.

62. These issues are based on the five questions for any jurisdiction striving to effectively apply the common-interest privilege identified by Professor Schaffzin. *See*, An Uncertain Privilege, at 69.

63. *See, e.g., Strougo v BEA Assocs*, 199 FRD 515, 520 (SDNY 2001); *In re Pittsburgh Corning Corp*, 308 BR 716, 728 (Bankr WD Pa 2004).

64. *See, e.g., Hewlett-Packard Co v Bausch & Lomb, Inc*, 115 FRD 308 (ND Cal 1987) (applying common-interest rule to protect disclosure of patent opinion letter to potential purchaser of patent); *In re Teleglobe Communications Corp*, 493 F3d 345, 364 (3d Cir 2007) (noting that the common-interest doctrine applies in civil and criminal litigation, and even in purely transactional contexts).

65. *See Walsh v Northrop Grumman Corp*, 165 FRD 16, 19 (EDNY 1996) (holding that the common-interest privilege did not apply, because developing a business strategy did not transform the parties' common interest into a legal interest, even though there was a concern about litigation); *SCM Corp v Xerox Corp*, 70 FRD 508, 512 (D Conn 1976) (holding that the parties did not share a common interest but were only negotiating at "arm's length" a business transaction between themselves).

66. *Hawkins*, 2010 US Dist LEXIS 55260 at *7.

67. Restatement (Third) of the Law Governing Lawyers § 76 cmt e (2000).

68. *Hawkins*, 2010 US Dist LEXIS 55260 at *7.

69. *Id.*

70. *Cozzens v City of Lincoln Park*, No. 08-11778, 2009 US Dist LEXIS 64112, at *4 (ED Mich July 24, 2009) (Hluchaniuk, Mag J) adopted by No 08-11778, 2009 US Dist LEXIS 94463 (ED Mich Oct 9, 2009) (O'Meara, J); *Dura Global*, 2008 US Dist LEXIS 41432 at *3.

71. *Dura Global*, 2008 US Dist LEXIS 41432 at *3.

72. *See United States v Newell*, 315 F3d 510, 525 (5th Cir 2002) (recognizing that "[c]ommunications between potential co-defendants and their counsel are only protected if there is 'a palpable threat of litigation at the time of the communication, rather than a mere awareness that one's questionable conduct might someday result in litigation'").

73. *See e.g. United States v BDO Seidman, LLP*, 492 F3d 806, 814-18 (7th Cir 2007) (holding that the common-interest doctrine applied to support the claim of attorney-client privilege regarding the voluntary disclosure of a legal memorandum despite the absence of a threat of litigation).

74. *Hawkins*, 2010 US Dist LEXIS 55260 at *8.

75. *Dura Global*, 2008 US Dist LEXIS 41432 at *3.

76. *Id.* at 3; *Hawkins* at *8.

77. Restatement (Third) of the Law Governing Lawyers § 76 cmt d (2000).

78. *Hawkins*, at *8.

79. *See United States v McPartlin*, 595 F2d 1321 (7th Cir 1979) (citing the Supreme Court's approval of proposed Federal Rule of Evidence 503(b)(3), which extends the privilege to communications by a client to a lawyer representing another in a matter of common interest).

80. *See United States v Bay State Ambulance & Hosp Rental Serv, Inc*, 874 F2d 20, 29 (1st Cir 1989) (denying assertion of joint-defense privilege when communications from client to another client's attorney were made without the client first consulting his own attorney).

81. Proposed Fed R Evid 503(b)(3).

82. *See In re Teleglobe Communications Corp*, 493 F3d 345 (3rd Cir 2007) (requiring that information be shared with an attorney for the common-interest privilege to apply).

83. In *In re Smirman*, the court upheld the common-interest privilege for a nonparty that had disclosed its attorney's patent opinion to its customer, which was subsequently sued for patent infringement. No. 09-51223, 267 FRD 221 (May 12, 2010) (Zatkoff, J). But in *Smirman*, the party seeking discovery did not challenge the common-interest agreement, but instead asserted that it was entitled to the documents at issue because the customer that received the documents was now relying on an advice-of-counsel defense.

84. *See United Sates v Gotti*, 771 F Supp 535, 545 (EDNY 1991) (stating that extending the privilege to communications between clients, even in the absence of counsel, is not supported in law or logic and is therefore rejected).

85. *Hawkins*, 2010 US Dist LEXIS 55260 at *7.

86. *Dura Global*, 2008 US Dist LEXIS 41432, at *2.

87. *An Uncertain Privilege,* at 83.

88. Restatement (Third) of The Law Governing Lawyers § 76 cmt g.

89. *See e.g., Matter of Grand Jury Subpoena Duces Tecum Dated November 16, 1974*, 406 F Supp 381, 386 (SD NY 1975); *see also* Restatement (Third) of The Law Governing Lawyers § 76(2), cmt. f.

90. *Dura Global*, 2008 US Dist LEXIS 41432, at *2; *see also*, *In re Smirman*, 267 FRD at 221, 223 (same).

91. *See* Restatement (Third) of The Law Governing Lawyers § 76 cmt c ("Exchanging communications may be predicated on an express agreement, but formality is not required.").

92. *City of Kalamazoo v Michigan Disposal Serv Corp*, 125 F Supp 2d 219, at 232.

93. The "general rule [is] that there is no attorney-client relationship between counsel for co-defendants in a joint defense situation." *City of Kalamazoo v Michigan Disposal Serv Corp*, 125 F Supp 2d 219, 234 (WD Mich 2000). "This general rule is unexceptional, but it does not erect an impregnable barrier against finding an attorney-client relationship in all cases. Numerous authorities recognize that, even where counsel are acting in a joint defense situation on behalf of their own clients, the circumstances of that representation may create an implied attorney-client relationship with co-defendants." *Id.* (citing *United States v Henke*, 222 F3d 633, 637 (9th Cir 2000) ("A joint defense agreement establishes an implied attorney-client relationship with the co-defendant ...")).

94. *See*, *e.g., Trading Techs Int'l, Inc v eSpeed Int'l, Ltd*, No 04 C 5312, 2007 US Dist LEXIS 36797 (ND Ill May 17, 2007) (requiring the identification of group members in lieu of producing agreement, which did not exist), *later proceeding*, 507 F Supp 2d 854, *aff'd*, 595 F3d 1340 (Fed Cir 2010).

95. *See In re Shared Memory Graphics LLC*, 659 F3d 1336, 1340-41 (Fed Cir 2011) (upholding broad waiver where there was a non-attorney-client relationship involving sophisticated parties).

96. *See ABC Barrel & Drum Sites v Detrex Corp*, No 220784, 2002 Mich App LEXIS 234 (Fed 19, 2002) (holding that merger clause in joint-defense agreement precluded claim based on alleged promises made to induce entry into agreement, including that litigation would be aggressively defended and party's share of expenses would not exceed certain sum).

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Diversity Jurisdiction and Limited Liability Companies

By Gavin J. Fleming and Eric A. Parzianello

Introduction

In *CMPS Inst, LLC v MMG II, LLC*[1] and *Vericorr Packaging, LLC v Osiris Innovations Group, LLC,*[2] the United States District Court for the Eastern District of Michigan joined the majority of federal courts in holding that, for purposes of diversity jurisdiction,[3] Michigan limited liability companies are deemed to be citizens of each of the states in which their members reside. Because a match between the citizenship of a plaintiff and a defendant will destroy diversity, the decision is important for business lawyers for two reasons. First, it is important to understand why these quasi-corporate entities are treated like partnerships for purposes of diversity jurisdiction. Second, the practical requirement of the decision is now a critical component part to any pre-suit investigation. Consequently, given the import of *CMPS* and *VeriCorr*, this article outlines the legal rationale for *CMPS* and *VeriCorr* and suggests the approach that must be taken before filing a claim in federal court based on diversity jurisdiction on behalf of a limited liability company.

Background and Current Law

The Limited Liability Company

Under the Michigan Limited Liability Company Act, a limited liability company is defined as an "unincorporated membership organization."[4] The limited liability entity allows its members the freedom to be taxed as if they were partners and to enjoy the protections of the corporate veil.[5] These entities are therefore claimed to be hybrids of corporations and partnerships.

A comparison of the Michigan Business Corporation Act and Michigan Limited Liability Company Act reveals numerous similarities between the statutory schemes.[6] First, both entities are governed by controlling shareholders or members who often work for the business and manage its affairs.[7] The statutory rights and duties of those in control and those not in control are virtually identical.[8] For example, the individual or entity in control makes the day-to-day business decisions, but is required to hold meetings, take votes, and perform other requirements before certain actions can be taken.[9] In short, the corporate governance structure that pervades the Business Corporation Act is incorporated in to the Limited Liability Company Act. Additionally, minority shareholders or members have specific statutory rights in the event of oppression, deadlock, and other events that require court intervention.[10]

Diversity Jurisdiction Relative to Corporations and Unincorporated Entities

Every first year law student learns that "[t]he district court shall have original jurisdiction of all civil actions where the matter in controversy exceeds the sum or value of $ 75,000, exclusive of interest and costs, and is between… citizens of different states."[11] The general rule applies to individuals, corporations, and unincorporated entities.

Because a corporation is deemed to be a citizen of a state, Congress amended 28 USC 1332 to specifically address the application of diversity jurisdiction to corporations. 28 USC 1332(c) specifically addresses diversity jurisdiction regarding corporations.[12] Under 28 USC 1332(c)(1), "a corporation shall be deemed to be a citizen of every State and foreign state by which it has been incorporated and of the State or foreign state where it has its principal place of business…."[13] Commonly known as the "Entity Test," this rule makes the task of determining the citizenship of a corporation fairly straightforward.

Unincorporated entities, such as partnerships, are treated differently. Specifically, a partnership is deemed a citizen of each state in which a partner resides.[14] This rule, which is known as the "Persons Composing Rule," requires a searching analysis to determine the citizenship of each partner or member. As developments in corporate/business law spawned new hybrid entities such as LLCs (which, as noted above, have numerous similarities to corporations), the federal courts began to struggle with the issue of whether the citizenship of these hybrid entities should fall under the Entity Test or the Persons Comprising Rule.

CMPS Inst, LLC v MMG II, LLC

CMPS involved a lawsuit between two limited liability companies.[15] The claims in *CMPS* ranged from breach of contract to violation of the Michigan Limited Liability Company Act.[16] *CMPS* originally filed the case in the Washtenaw County Circuit Court. *MMG* timely removed the case to the United States District Court for the Eastern District of Michigan.[17] *CMPS* moved to have the case remanded.[18] In a published opinion, Judge Feikens granted the motion for remand.[19]

Judge Feikens' rationale for holding that a limited liability company is a citizen of every state in which its members reside is straightforward: because Michigan law defines these entities as "unincorporated membership organizations," they cannot be deemed "corporations" under applicable federal law.[20] Specifically, as noted above, corporations are deemed to be citizens of the state in which they are incorporated.[21] The plain language of the statute does not permit the statute to be extended to hybrid or quasi-corporate entities.[22] Noting that federal courts have followed suit and refused to extend the term "corporation" to include a limited liability company,[23]Judge Feikens simply joined the growing majority of courts that treat limited liability companies in this fashion.

Indeed, in one of the earliest cases on this issue, in dictum, Judge Richard Posner made the point that limited liability companies are hybrid entities and therefore are not corporations for purposes of 1332.[24] Today, with the exception of the Tenth Circuit[25], which has simply not had occasion to pass on the issue, every other circuit follows the Persons Comprising Rule.[26]

In *CMPS*, Judge Feikens opinion also made specific reference to the common sense policy arguments of *MMG*'s counsel regarding the burden this rule places on litigants. Specifically, MMG's counsel set forth two policy reasons for utilizing the Entity Test: 1) the process of having to look to each members citizenship before filing suit is highly inefficient, involving complex multiple-level inquiries; and 2) members of LLCs are now unfairly restricted from litigating in federal court, depriving them of the ability to litigate in a neutral forum.[27] Judge Feikens noted that both of these arguments were persuasive, but nonetheless declined to adopt them.[28]

The import of *CMPS* and *VeriCorr* is clear: litigants must perform a multi-level analysis of the citizenship of every member of the limited liability company.

VeriCorr Packaging, LLC v Osiris Innovations Group, LLC

In *VeriCorr*, plaintiff filed suit in the United States District Court for the Eastern District of Michigan alleging that the court had jurisdiction under 28 USC 1332.[29] Defendant apparently did not dispute the jurisdictional allegation.[30] Nevertheless, the court, on its own initiative, issued orders requiring each party to disclose the citizenship of each of its members.[31] Following the submission of the disclosures, the court discovered that there was not complete diversity of citizenship.[32]

VeriCorr's counsel filed a brief arguing that a limited liability company should be a citizen of the state where it is organized.[33] The court disagreed, citing to the "prevailing" federal law on this point and discounting the cases cited by plaintiff's counsel.[34]

Under *CMPS* and *VeriCorr*, which remain good law as of the date of submission of this article, a searching inquiry of the citizenship of each member is required.

The Effect of *CMPS* and *Vericorr*

Practical Requirements

The import of *CMPS* and *VeriCorr* is clear: litigants must perform a multi-level analysis of the citizenship of every member of the limited liability company. In *VeriCorr*, plaintiff's counsel submitted the following table to the court, which appears in the court's opinion:[35]

Member	Citizenship
Sabeli, LLC	North Carolina LLC whose sole member is North Carolina citizen
Knot Tee Time, LLC	North Carolina LLC whose sole member is Florida citizen
MarBry Holdings, LLC	Florida LLC whose sole member is Florida citizen
Janet B. Simpson	North Carolina
John G. Sutlive	Georgia
John Blanton	North Carolina
Adriana Avila	Michigan
Rick Nickerson	Michigan
Larry Larkin	Georgia
Kathy McClure	Illinois
Keith Souther	North Carolina

This table illustrates the analysis that must be performed. Specifically, each member must be located and interviewed to clarify where the member resides. In addition, in the event the member is an LLC, counsel must discern if the LLC has one or more members

and where each member resides. While the table set forth above is a good starting point, the best practice would be to obtain affidavits from every member.

Importantly, relying on the client's records in this regard may not be sufficient. Residence of individuals can change and that change may not be reflected in the corporate records.

In summary, as a practical matter, counsel for an LLC Plaintiff must conduct a rigorous and searching factual investigation.

CMPS *and* VeriCorr *Place a Heavy Burden on Counsel and Litigants*

For numerous reasons, determining the citizenship of every member of a limited liability company is burdensome in today's corporate and legal world. At the outset, if the plaintiff is at the bottom of an entity chart, for many national businesses determining citizenship could take weeks of phone calls, e-mails, and research. For example, as noted above, such a task may entail contacting numerous people who may or may not be available to answer counsel's questions. Thus, in a case involving a request for injunctive relief, invaluable time may be lost, compromising the ability of counsel to act quickly.

Second, the process of scrutinizing every member's citizenship imposes a huge cost on clients. While many clients may have a working entity chart, very few have the level of detail seemingly required. In the wake of *Iqbal*[36] and *Twombly*,[37] the Federal Rules of Civil Procedure may arguably require counsel to detail this exhaustive process in the Complaint, spending paragraph after paragraph on the citizenship issue. These heightened pleading requirements increase the cost of litigation and make it more difficult for lawyers to comfortably estimate the cost of the initial phase of the case.

Finally, because the domicile and residence rules are less than clear, discerning the residence of a member necessarily requires detailed analysis. For example, the individual who owns a home in two states may claim one as their residence, but *VeriCorr* and *CMPS* seemingly require an evaluation of whether this claim is accurate.

Business clients from competitive markets typically make emergency requests for assistance that may involve the filing of a motion for preliminary injunction or temporary restraining order. Many members of the section regularly counsel clients with these concerns. The rationale for obtaining an injunction is generally to prevent irreparable harm from taking place. Having a verified complaint dismissed without prejudice on jurisdictional grounds could cause the party seeking the injunction a loss of valuable time at best and untold harm to a clients business at worst. Moreover, when acting as local counsel for out-of-state lawyers, there is nothing worse than having to explain why the court elected to dismiss the complaint.

Conclusion

Because the *CMPS* and *VeriCorr* cases will remain good law for the foreseeable future, business lawyers must engage in the analysis set forth above. Even though such an analysis is burdensome in today's corporate environment, until the United States Supreme Court or Congress elects to expand 28 USC 1332(c), practitioners must perform the jurisdictional analysis as a matter of course.

[A]s a practical matter, counsel for an LLC Plaintiff must conduct a rigorous and searching factual investigation.

NOTES

1. 521 F Supp 2d 616, 617 (ED Mich 2007).
2. 501 F Supp 2d 989, 990 (ED Mich 2007).
3. 28 USC 1332(a).
4. MCL 450.4102(2)(k).
5. *See generally* MCL 450.4101, *et seq.*
6. *Compare* MCL 450.4101, *et seq.* with MCL 450.1101.
7. *Id.*
8. *Id.*
9. *Id.*
10. *Compare* MCL 450.1489 with MCL 450.4515(1).
11. 28 USC 1332.
12. 28 USC 1332(c) (1958).
13. 28 USC 1332(c)(1).
14. *Cosgrove v Bartolotta*, 150 F3d 729, 731 (7th Cir 1998).
15. 521 F Supp 2d at 617.
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.*
20. *Id.*
21. 28 USC 1332(c)(1).
22. *Id.*; *see also Cosgrove*, 150 F3d at 729.
23. *Id.*
24. *Id.*
25. *Citadel Crossing Assocs, LP v CentiMark Corp*, No 11-cv-02653-CMA, 2011 US Dist LEXIS 125164 (D Colo Oct 27, 2011) (Although neither the Supreme Court nor the Tenth Circuit have spoken specifically on the issue of citizenship of LLCs or a partnership, the broad consensus throughout the circuits is that an LLC, much like a partnership, is deemed to be a citizen of all of the states of which its members are citizens. . .[t]hus, in order to ascertain whether Plaintiffs Citadel and Nesbitt are actually diverse from Defendant, this Court need[s] to know each member's citizenship, and if necessary each member's members' citizenships.")

26. *See Wetmore v MacDonald, Page, Schatz, Fletcher & Co, LLC*, 476 F3d 1, 1 (1st Cir 2007) (holding that parties were diverse because none of LLC's members shared plaintiff's citizenship); *Handelsman v Bedford Vill Assoc Ltd P'ship*, 213 F3d 48, 52 (2nd Cir 2000) (holding that LLCs "for diversity purposes [were] citizens of Florida because both entities have Florida members"); *Zambelli Fireworks Mfg Co v Wood*, 592 F3d 412, 420 (3rd Cir 2010); *General Tech Applications, Inc v Exro Ltda*, 388 F3d 114, 120 (4th Cir 2004) (holding that an LLC "has the citizenship of its members"); *Harvey v Grey Wolf Drilling Co*, 542 F3d 1077, 1080 (5th Cir 2008); *Thomas v Guardsmark, LLC*, 487 F3d 531, 534 (7th Cir 2007) (stating that "[f] or diversity jurisdiction purposes, the citizenship of an LLC is the citizenship of each of its members"); *One-Point Solutions, LLC v Borchert*, 486 F3d 342, 346 (8th Cir 2007) (holding that "[a]n LLC's citizenship, for purposes of diversity jurisdiction, is the citizenship of each of its members"); *Johnson v Columbia Props Anchorage, LP*, 437 F3d 894, 899 (9th Cir 2006) ("We therefore join our sister circuits and hold that, like a partnership, an LLC is a citizen of every state of which its owners/members are citizens."); *Rolling Greens MHP, LP v Comcast SCH Holdings LLC*, 374 F3d 1020, 1022 (11th Cir 2004) (joining all other federal circuits "that have answered this question . . . in the same way: like a limited partnership, a limited liability company is a citizen of any state of which a member of the company is a citizen").

27. 521 F Supp 2d at 618.

28. *Id.*

29. 501 F Supp 2d at 990.

30. *Id.*

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.* (internal citations omitted).

35. *Id.*

36. 556 US 662 (2009).

37. 550 US 544 (2007).

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Agreements to Agree: Drafting Tips for Keeping the Deal Together and Avoiding Unwanted Consequences

By T.L. Summerville*

Introduction

Parties to sophisticated transactions have often sought ways to hold one another contractually accountable during negotiations without also being responsible for the contemplated deal before it is vetted to their satisfaction. In that regard, business lawyers have relied on agreements to agree to keep deals together before consummation. Agreements to agree, however, may not be as reliable as the drafters might hope, and their drafting and execution can have unintended consequences. This article briefly discusses caselaw affecting agreements to agree and discusses ways attorneys can protect their clients from liability before a transaction is complete.

The *Pennzoil* Problem

Agreements to agree gained great notoriety in 1985 when a Texas jury returned a verdict of $10.53 billion against Texaco, Inc. in a lawsuit brought by Pennzoil Company. At the time the verdict was the largest damages award ever rendered by a civil jury.[1] Although the suit was filed in Texas state court, Texaco obtained an injunction against the judgment's enforcement in the United States District Court for the Southern District of New York. Pennzoil appealed that decision to the Second Circuit Court of Appeals and then to the United States Supreme Court.[2] In an opinion written by Justice Powell[3], the Supreme Court reversed the lower courts' rulings on *Younger* abstention grounds, thereby permitting Pennzoil to proceed with efforts to collect a judgment that both sides agreed would exceed $11 billion.[4]

The lawsuit between Pennzoil and Texaco is of critical importance to business lawyers. As Professor Lloyd observed in his 2005 article, it may be tempting to assume the jury verdict arose from a mass toxic tort or environmental liability case, but the reality is that Texaco's liability stemmed from a corporate transaction—its 1984 acquisition of Getty Oil Company.[5]

Before Texaco purchased the stock of the company founded by oil magnate J. Paul Getty, Getty Oil had been negotiating a sale with Pennzoil.[6] In early January 1984, Pennzoil and Getty Oil reached an agreement in principle on the terms of that purchase.[7] The Getty Oil board of directors agreed to sell the company to Pennzoil for the equivalent of between $112.50 and $113.00 per share.[8]

After reaching agreement on the purchase price, Getty Oil and Pennzoil prepared a press release describing the parties' agreement, but clarifying that "[t]he transaction [was] subject to [the] execution of a definitive merger agreement, approval by the stockholders of Getty Oil and completion of various governmental filing and waiting-period requirements."[9] Both Getty Oil and Pennzoil agreed to the language of the press release, which was vetted by their lawyers.[10] The press release also specifically referred to the parties' deal as an "agreement in principle."[11]

After learning about the deal between Getty Oil and Pennzoil, representatives of Texaco approached Gordon Getty, one of J. Paul Getty's sons and controller of a trust that owned 40 percent of Getty Oil's stock, about a transaction between Texaco and Getty.[12] With no formal agreement executed between Getty Oil and Pennzoil, Texaco and Getty Oil negotiated a separate deal apparently with little or no concern for the effect their transaction might have on Pennzoil or its consequences to either of them.[13]

When Pennzoil learned of Getty Oil's agreement with Texaco, it threatened to sue for breach of contract.[14] Getty Oil, however, acted first and filed suit in Delaware seeking a declaration that there was no binding contract with Pennzoil.[15] Pennzoil initiated its own suit, also in Delaware, against Getty Oil for specific performance.[16] Upon learning of certain indemnities given by Texaco to Getty Oil as part of that agreement, Pennzoil amended its suit adding a claim for tortious interference against Texaco.[17] The Delaware Court denied Pennzoil's request for a pre-

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liminary injunction, and before either Getty Oil or Texaco could file an answer to Pennzoil's complaint, Pennzoil dismissed that action and filed a new suit against Texaco in Texas.[18]

The trial lasted more than five months, and at the conclusion, the jury found that Texaco had indeed interfered with Pennzoil's agreement with Getty Oil, although the trial court never instructed the jury on the difference, if any, between a "contract" and an "agreement" under applicable law.[19] The jury awarded compensatory damages in favor of Pennzoil of $7.53 billion and another $3 billion in punitive damages.[20] *Pennzoil Co v Texaco, Inc* thus became a critical case in American contract and business tort law. Indeed, the prevailing sentiment in this country at that time was that Pennzoil's suit stood on shaky ground at best. Once the jury verdict was rendered, however, transactional lawyers and business litigators took note that even when parties believe they are not executing a binding agreement, the law—or a finder of fact—may reach a different conclusion.

The question for business lawyers thus becomes: how can parties draft a non-final agreement that will be binding in some respects, or not binding at all?

Why Parties May Want an Agreement to Agree

Although *Pennzoil Co v Texaco, Inc* changed the landscape for the enforceability of agreements to agree, Michigan has long held that such agreements are unenforceable where key provisions are not included. The Michigan Court of Appeals recently restated the law applicable to agreements to agree in *Trapp v Volmer:*[21]

> Michigan law recognizes that parties may enter into an enforceable contract that requires them to execute another contract at a later date. *Opdyke Investment Co. v. Norris Grain Co.*, 413 Mich. 354, 359, 320 N.W.2d 836, ___ (1982); *Prof. Facilities Corp. v. Marks*, 373 Mich. 673, 679, 131 N.W.2d 60 (1964); *Hansen v. Catsman*, 371 Mich. 79, 82, 123 N.W.2d 265 (1963). However, to be valid, a contract to contract must contain all essential elements that are to be incorporated into the final contract. *Opdyke*, 413 Mich. at 359 (citing *Socony-Vacuum Oil Co. v. Waldo*, 289 Mich. 316, 323, 286 N.W. 630 (1939)). If any material term is left to be decided in the future, no contract is made. *Hansen*, 371 Mich. at 82.[22]

Nevertheless, parties to a complex transaction may want some form of a binding agreement to agree in place. Under Michigan law, the easiest way to avoid a result like the one in *Pennzoil* is to leave a material term open. But if that is done, then either side could walk away at any time with impunity. That result may also be contrary to the negotiating parties' wishes. That said, inserting all materials terms may also lead to an undesirable result—being held responsible for breaching the contemplated agreement before it is fully executed.

In transactions where not much is at stake for the parties, drafting an agreement to agree that omits material terms may pose no significant hurdle. But in complex mergers and corporate takeovers, the parties may wish to hold the other accountable in case the deal falls apart. Parties to a complex merger may invest significant resources and money performing due diligence reviews, and they may come very close to reaching a final agreement. But if the material terms have not been put into writing and agreed upon, the time and money spent by one side may be for naught if the other walks away. In other words, a party seeking to acquire another company could spend tens, if not hundreds, of thousands of dollars investigating and negotiating a deal, only to be left holding the bag if the seller suddenly decides to walk away. That was essentially Pennzoil's position after Getty Oil agreed to sell its stock to Texaco. The question for business lawyers thus becomes: how can parties draft a non-final agreement that will be binding in some respects, or not binding at all?

Obviously, parties not wishing to be bound to an agreement can avoid the issue altogether by agreeing to nothing, in writing or otherwise. But that view is too simplistic and ignores a basic reality of commercial transactions: parties to a merger or acquisition need to be able to bargain with one another and conduct their respective investigations knowing the other side is equally motivated. The less one side has at risk, the less reason the other has to trust that the deal will go through. Putting nothing in writing means a seller could expose sensitive corporate records and books to a prospective buyer with little or no assurances in place as to the buyer's level of interest. A seller's chances of closing the deal are lessened if the buyer is not on the hook.

The Lesson of **Findling v Lossing***:* *Less is More*

In Michigan, when parties to a transaction decide to execute an agreement to agree, they must be careful about what is put in writing. In addition to the handling of material terms, the parties should also give consideration to the length and scope of the agreement to agree. The more that is put in writing, the more a court may be inclined to enforce some sort of agreement. *Findling v Lossing*[23] is a recent Michigan case that stands as an example of parties going too far with an agreement calling for the execution of a later binding agreement.

In *Findling*, a divorcing couple executed a Memorandum of Understanding that, among other things, outlined their respective responsibilities relating to a business they had owned together, Total Travel Management, Inc., and called for their agreement to be reflected in their final divorce decree.[24] The wife, Linda Lossing, owned 51 percent of the business's shares and agreed to pay her husband, David Garback, $600,000 for the value of his shares.[25] In particular, the Memorandum of Understanding provided that:

> [t]he balance of value less loan of Mr. Garback's stock[ ] is $600,000.00. Linda [Lossing] *will* cause TTM to redeem Brent Garback's stock over a period of 60 months. Payments in the amount of $10,000.00 per month *shall* be paid by TTM to Brent Garback commencing with the entry of the Judgment of Divorce. Part of this payment is interest at the rate of 4.5% per annum. Linda [Lossing] *shall* guaranty these payments with a written guaranty.[26]

The Memorandum of Understanding was executed on December 15, 2005.[27] The parties' divorce decree was entered in June 2006.[28] By January 2007, Lossing had paid none of the money referenced in the Memorandum of Understanding to Garback.[29] Lossing also attempted to discharge the debt owed to Garback in a Chapter 11 bankruptcy proceeding.[30] In response, David Findling, a receiver appointed by the family court, filed suit to have the $600,000 debt declared to be nondischargeable.[31] Findling also sued Lossing in state court for breach of contract based on her failure to abide by the terms of the Memorandum of Understanding.[32] The trial court granted summary disposition in Findling's favor, finding that the Memorandum of Understanding "clearly evidenced the parties' intent that [it] be a [binding] settlement agreement."[33] On appeal, Lossing argued that the Memorandum of Understanding "was simply an agreement to agree, [and] that the parties did not intend it to be a binding contract."[34]

Rejecting Lossing's argument, the Michigan Court of Appeals noted several factors it believed demonstrated that the Memorandum of Understanding was indeed intended to be binding. Among them were its length and breadth of subjects covered.[35] The Memorandum of Understanding "span[ned] 10 pages and cover[ed] division of property ranging from 401Ks, to real estate, to a wine collection."[36] Also arguing in favor of the Memorandum of Understanding's binding nature was language in the introduction stating that the Memorandum of Understanding's terms would be "put on the record" and a provision specifying that the parties' divorce decree would incorporate the Memorandum of Understanding's terms.[37] In addition, the court of appeals noted that "just above the signature lines, the Memorandum of Understanding read[], 'The undersigned have read the foregoing agreement, understand and approve all of its terms and conditions, and agree to execute same voluntarily and *be bound by all its terms and conditions*.'"[38]

The *Findling* case stands as a prime example of what parties not intending to be bound should not do. Irrespective of whether Lossing actually thought the Memorandum of Understanding was meant to be an agreement to agree, a point the court of appeals did not credit, parties intending not to be bound would be wise to heed *Finding*'s warnings. Everything from boilerplate terms respecting signatures to the length of the document may be seen as evidence of an agreement to be bound. In *Findling*, the scope, length, and language of the Memorandum of Understanding all doomed Lossing's attempt to avoid responsibility for the $600,000 owed to her ex-husband. Lawyers wishing to protect their clients from being bound would be wise to note these factors when drafting inchoate agreements.

An Agreement to "Negotiate"

In *Trapp,*[39] the Michigan Court of Appeals upheld a trial court ruling finding that an agreement between two parties to "develop a succession plan whereby they will either sell their stock to an employee stock option plan (ESOP) or exchange their stock through a

In Michigan, when parties to a transaction decide to execute an agreement to agree, they must be careful about what is put in writing.

merger or acquisition" was unenforceable.[40] The agreement called for the succession plan to "be in effect by March 1, 2005" and further provided that "[a]ny changes or alternative resolutions must be mutually agreed upon by both parties."[41] The parties never implemented a succession plan, and Daniel Trapp sued his former boss, Terry Vollmer, for breach of the agreement.[42] Although the agreement at issue sued on the identified parties, the subject matter, and the implementation date, "it contain[ed] no specifics regarding the succession plan such as a mechanism for determining the stock purchase price and the plan's components."[43] Because the agreement lacked "particulars with regard to its subject matter: the succession," the court of appeals found that it was "merely an unenforceable agreement to negotiate, rather than an enforceable agreement to agree…."[44]

The end result is that an agreement to negotiate material terms in the future, or one that leaves material terms open, is not a binding contract in Michigan.

It is worth noting the court of appeals' distinction in *Trapp* between an unenforceable agreement to *negotiate* and an enforceable agreement to *agree* on something in the future. The distinction flows from the court's formulation of Michigan law. The agreement in *Trapp* left open a material term. Therefore, it could not be an enforceable agreement to agree. The court of appeals may have chosen to refer to the agreement in *Trapp* by another name to avoid confusion. The end result is that an agreement to negotiate material terms in the future, or one that leaves material terms open, is not a binding contract in Michigan.

Once again, the importance of careful drafting becomes paramount. In this case, the plaintiff wanted to enforce the agreement against the defendant but could not do so because an important aspect of Michigan law respecting agreements to agree was overlooked—the parties left an essential term of their agreement unresolved. Parties wishing not to be bound to a final agreement would be mindful to note this result. If a material term is left open, the agreement or some portion thereof may not be enforceable. Parties wishing not to be left without a remedy, on the other hand, may consider a liquidated damages provision—commonly called a "break up fee"—with explicit consideration and terms spelled out or an escrow agreement respecting funds each side is to deposit as an insurance policy of sorts for the benefit of the other party. In the event one side walks away, the other is entitled to receive payment of all or some significant portion of the escrowed amount.

Remark LLC v Adell Broadcasting—*Unintended Consequences*

In September 2011, United States District Judge George Steeh ruled that parties negotiating a settlement agreement were bound to its terms even though the agreement had not been executed. In *Remark LLC v Adell Broad,*[45] the plaintiff, Remark LLC, sued Adell Broadcasting for copyright infringement. After reaching an out-of-court resolution, the parties began working on a settlement agreement and exchanged several red-lined versions for comment by their attorneys.[46] Remark's counsel, upon reviewing a version of the settlement agreement sent by Adell's counsel on December 11, 2009, made the following representation in an e-mail:

> We've reviewed your proposed revisions. Because we'd like to get this wrapped up, we will agree to all of your proposed changes. Please incorporate them into a final version for execution. As a reminder, payment is due…within 7 business days of execution. I will follow up with method and address, etc. Thank you.[47]

Judge Steeh found that "Remark's acceptance of Adell's 'red line verson' [bound] both parties to the agreement."[48] But if that were not enough, the court went on to find that Adell's response left acceptance beyond doubt:

> Attached is a Final Version of the… [s]ettlement [a]greement. Please have your clients execute the agreement and return 2 originals to me for execution by [Adell]. Once the [a]greement has been fully executed, we will return one of the fully executed Agreements and arrange for payment of the settlement.[49]

To Judge Steeh, Adell's "unequivocal and unambiguous" assent demonstrated that the parties had reached "a meeting of the minds on the materials terms of the settlement agreement and led the court to hold that the settlement agreement was fully enforceable, even though it had not been executed.[50] In particular, Judge Steeh noted that the parties had agreed on: "(1) the payment of $50,000 to Remark, (2) no further use or displays of the [infringing] commercial, and (3) release of liability."[51] The court found that language stating that agreement the would be "[e]ffec-

tive as of the date the parties sign[ed] the Agreement[,]" was neither controlling nor persuasive, as it was not a material term of the parties' agreement.[52]

Adell argued that the Michigan Court of Appeals' decision in *Angelo DiPonio Equipment Co v State of Michigan*[53] required that the settlement agreement be held unenforceable.[54] Judge Steeh rejected that contention, finding that the parties in *DiPonio Equipment* were clearer in their intent not to be bound when exchanging drafts:

> In *DiPonio*, the [Court of Appeals] held that the defendants had not made an offer to contract because the unsigned contractual documents were sent to the plaintiff along with a cover letter "indicat[ing] that execution of the contract forms by plaintiffs did not constitute an award of the contract."[55]

In *Remark*, on the other hand, Judge Steeh noted that

> [t]here [was] no indication from the email correspondence … that "effective as of the date the parties sign the agreement" was a material term… or that the agreement would not be enforceable until signed by Adell. In light of the circumstances at the time, the parties became contractually bound [when Remark agreed to all of Adell's proposed changes] on December 14, 2009.[56]

Although the agreement at issue in *Remark* was a settlement agreement, rather than an agreement to agree, the key lesson is the same for drafters of agreements to agree. The inclusion of material terms coupled with evidence demonstrating an intent to be bound may lead a court to find an enforceable agreement, even where the parties may have not explicitly so provided. The result in *Remark* may have been avoided had the lawyers clearly conveyed that the settlement agreement was never intended to be binding or explicitly provided that execution of the document at a later time was key to an enforceable contract. Had that been the case, Adell might have avoided enforcement of the settlement agreement.

Conclusion

Since *Pennzoil Co v Texaco, Inc*, agreements to agree have presented significant problems for transactional lawyers and litigators because, in some respects, it blurred the lines between what is and what is not an enforceable agreement to agree. Several of the material terms were included in the press release, but so were provisions explaining that the agreement was one "in principle" and that a final document would need to be executed. While the rule in Michigan has long been that an agreement to agree is only enforceable if it includes all material terms, based on the holdings of *Lossing*, *Trapp*, and *Remark* it is entirely possible that a court applying Michigan law would have found that a binding agreement existed between Pennzoil and Getty Oil.

To avoid that result, drafters of agreements to agree that are not intended to create legally binding obligations should be careful not to include all material terms and avoid, where possible, drafting documents that are lengthy and cover the waterfront in terms of subject matter. To make the agreement not to be bound clear, best practices suggest that drafters of agreements to agree should include a provision explicitly stating that no binding agreement between the parties is intended, nor shall one take effect, unless and until a comprehensive and fully integrated agreement is executed through handwritten signatures of identified representatives of the parties. Documents exchanged as part of the negotiating process should also contain an explicit statement of that intent and reservation.

In addition, parties to a transaction could accomplish a similar result, i.e., avoiding liability for a deal that does not close, with an agreement to agree, but subject to specific conditions precedent. Drafters could include in purchase agreement provisions that require the satisfaction of defined conditions precedent for the deal to become finally consummated and specify that no legal or equitable consequences will result to either side if not. This arrangement has the effect of binding the parties to the transaction while also providing peace of mind that liability will not result if the deal does not close because of an unsatisfied condition.

The inclusion of material terms coupled with evidence demonstrating an intent to be bound may lead a court to find an enforceable agreement, even where the parties may have not explicitly so provided.

NOTES

1. See Robert M. Lloyd, Pennzoil v. Texaco, *Twenty Years After: Lessons for Business Lawyers*, 6 Tenn J Bus L 321 (2005).

2. See *Pennzoil Co v Texaco, Inc*, 481 US 1, 6 (1987).

3. Chief Justice Rehnquist and Justices White, O'Connor, and Scalia joined in Justice Powell's opinion for the majority. Justices Scalia, Brennan, Blackmun,

Marshall, and Stevens each filed separate opinions concurring in the majority's judgment. Thus, the majority's judgment reversing the rulings of both the Second Circuit Court of Appeals and the Southern District of New York was unanimous. *Pennzoil Co*, *supra* at 3-4.

4. *Pennzoil Co*, supra at 4.
5. Lloyd, *supra* at 321.
6. *Id.* at 326-28.
7. *Id.* at 326-331.
8. *Id.* at 331.
9. *Id.* at 332.
10. *Id.* at 332.
11. *Id.* at 332.
12. *Id.* at 324, 333.
13. *See id.* at 333-337.
14. *Id.* at 339.
15. *Id.* at 339-340.
16. *Id.* at 340.
17. *Id.* at 340.
18. *Id.* at 341-342.
19. *Id.* at 343, 347.
20. *Id.* at 348.
21. No 297116, 2011 Mich App LEXIS 1081 (June 16, 2011).
22. *Trapp*, *supra* at *1.
23. No 296841, 2011 Mich App LEXIS 754 (Apr 26, 2011).
24. *Id.* at *1.
25. *Id.*
26. *Id.* (emphasis added).
27. *Id.*
28. *Id.*
29. *Id.*
30. *Id.*
31. *Id.* at *2.
32. *Id.*
33. *Id.*
34. *Id.* at *4.
35. *Id.*
36. *Id.*
37. *Id.*
38. *Id.* (emphasis added).
39. No 297116, 2011 Mich App LEXIS 1081 (June 16, 2011).
40. *Id.* at *1.
41. *Id.*
42. *Id.*
43. *Id.* at *2.
44. *Id.* at *2.
45. No. 10-12767, 2011 US Dist LEXIS 106877 (ED Mich Sept 20, 2011).
46. *Id.* at *1-*2.
47. Id. at *2.
48. *Id.* at *11.
49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.*
53. 107 Mich. App. 756, 309 NW2d 566 (1981).
54. *Id.*
55. *Remark LLC*, *supra* at *11.
56. *Id.*

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Indemnification Clauses: Be Careful What You Ask For (Or Agree To)

By Michael S. Callahan

The 2009 Michigan Supreme Court case of *Zahn v Kroger Co*[1] provides an excellent analysis of the current status of express contractual indemnification law in the state of Michigan, as well as useful guidance on how express contractual indemnification meshes with worker's compensation requirements. In addition, the opinion sheds light on the relationship between statutory comparative fault provisions and valid contractual indemnification provisions. For business attorneys, a working knowledge of the *Zahn* case can be very helpful in drafting form documents (e.g. purchase orders, sales agreements) as well as negotiating specific terms of an indemnification clause for customized transactions.

The facts of the *Zahn* case are fairly common. An employee of a subcontractor was injured at a construction site; the injured employee sued the general contractor and the owner of the site. The owner filed a third-party claim against the general contractor seeking indemnification, and the general contractor in turn filed a third-party claim against the subcontractor/employer, also seeking indemnification (presumably, the injured party did not sue his employer (the subcontractor) because of the bar-created under worker's compensation laws that generally prevent an employee from suing his/her employer for injuries due to work related accidents).[2] The general contractor settled with both the plaintiff/injured party and the owner of the site, leaving only the general contractor's claim against the subcontractor/employer. The general contractor obtained a judgment against the subcontractor/employer enforcing the terms of the indemnification clause between the general contractor and the subcontractor. After determining the general contractor was 20 percent at fault, the court required the subcontractor/employer to indemnify the general contractor for 80 percent of the settlement paid by the general contractor, as called for by the indemnification clause; the indemnification clause explicitly excluded damages arising exclusively through the negligence of the general contractor.

The subcontractor/employer appealed, claiming that a Michigan statute, MCL 600.2956, limits the application of contractual indemnification because the statute requires that parties be held responsible only for their pro rata share of negligence.[3] The court of appeals rejected this argument and ruled that the cited statute does not apply to claims based on contract. The Michigan Supreme Court granted leave to appeal to review the issue of whether MCL 600.2956 was applicable and also requested that the parties address whether the exclusive remedy provisions of the worker's comp law in any way preclude an employer (in this case the subcontractor) from voluntarily subjecting itself to liability for negligence by means of an indemnification contract.

The Michigan Supreme Court upheld the court of appeals decision that MCL 600.2956 does not apply to claims based on contracts. The Supreme Court quoted extensively from the case of *Essell v George W Auch Co*[4] in reaching the conclusion that the language selected by the legislature for MCL 600.2956 does not bar actions to recover based on contractual obligations and that the contractual language selected by the parties is controlling. As for the exclusive remedy provisions of the worker's comp law, the Supreme Court held that "… an employer may voluntarily subject itself to liability for damages to employees from which it would otherwise be insulated." [5]

A number of very useful points emerge from the *Zahn* case. First and foremost, courts will enforce indemnity agreements as written, provided there is no ambiguity. Indemnification agreements are subject to the same rules of construction as contracts in general, and therefore, a court will only consider the language used by the parties (i.e. will not consider parole evidence) in evaluating any claims.[6] The indemnification language in the *Zahn* case called for the subcontractor to indemnify the general contractor "…to the fullest extent permitted by law… to the extent of the negligence attributed to such acts or omissions by the Subcontractor" but with

an exception for "…damages arising exclusively through the negligence of Martin" (the general contractor)."[7] The trial court found negligence by both the subcontractor and the general contractor and allocated fault 80 percent to the subcontractor and 20 percent to the general contractor. The appeal by the subcontractor sought to have MCL 600.2956 applied, presumably so that its 80 percent allocation could be reduced. It is unclear how the subcontractor could rely on MCL 600.2956 (which calls for a party to be liable for its pro rata share) where the subcontractor's pro rata share, as determined by the trial court, is 80 percent. In any event, the Michigan Supreme Court has clearly indicated that parties may, by contract, operate entirely outside the scope of MCL 600.2956 since the statute only applies pro rata allocation in the context of tort claims or claims seeking damages for personal injury, property damage, or wrongful death, whereas the claim in the *Zahn* case is purely contractual, specifically for indemnification and, therefore, not impacted by the cited statute.

As for the argument that the worker's comp law bars a third-party claim for indemnification that is in turn predicated on a negligence claim by an employee, the court used the following three sentences to reject it: "…Although Cimarron (injured party's employer) cannot be held directly liable for negligence by its own employee by virtue of the WDCA, nothing in contract law precludes an employer from voluntarily assuming liability for negligence through a contractual arrangement. Similarly, nothing in the WDCA precludes parties from entering into such an agreement. Accordingly, we conclude that the contract language controls, and we affirm the judgment of the Court of Appeals."[8] The result is that contractual obligations to third parties can expose an employer to liability that is otherwise barred by the worker's comp law.

The *Zahn* case involved a construction contract that includes indemnification by subcontractors, which is a fairly common practice. The holdings of the *Zahn* case should also be applicable in the context of other commercial relationships, provided the bargaining power of the parties is not so unequal as to give justification for not enforcing an agreement as written. For instance, a seller that provides sophisticated machinery to a buyer may include a provision that requires the buyer to abide by all directions in the manuals for the machinery and also include an indemnification provision so that if the buyer fails to abide by all directions in the manual, the seller could look to the buyer in the event a buyer's employee were injured and the injured employee then pursues, among others, the seller. If an employee of the buyer is injured while using the sophisticated machinery, the employee would be barred from suing his/her employer (the buyer) but would receive worker's compensation benefits from the buyer (or the buyer's worker's compensation carrier). The injured party could, however, sue the seller of the sophisticated machinery and possibly others in the chain of distribution. The theories of recovery are state law-specific but, in general, the injured employee relies on product liability law. At this point, the seller would seek to rely on its contractual indemnification rights to recover from the buyer and/or be defended by the buyer, depending on the exact terms of the indemnification clause, provided that the seller can establish the predicate facts that trigger the indemnification obligation. In this example, the seller would have to prove that the buyer did not abide by the directions in the manual and that the injury to the plaintiff/employee of buyer was due to or resulting from the failure by buyer to abide by the directions in the manual. The seller may even be able to seek indemnity and defense from the buyer based merely on *allegations* of the buyer's failure to follow the directions in the manual (regardless of whether buyer did in fact follow all directions) depending on the exact terms and provision of the indemnification clause. At the risk of stating the obvious, the specific language of an indemnification clause is extremely important in determining the magnitude of exposure of the indemnifying party as well as the proofs the indemnified party must produce. Several excellent articles/presentations are available that address indemnification issues in the context of specific areas/applications.[9]

[T]he specific language of an indemnification clause is extremely important in determining the magnitude of exposure of the indemnifying party as well as the proofs the indemnified party must produce.

A number of Michigan cases following *Zahn* have interpreted various terms and provisions contained in indemnification clauses. The overriding theme of these cases is that the court will apply well-accepted rules of contractual interpretation, which means the court will give meaning to all of the words in an indemnification clause and will enforce the results of these words. Two significant consequences of contractual interpretation of indemnification clauses are that a party can be indemnified for its own negligence and that a party seeking to be indemnified does

not have to show fault or misconduct by the party from which indemnification is sought. Several recent Michigan Court of Appeals cases provide excellent examples.

In the case of *Ajax Paving Indus, Inc v VanOpdenbosch Constr Co,*[10] the court of appeals upheld a very broad indemnification provision, citing the *Zahn* decision for the proposition that the court applies to indemnity contracts the same contract construction principles that govern any other type of contract. The court upheld an indemnification clause that covered damages "…caused, occasioned or contributed to, or claimed to be caused, occasioned or contributed to by any act, omission, fault or breach of subcontractor…." The court affirmed summary disposition for the general contractor on its indemnification claim against the subcontractor, indicating that "…the language provides only that a claim must be made without specifying who must make the claim or, more importantly, that the claim even need be proven."[11] The court also ruled that the general contractor could recover costs and expenses under the indemnification clause from the time of the underlying claim, notwithstanding the fact that the general contractor did not notify the subcontractor of the underlying claim until eighteen months after it had been filed.

In *Steffey v Morris,*[12] the court of appeals held that the indemnification language in a listing agreement was applicable, regardless of any negligence by the party seeking to be indemnified because "the plain language of the indemnification clause demonstrates that the parties intended the provision to apply to any circumstance where the cause of action arose out of any act or omission of Sun Coast (broker) regardless of claims of contributing or comparative negligence."[13]

In *Mutual v Kojaian Mgmt Corp*,[14] the court of appeals upheld a very broad indemnification clause, stating as follows: "We also note that the language of the indemnification provision is extremely broad. The provision covers claims that are *alleged* to arise, directly or *indirectly,* out of *or in connection with* Bonded's contractual performance or failure to perform. Parties are free, under their freedom of contract, to allocate risks and responsibilities however they wish. See *Rory v. Continental Ins. Co.* 473 Mich 457; 703 NW2d 23 (2005) (parties have freedom to contract)."[15]

Last, in *Greene v Sterling Woods Condo Ass'n*,[16] the court of appeals ruled that because the indemnification clause at issue did not explicitly include "negligent omissions," the party seeking indemnification based on the negligent *failure* of another party to perform certain contractually agreed functions could not recover under the indemnification language but could assert a breach of contract claim. The point is, once again, that the court will closely read the exact words of an indemnification clause and then apply the result.

The takeaway from this article is that courts will enforce what the parties' agreement states regarding indemnification. The commercial realities of a given transaction dictate how broad or narrow an indemnification clause may be. The clause need not necessarily be mutual or balanced, but in all events, each party should make sure it fully understands the scope and ramifications of the indemnification clause before agreeing to it.

[E]ach party should make sure it fully understands the scope and ramifications of the indemnification clause before agreeing to it.

NOTES

1. *Zahn v Kroger Co*, 483 Mich 34, 764 NW2d 207 (2009).

2. MCL 418.131.

3. MCL 600.2956 reads in pertinent part as follows: "Except as provided in [MCL 600.6304] in an action based on tort or another legal theory seeking damages for personal injury, property damage, or wrongful death, the liability of each defendant for damages is several only and is not joint. However, this section does not abolish an employer's vicarious liability for an act or omission of the employer's employee."

4. *Essell v George W Auch Co*, No 240940, 2004 Mich App LEXIS 606 (Feb 24, 2004) (unpublished).

5. *Zahn* at 37.

6. *See Ajax Paving Indus, Inc v Vanopdenbosch Constr Co*, 289 Mich App 639, 797 NW2d 704 (2010).

7. *Zahn* at 38 (explanation added).

8. *Zahn* at 42 (explanation added).

9. Gregory Drutchas & Richard M. Mitchell, *Insurance and Indemnification Issues for Health Care Practioners, Providers and Payers* (8th Annual Michigan Health Care Institute held Mar 7-8, 2002); Mark S. Allard, *Indemnification and Hold Harmless Agreements; Where Do Your Responsibilities Lie?*(ICLE seminar, Ethics and Your Practice held Nov 11, 2003); Susan M. Kornfield, *Strategic Considerations in "Standard" License Agreements* (17th Annual Business Law Institute held June 3-4, 2005); Kevin T. Block, *Drafting Effective Indemnification and Escrow Agreements* (22nd Annual Business Law Institute held May 21-22, 2010).

10. See FN 6.

11. *Ajax* at 645.

12. *Steffey v Morris*, No 293078, 2010 Mich App LEXIS 2089 (Oct 28, 2010) (unpublished).

13. *Id.*

14. *Mutual v Kojaian Mgmt Corp*, No 293740, 2010 Mich App LEXIS 2466 (Dec 21, 2010) (unpublished).

15. *Id.*

16. *Greene v Sterling Woods Condo Ass'n*, No 295030, 2011 Mich App LEXIS 626 (Apr 7, 2011) (unpublished).

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The Naked License: What Business Lawyers Need to Know to Protect Their Clients Against Trademark Abandonment

By Beverly M. Griffor

Introduction

The Lanham Act, 15 USC 1051 et seq. enacted by the United States Congress in 1946, provides a national registration system for trademarks that protects the owners of each federally protected mark against its unauthorized use. A trademark, at its core, is more than the name or logo affixed to a product. It is a designation of origin and a symbol of status, designating the quality of the source of the identified goods or services. Trademark holders are also protected against the use of similar marks by other parties if such use is likely to result in consumer confusion or the dilution of a famous mark. The trademark denotes for the end consumer where the goods in question come from, who makes them, or who is responsible for them. Consumers, in turn, rely on these protected marks to insure that they purchase the same product or service they have come to know from prior experience. They become comfortable with a particular provider of goods, or prefer one over another.

Licensing of a Trademark

Vendors can use the trademark system to sell goods that originate from another source. The most familiar of these circumstances to average consumers is any fast food chain, where an owner pays a fee to a larger company for the ability to use the trade name of the chain and even sell its goods. A trademark license is an agreement between a trademark owner, or "licensor," and another entity called "the "licensee." Typically, a contract is drawn up in which the licensor grants the licensee express permission to use the trademark in relation to the licensee's products or services. This is an advantageous agreement for both parties. The licensor is able to profit from the licensing payments and any negotiated royalties, while the licensee is able to gain customer confidence through the affiliation with the famous mark.

Trademark Abandonment

While it is theoretically possible for a trademark to remain in perpetuity, a trademark owner must carefully guard against abandonment. The abandonment of a trademark can occur in a number of ways, such as nonuse of the mark for three or more years, or deliberate discontinuation.[1]

The consequences of abandonment for an existing trademark license can be dire. If the licensor no longer has an exclusive and enforceable right to the use of the trademark to designate its goods, there is no reason for the licensee to continue to pay for the right to use the mark. Consumers will no longer be able to rely on the mark as a designation of origin, since the mark is not under the exclusive control of the original trademark holder. When abandonment occurs, the mark is free to be used by others, including a licensee. Because of this concern, it is very important to be sure that the licensor carefully guards its rights and protects the integrity of its protected marks.

Naked Licensing of the Trademark

One of the ways in which a trademark can be abandoned, even as to the licensee, is through "naked licensing" of the trademark.[2] "A license of a trademark that does not place sufficient controls on the licensees' use of the mark is termed a 'naked license.'"[3] Any business that handles its mark, in part, through licensees is required to have power over the quality of the goods or services sold under its mark. The failure of the licensor to adequately control the quality of the goods or services bearing its trademark can also trigger abandonment through the creation of a "naked license."[4]

A naked license is a license in name alone, bare, stripped, and exposed. Its terms fail to ensure a consistent and repeatable experience for consumers to rely on, especially with regard to quality. If the mark is no longer a

designation for the quality of the goods that a consumer should expect, then the mark holder forfeits its rights to the mark. When this happens the mark may lose its meaning as a predictor of quality and cease to function in the marketplace as a protected mark should. When courts find a naked license, they are capable of declaring that the trademark has been abandoned as to the licensee or as to the world.

The Legal Landscape

While naked licensing has long been an area of scrutiny in the federal courts, a number of circuits have, in very recent years, begun to address more seriously the issue of quality control within the doctrine of naked licensing. While some jurisdictions have not had the opportunity to address this issue, others have begun to weigh in. The most pivotal issues in all of the cases decided are centered on the issue of quality control between a licensor and an alleged licensee. The cases look at how much control and oversight is enough for a trademark holder to reasonably say that they are controlling the quality of the goods or services. Each circuit deciding this issue has independently undertaken an evaluation of this principle. While the United States Supreme Court has yet to address the issue, the various circuits have not shied away from issuing opinions.[5] Taken together, these decisions, little by little, flesh out the boundaries of the behavior that encompasses naked licensing.

The abandonment of a trademark can occur in a number of ways, such as non-use of the mark for three or more years, or deliberate discontinuation.

The earliest courts to address the consequences of trademark licensing gone awry pointed out that "the only effective way to protect the public where a trademark is used by licensees is to place on the licensor the affirmative duty of policing in a reasonable manner the activities of his licensees."[6] The courts began to focus on whether the use of the mark "is controlled sufficiently by the licensor to protect his mark is whether the licensees' operations are policed adequately to guarantee the quality of the products sold under the mark."[7] "If a trademark owner allows licensees to depart from its quality standards, the public will be misled, and the trademark will cease to have utility as an informational device."[8] Abandonment results in "the loss of trademark rights against the world."[9]

The naked license, also called the uncontrolled license, was discussed at length by the Tenth Circuit, which explained that when "a trademark owner engages in naked licensing, without any control over the quality of goods produced by the licensee, such a practice is inherently deceptive and constitutes abandonment of any rights to the trademark by the licensor."[10] This view is maintained throughout the years and is reinforced by the Third Circuit, which held that "[w]hen the trademark owner fails to exercise reasonable control over the use of the mark by a licensee…the mark no longer identifies goods and services that are under the control of the owner of the mark."[11]

In *FreecycleSunnyvale v. The Freecycle Network,* there was no written or oral license agreement between the licensee and licensor, although Freecycle had sent an e-mail to its members and had posted a few voluntary guidelines and policies on its Web site.[12] After this minimal communication, the licensor made no attempt to enforce or monitor even those minimal standards it suggested. The court determined that Freecycle did not have a close working relationship with licensees that could even arguably justify its reliance on the independent quality controls of the licensees. The Ninth Circuit, in the first case involving a charitable organization, also held that the doctrine applied equally to non-profit entities.[13]

The United States Patent and Trademark Office (USPTO) has even evaluated the possibility of trademark abandonment through naked licensing in the registration stage of a mark. In *Zoba International Corp. v. DVD Format/Logo Licensing Corp.*, a petition to cancel was filed alleging that the pending registrant permitted the use of its DVD logo in an unmonitored manner "for extensive periods of time with indifference" to the quality of the products of licensees.[14] The Trademark Trial and Appeal Board of the U.S. Patent and Trademark Office determined that this pleading was adequate to survive a motion to dismiss.

The Seventh Circuit recently addressed the issue of naked licensing for the first time in *Eva's Bridal Ltd v Halanick Enters, Inc.*[15] The court examined the licensing agreement and determined that there were no quality controls or monitoring provisions contained within it. Additionally, the licensor admitted that it practically did not have any such controls in place to maintain the standards of the licensor, but rather relied only on the fact that the store sold high-end merchandise. The court was not persuaded by this argu-

ment and focused instead on consumer expectations and the consistency of the mark. The court held that:

> Trademark law requires that "decision making authority over quality remains with the owner of the mark."… How much authority is enough can't be answered generally; the nature of the business, and customers' expectations, both matter. Ours is the extreme case: plaintiffs had, and exercised, *no* authority over the appearance and operations of defendants' business, or even over what inventory to carry or avoid. That is the paradigm of a naked license.[16]

The court determined that the licensor had abandoned the mark as to the licensee, through naked licensing. It further explained that the licensee was free to use the mark without paying any compensation for its use.

Avoiding the Naked License: Ten Things to Remember

1. A trademark licensing agreement *must* always be in writing.
2. Trademark licensing agreements must include quality control language that requires the licensee to maintain a consistent quality of goods and services.
3. The agreement should include the right to inspect the licensee's actual goods or services, and the licensor should actively exercise that right.
4. The agreement should permit the licensor to monitor overall quality through inspections and other supervisory activities.
5. Licensees should be required to submit quarterly reports on the quality of the goods sold, including any difficulties encountered in maintaining quality, such as customer complaints.
6. Provisions should clearly place control of new, supplementary, or additional products associated with the mark in the hands of the licensor.
7. Licensors should require that advertising and promotional materials created by licensees be approved by the licensor prior to distribution.
8. The licensing agreement should detail how the parties will maintain a record of all efforts to monitor and control quality of goods and services, such as inspections.
9. The agreement must spell out the consequences of breaching the license and the time allotted to correct or remedy any breach.
10. The licensing agreement must contain provisions by which it can be terminated or revoked by the licensor if the licensee fails to meet quality standards or obstructs attempts to monitor that quality.

The courts have been very clear about their position: abandonment through naked licensing is a problem that licensors should avoid. While it is important that trademark licensing agreements are in writing and must include robust quality control language, this is not sufficient. It is possible that in a comparatively short time, the absence of quality control can eat away at a trademark's capacity to serve as an indicator of origin and worth, even diminishing its value overall in the market. The license should expressly give the trademark owner a right of quality control, including the right of inspection, and the licensor should follow through with the enforcement of that right. Trademark licensors must be attentive and require licensees to correct any improper or unsanctioned usage as soon as the licensor becomes aware of such use. If the licensor fails to address such behavior, it may find itself dealing with a naked licensing assertion.

In the event that naked licensing ever becomes an issue in trademark litigation or negotiation, the licensor will be relying on records of its regular and consistent endeavors to monitor quality and to control its licensees' use of its mark. It is this documentation that licensors must have prepared in the event of a dispute, and it is the licensing agreement itself that is the basis for most of this information.

Trademark licensing can be an effective way for a trademark owner to grow its brand and to bring in additional revenues. Because companies are taking this opportunity to expand, it is important that licensing agreements be crafted to protect the mark that the company has worked so hard to establish. In order to preserve the value of the licensor's trademarks and to assure the licensor that it is protected from losing its trademark rights altogether, it is imperative for the drafter to be as informed as possible. With this information, a business lawyer can offer clients the most protection possible to maintain and strengthen their intellectual property rights in protected marks.

The most pivotal issues in all of the cases decided are centered on the issue of quality control between a licensor and an alleged licensee.

NOTES

1. For definitions of abandonment and other instances of behavior that are defined as abandonment, see Lanham Act, 15 USC 1127.

2. See Lanham Act, 15 USC 1127, supra.

3. Mark H. Miller, *Unintentional Franchising*, 36 St. Mary's L J 301 at fn 63 (2005). See also *Black's Law Dictionary* at 931 (7th Ed 1999).

4. See *Eva's Bridal Ltd v Halanick Enters, Inc,* 639 F3d 788 (7th Cir 2011).

5. The Sixth Circuit has not had the occasion to render an opinion related to quality control in relation to naked licensing. In fact, the court has not addressed the quality control aspect of the doctrine on the merits. The court found in *Ritchie v Williams,* 395 F3d 283(6th Cir 2005), that no control was exercised at all in relation to any aspect of the mark's use. The court did not reach a discussion involving quality when rendering its opinion and most of the opinion focuses on co-ownership and other intricacies existing between the parties.

6. *Dawn Donut Co v Hart's Food Stores, Inc*, 267 F2d 358, 367 (2nd Cir 1959).

7. *General Motors Corp v Gibson Chemical & Oil Corp,* 786 F2d 105, 110 (2nd Cir 1986).

8. *TMT North America, Inc v Magic Touch GmbH,* 124 F3d 876 (7th Cir 1997) (citing *Kentucky Fried Chicken Corp v Diversified Packaging Corp*, 549 F2d 368, 387 (5th Cir 1977)).

9. *Id.*

10. *Stanfield v Osborne Indus*, 52 F3d 867, 871 (10th Cir 1995).

11. *Doeblers' Pennsylvania Hybrids, Inc v Doebler,* 442 F3d 812, 823 (3rd Cir 2006) (citing 2 *McCarthy on Trademarks* § 18:48).

12. 626 F3d 509 (9th Cir 2010).

13. *Id.*

14. 98 USPQ2d 1106 (TTAB 2011).

15. 639 F3d 788 (7th Cir 2011).

16. *Id.* at 791.

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Barring the Door: The International Trade Commission As a Means to Prevent Importation of Goods Utilizing Misappropriated Trade Secrets

By Daniel D. Quick and H. Jonathan Redway

Introduction

A company may have facilities spread across the globe, critical suppliers in far-flung locations, or simply an unscrupulous employee with an e-mail account. Whatever a company's situation, its trade secrets are often portable and sometimes stolen and sent abroad for misuse. When a company learns that its trade secrets are being used unlawfully, in Taiwan or China, for example, to manufacture products to be imported into the United States, the prospect of filing a lawsuit to address the wrong can be less than satisfying because of difficulties in obtaining jurisdiction over and discovery from the thief or enforcing a judgment after years of litigation.

Trade secret holders now have a new weapon that they can use to try to limit the damage from trade secret misappropriation outside the United States: the International Trade Commission ("ITC"). For many years, the ITC has been used by holders of patent, trademark, or copyright interests against foreign infringers. ITC proceedings can be particularly useful because they proceed more quickly than federal court litigation and may result in an order preventing the importation of infringing products into the United States. Yet, ITC jurisdiction was not regularly invoked for trade secrets claims. Recently, in the case of *TianRui Group Co v International Trade Comm'n*[1], the Court of Appeals for the Federal Circuit upheld the ITC's decision in a Section 337[2] case blocking importation of products produced by a foreign company using trade secrets stolen from a U.S. competitor even though all of the acts relating to the misappropriation occurred outside the United States.

The court's ruling in *TianRui* moves to the forefront the prospect of a powerful new tool in the war against trade secrets misappropriators. In the right circumstance, the relative speed and efficiency of an ITC proceeding can greatly assist a trade secrets holder to prevent further loss of market share and damage by stopping offending products at the border. The basics of ITC proceedings are reviewed below, followed by some practical advice for parties or lawyers contemplating these actions.

Background on Section 337 Claims

Section 337 of the Tariff Act of 1930 has existed for the protection of patents, trademarks, copyrights, and trade secrets in the importation of articles since the onset of the Great Depression of the 1930s. Today, Section 337 is recognized as a particularly effective remedy against the importation of articles that infringe United States patents.

Traditional Section 337 actions before the ITC have various potential advantages for the injured claimant including expanded jurisdiction, a fast-track discovery procedure, and remedies tailored to protecting U.S. companies' intellectual property rights.

Expanded Jurisdiction

- Plaintiff can obtain jurisdiction over foreign parties that he/she might not otherwise be able to reach in a traditional federal district court proceeding.
- Plaintiff is entitled to discovery from foreign entities that he/she might not ordinarily be permitted to obtain through traditional federal district court proceeding.

Fast-Track Procedure

- The ITC procedure of bringing a claim is completed in approximately

one year.[3] This is faster than most federal courts, which can often take several years.

- Discovery is fast-tracked and demanding of defendants. Discovery begins almost immediately upon commencement of an investigation. Failure to comply with discovery requirements can result in a finding against the alleged wrongdoer.

Remedies

- The ITC's traditional remedy is an exclusion order prohibiting the entry of accused products into the United States. Accused products are seized at the border before they reach the U.S. market.
- Remedies can include a "general exclusion order." This remedy prohibits any supplier, not merely the named wrongdoers, from importing unlawful products regardless of their source.
- Remedies can include excluding not only the unlawful product but any larger product that incorporates the misappropriated product. For example, if the manufacturing process of a computer chip is found to have been misappropriated, assuming the chip is found to be core to the operations of a computer, then, both the chip and the computer containing the chip could be seized at the border.

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A few examples of past cases demonstrate the potential utility of a Section 337 case. The American automotive industry has used Section 337 cases in the past as a method to protect their proprietary information outside of the trade secret context. In one Section 337 investigation, *In re Certain Automotive Parts,* Ford Global Technologies, LLC brought a complaint alleging infringement of patents it held for a variety of automotive parts, including: head lamps, tail lights, vehicle grille designs, as well as others.[4] One of the respondents accused of misappropriating the proprietary information was a Taiwanese company.[5] The ITC determined that the asserted patents were infringed by foreign competitors and issued a general exclusion order prohibiting the importation of these products.[6] More recently, an automotive supplier, Robert Bosch LLC, brought a Section 337 claim for infringement of patents that it holds for certain "wiper blades."[7] Companies from Taiwan, Korea, China, and Canada were listed as respondents in this investigation.[8]

Trade Secrets, the ITC and *TianRui*

There are many advantages to bringing a Section 337 claim before the ITC. Despite these clear benefits, few companies have made use of the speedy and powerful relief offered by Section 337 to protect against misappropriation of trade secrets. With the vulnerability that large, multi-national corporations face with regard to the misappropriation of their proprietary information, it is difficult to understand why more companies have not sought out the ITC for potential remedies. This could be about to change as a result of the holding in *TianRui.*

TianRui involved Amsted Industries, an Illinois-based cast steel railway wheel manufacturer, who accused a Chinese company with which it had some business dealings of misappropriating proprietary information.[9] Amsted was found to own two secret processes for the manufacturing of cast steel railway wheels.[10] Amsted used one of the processes in its domestic production and the other process it licensed to firms in China, including the firm Datong.[11] The firm TianRui sought Amsted's license for wheel manufacturing technology, but the parties could not agree on terms.[12] Thereafter, TianRui hired Datong employees with knowledge of Amsted's wheel manufacturing processes.[13] Amsted alleged that the hired employees disclosed confidential information to TianRui who then manufactured wheels with Amsted's secret process.[14] TianRui and another company formed a business partnership that then marketed and imported these wheels into the United States.[15]

The ITC found that TianRui had stolen the process from Amsted and blocked importation of the misappropriated products into the United States.[16] The Federal Circuit, in addition to affirming the ITC's decision to block importation of the misappropriated products, stated:

1. the ITC should apply federal trade secret law;[17]
2. the ITC has authority to consider conduct occurring in foreign countries;[18]
3. a domestic manufacturer can assert a trade secret violation claim even if the manufacturer is no longer prac-

ticing the trade secret.[19]

1) Application of Federal Law to Section 337 Trade Secret Cases

The Federal Circuit in *TianRui* considered what law should apply to a Section 337 case involving theft of trade secrets.[20] The question presented was whether to apply the law of a particular state, in this case Illinois, or whether to use a "single federal standard."[21]The court found that because international commerce is "a field of special federal concern," a federal standard should apply to Section 337 cases dealing with trade secrets.[22] This conclusion provides simplicity and predictability for domestic companies.

2) Considering Conduct in Foreign Countries in Section 337 Cases

The Federal Circuit also addressed the issue of whether the ITC can consider conduct occurring in foreign countries in a Section 337 trade secret case.[23] The Federal Circuit discussed the "principle against extraterritoriality," which is "rooted in the commonsense notion that Congress legislates with domestic concerns in mind."[24] However, it noted that in the context of Section 337: 1) the statute is directed toward the importation of articles; 2) the court would not be addressing the extraterritorial conduct if it were not related to the importation of misappropriated products; and, 3) the legislative history to the passage of Section 337 contemplated consideration of conduct abroad.[25] In light of these observations, the Federal Circuit held that the ITC can consider conduct occurring in foreign countries in a Section 337, trade secret misappropriation case.[26] This holding will better enable domestic companies to reach those who misappropriate their trade secrets to foreign countries.

3) Asserting a Section 337 Claim When The Manufacturer Is No Longer Practicing the Trade Secret

The last major issue that the Federal Circuit considered was whether a manufacturer would have standing to block the importation of a product created with stolen trade secrets when the company from whom the secrets were stolen no longer practices the trade secret in a domestic industry. The Federal Circuit evaluated a variety of tests that have been applied over the years, settling on a flexible interpretation of what constitutes an "industry."[27] The appellate court noted that the wheels produced by TianRui could directly compete with wheels domestically produced by the trade secret owner. The Federal Circuit found that there was a sufficient foundation for the ITC's conclusion that even when the manufacturer bringing a Section 337 claim no longer practices the trade secret, he can still succeed on a claim if the importation of the accused product injures an "industry."[28] This ruling should further enable many U.S. companies who do not actively practice each and every one of their trade secrets to protect all of their proprietary information from misappropriation abroad.

Practical Considerations

An ITC proceeding is not a panacea. It does not provide for an award of damages, which would have to be pursued independently via a traditional civil action. Moreover, and most significantly, the "field of battle" for ITC proceedings can be markedly different than that of regular civil litigation.[29]

ITC proceedings are overseen by administrative law judges who, together with their staff, have significant latitude in terms of how the ITC action will proceed, and thus familiarity with the personnel and the procedures is a paramount consideration for parties appearing before the ITC. Moreover, unlike civil litigation, before filing a complaint with the ITC, the petitioner has the opportunity to meet with the ITC's Office of Unfair Import Investigations (OUII). The OUII staff provides an initial review of the complaint to ensure that the information contained in the complaint is sufficient. This process is confidential and is favored by the ITC because it increases efficiency and ensures that the issues are fully developed prior to initiation of the action. The ITC decides whether it will initiate an investigation without hearing from any of the respondents. If it determines to institute an investigation, the ITC itself serves the complaint and notice of investigation on the named respondents to the investigation, as well as the embassy of each foreign respondent.

After an investigation is initiated, an administrative law judge (ALJ) is appointed to make an initial determination as to whether there has been a Section 337 violation. In addition, the ITC may appoint staff attorneys to also participate in the proceeding with the parties. The ITC staff attorneys act as an impartial representative of the public interest and have equal opportunity to participate in

[F]amiliarity with the personnel and the procedures is a paramount consideration for parties appearing before the ITC.

the proceedings by submitting briefs on issues and questioning witnesses.

Familiarity with these practices and the personnel can greatly assist a petitioner. The universe of active ITC practitioners remains relatively small and predominantly focused in the greater Washington D.C. area. While being such an "expert" is not a necessity, past experience should help a petitioner navigate somewhat unfamiliar waters. The best practice may be to have a team of both a seasoned commercial litigation attorney and an ITC practitioner, which combines the strongest talents of both areas of expertise and will make for efficient use of time if the petitioner also pursues a civil action for damages.

In that regard, a petitioner needs to consider the interplay between an ITC proceeding and any potential civil litigation. Often parallel actions are filed. The additional cost of filing the parallel action is lessened by numerous factors. First, the discovery and issue development in the ITC and a civil action are largely the same and can be used in the latter. Second, the civil action may be stayed by the respondent pending resolution of the ITC investigation pursuant to 28 USC 1659, thereby avoiding additional expense until after the ITC action is concluded. This is done in the vast majority of district court cases in which an ITC action is also filed. Finally, while a district court does not have to apply any findings or ruling of the ITC, the ITC findings are obviously highly persuasive. Conversely, an adverse decision before the ITC does not preclude a civil action due to the difference in procedure and standards applied.

In that regard, a petitioner needs to consider the interplay between an ITC proceeding and any potential civil litigation.

Finally, petitioners must realize that the ITC's greatest advantage—speed—can also be its greatest negative attribute. Petitioners are often unprepared for the accelerated pace of proceedings, which will require more executive and personnel time and, notably, much more spent on attorneys in a far more compressed time frame than a multi-year civil law suit.

Conclusion

The ITC is not for everybody and does not solve all ills caused by trade secret misappropriation. But in this increasingly global economy, the ability to obtain a relatively quick order blocking the importation of goods using your misappropriated trade secrets is a potentially powerful tool.

NOTES

1. *TianRui Group Co v International Trade Comm'n*, No 2010-1395, 2011 US App LEXIS 20607, at *2-3 (Fed Cir Oct 11, 2011).
2. 19 USC 1337.
3. In 2011, investigations were completed in an average of 13.7 monts. ITC press release: www.usitc.gov/press_room/documents/featured_news/337_timeframes_article.htm.
4. *In re Certain Auto Parts*, Inv No 337-TA-557, 2007 ITC LEXIS 681, Commission Opinion, p 1 (June 6, 2007); *In re Certain Auto Parts*, Inv No 337-TA-557, 2007 ITC LEXIS 681, General Exclusion Order (June 6, 2007).
5. See Commission Opinion, *supra* note xxvi, at 1
6. *Id.*
7. See Press Release, US International Trade Commission (Nov 22, 2011), available at: http://www.usitc.gov/press_room/news_release/2011/er1122jj1.htm.
8. *Id.*
9. *TianRui Group Co v International Trade Comm'n*, No 2010-1395, 2011 US App LEXIS 20607 at *6 (Fed Cir Oct 11, 2011).
10. *Id.*
11. *Id.* at * 3-4.
12. *Id.* at *3.
13. *Id.* at *3-4.
14. *Id.* at * 4.
15. *Id.*
16. *Id.* at *7-8
17. *Id.* at *11.
18. *Id.* at *2.
19. *Id.* at *2-3.
20. *Id.* at *11.
21. *Id.* at *10-11.
22. *Id.* at * 12.
23. *Id.* at *12.
24. *Id.* quoting *Smith v United States*, 507 US 197, 204 n 5 (1993) (internal quotations omitted).
25. *Id.* at *17-26.
26. *Id.* at *26.
27. *Id.* at *40-41.
28. *Id.* at *2-3.
29. There are many primers and articles available regarding the basics of ITC proceedings. See, for example, Atkins & Pan, *An Updated Primer on Procedures and Rules in 337 Investigations at the U.S. International Trade Commission*, 18 University of Baltimore Intellectual Property L.J. 105 (2010).

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Exclusivity and Requirements Contracts: Michigan's Muddled Law, the Majority Rule of Other States, and Their Impact on Automotive Suppliers

By Daniel N. Sharkey and Brent W. Warner*

Introduction

The enforceability of open quantity, or "requirements" supply contracts has gained increased visibility in the recent tumultuous years in the automotive industry. The current lean and fast-paced supply chain, which operates on just-in-time inventory systems, must operate without interruption. Raw material is often manufactured into a part, integrated into a sub-assembly, and installed in a vehicle, in the span of just a few days. To avoid dealing with multiple suppliers, and to leverage economies of scale, automotive suppliers usually source their needs for a particular component to a single supplier.

But limiting inventory and relying on a single source creates risk. A single supplier's refusal to ship parts can have a cascading adverse effect on the entire supply chain, and shut down an entire vehicle assembly operation in a few days. Supplier shutdowns can cause the automakers to almost immediately shut down their assembly lines. Today, even a mom-and-pop stamper can threaten to quickly wreak havoc on an entire vehicle platform's production.

The usual causes for a threatened stoppage of shipments are well known. Among other volatile forces, suppliers are often faced with circumstances that erode already-thin profit margins, such as rising costs of raw materials, volumes that are lower than forecasted, or currency exchange fluctuations. Continuing performance under long-term contracts can become the equivalent to corporate death sentences. Under these circumstances, suppliers often seek the advice of counsel to understand their rights, and explore legal avenues to either re-negotiate the terms of the agreement, or cease supply and "exit the business."

While buyers often have the long-term leverage and are able to impose their own boilerplate terms and conditions, suppliers often have enormous short-term leverage. The customer relies on a continuous and uninterrupted flow of parts, and therefore cannot usually respond to a supplier's demand by immediately switching to a new supplier. Apart from commercial issues such as pricing, buyers that want to re-source a part must identify and qualify the new supplier, obtain possession of the tooling used to make the parts, move the tooling to the new supplier, have sample parts manufactured, and submit the parts for approval. That process can take weeks or months, requiring an inventory bank of parts to bridge the gap during the move.[1]

While the supplier is focused on the immediacy of its adverse circumstances, the supplier's attorney will likely first focus on the terms of the contract.[2] In most cases, automotive supply contracts are, or at least are intended to be, requirements contracts, which Requirements are governed by UCC 2-306. While UCC 2-201 requires that every contract contain a quantity term to be enforceable, UCC 2-306 provides an express exception: requirements contracts are enforceable despite the absence of a specific, numeric quantity term. Requirements contracts only obligate a customer to purchase from its suppliers as many parts as the customer needs.

Unless carefully drafted, however, these contracts are vulnerable to a finding of invalidity. As explained below, unless the contract obligates the buyer to purchase all of its requirements exclusively from the supplier, there is a risk (the significance of which varies by state) that the buyer will not be able to enforce it beyond goods sold and delivered or released, and the supplier will be allowed

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to terminate deliveries and exit the business before the buyer has had an opportunity to resource.

The narrow purposes of this article are to describe the law in Michigan, to quickly survey the law in other states, and to provide practical recommendations for counsel advising suppliers regarding requirements contracts. Academics have considered in detail many related issues that are beyond the scope of this article, *e.g.*, does a buyer in a requirements contract breach the implied duty of good faith by reducing or eliminating its requirements?[3]

Identifying Requirements: What, Exactly, is a "Blanket"?

Requirements contracts, by their very nature, do not include a specific, numeric quantity terms, but they must include, "A term which measures the quantity by…the requirements of the buyer[.]"[4]

Buyers should explicitly identify the quantity as all of their requirements. Failing to refer to requirements and instead providing only forecast quantities that were not binding does not suffice to form a requirements contract.[5]

Any designation other than "requirements" runs the risk of being interpreted as something else, and rendering the contract unenforceable. For example, the word "blanket" may suffice as a quantity term, but sometimes it may not.[6] "As released" (which is virtually synonymous in the automotive industry for "blanket") may suffice, but premising the quantity requirements only on production releases to be issued in the future may not.[7] A term requiring that the supplier "satisfy plaintiff's needs" has also been ruled insufficient.[8]

A buyer should also avoid using equivocal language such as, "The Seller agrees to sell to the Buyer such quantities…as the Buyer may specify," or "delivery is to be made on an as required basis," or that the agreement covers a "possible requirement," or the seller "agrees to furnish buyer's requirements to the extent of and in accordance with buyer's written instructions." All of these phrases have been deemed insufficient to establish a requirements contract.[9]

Michigan's Murky Law Regarding Exclusivity

Does Michigan law obligate a requirements buyer to purchase all of its requirements exclusively from the supplier? The answer remains unclear. The Michigan Court of Appeals has ruled both ways on this issue. The U.S. District Court for the Eastern District of Michigan, however, has consistently ruled that exclusivity is not required.

Before 2005, Michigan state courts appeared to require complete exclusivity. In a 2004 case, *Benedict Mfg Co v Aeroquip Corp*, the Michigan Court of Appeals defined a requirements contract as one "in which the seller promises to supply *all* the specific goods or services which the buyer may need during a certain period at an agreed price in exchange for the promise of the buyer to obtain his required goods or services exclusively from the seller."[10]

In *Benedict Mfg Co*, the Michigan Court of Appeals relied on *Propane Indus, Inc v General Motors Corp*.[11] In that case, U.S. District Court for the Western District of Missouri, applying Kansas law, held that the purchase order at issue lacked mutuality and was invalid because the buyer did not expressly or implicitly promise to purchase exclusively from the seller.[12]

However, the court in *Propane Indus, Inc* held that exclusivity, "can be satisfied if the buyer contracts to purchase *up to a specified amount* exclusively from the seller."[13] In other words, according to the court in *Propane Indus, Inc,* "exclusivity" did not require that the buyer purchase "all of its requirements from the seller. The court further held that absent exclusivity, "[t]he promise of the seller becomes merely an invitation for orders and a contract is not consummated until an order for a specific amount is made by the buyer."[14]

Contrary to *Benedict Mfg Co*, the U.S. District Court for Eastern District of Michigan in *GMC v Paramount Metal Prods Co*[15] held that requirement contracts do not require exclusivity.[16] In that case, Paramount threatened to withhold its supply of seat frames unless General Motors (GM) either purchased Paramount's business or awarded Paramount $10 million in retroactive price increases. In exchange for continued supply, GM entered into an accommodation agreement granting Paramount financial incentives.[17]

A few months later, GM re-sourced the seat frame business and filed suit, seeking to invalidate the Accommodation Agreement on the basis of economic duress, enforce the prior purchase orders, and recover its cover damages.[18] Among other defenses, Paramount argued that GM's purchase orders

While the supplier is focused on the immediacy of its adverse circumstances, the supplier's attorney will likely first focus on the terms of the contract.

were unenforceable because they did not include a promise by GM to purchase exclusively from Paramount.[19]

The court disagreed with Paramount. It held that nothing in UCC § 2-306 or its official comments supported Paramount's assertion that requirements contracts must be exclusive, and therefore the purchase orders were enforceable contracts.[20] Quoting the Sixth Circuit's opinion in *Precision Rubber Prods Corp v George McCarthy, Inc*,[21] the court held that "a requirements contract may exist where 'all or some of' the purchaser's requirements are purchased from the seller."[22] But the court did not determine if the contract obligated GM to purchase "some" of its requirements, instead, the court held that GM only "owed a contractual duty…to execute the purchase orders 'in good faith and according to commercial standards of fair dealing in the trade.'"[23]

Unraveling the authorities set forth in *Paramount Metal*, however, reveals a shaky foundation. *Precision Rubber*, on which *Paramount Metal* relies, in turn adopted the "all or some of" phrase from the first paragraph of § 156 of Corbin on Contracts.[24]

In *Precision Rubber*, the Sixth Circuit did not consider that just a few paragraphs after the phrase it relied on, Professor Corbin went on to state that a requirements contract mandates exclusivity:

> It is true that by such a promise as this, the promisor may not undertake to continue a business on its present scale or even to run the business at all. It is true that the amount that will be needed or required will vary with the scale on which the business is run. Much, therefore, is left to the judgment of the promisor, even to his will and desire; but not everything is thus left. *The promise contains one very definite element that specifically limits the promisor's future liberty of action; he definitely promises that he will buy of no one else.* If he needs or requires or uses any of the named commodity, he must buy it of the one specified.

Corbin, 1A *Corbin on Contracts* § 156. It is possible that Professor Corbin may have meant, similar to the court's holding in *Propane Indus, Inc,* that the promisor promised not to buy the promised portion, as opposed to the entire requirement, elsewhere. In addition, *Paramount Metal* did not address earlier contrary Sixth Circuit authority.[25]

In short, *Paramount Metal* found that no exclusivity was required by relying on *Precision Rubber*, which in turn relied on Professor Corbin, whose message is not perfectly clear.

Nonetheless, *Paramount Metal* has been cited in subsequent Michigan decisions validating requirement contracts that do not require any exclusivity and do not even require a minimum purchase. For example, in *Plastech Engineered Prods v Grand Haven Plastics, Inc*,[26] a panel of the Michigan Court of Appeals *cited Paramount Metal*, and held that, "MCL 440.2306 expresses a legislative intent to enforce both exclusive and nonexclusive requirements contracts." Similar to the contract at issue in *Paramount Metal,* the contract at issue in *Plastech Engineered Prods* did not obligate the buyer to a minimum purchase.

But other panels of the Michigan Court of Appeals have disagreed. In *Acemco, Inc v Olympic Steel Lafayette*, the court again relied on *Propane Industrial*, the same Missouri case it had relied on in *Benedict Mfg*, to hold that exclusivity was a prerequisite to an enforceable requirements contract. In that case, seller Olympic, in response to an increase in raw material prices and buyer Acemco's growing orders, requested that Acemco pay premiums for continued shipments of steel. When Acemco refused, Olympic was late with some deliveries and missed others. Acemco made a cover purchase with another steel supplier, and filed suit against Olympic, seeking damages.[27] Olympic defended in part by arguing that the parties' agreement was unenforceable because it lacked a quantity term.[28] Acemco argued that the agreement did contain a specific quantity or, in the alternative, that the agreement was a requirements contract.[29] Reversing a jury verdict, the Michigan Court of Appeals found that the agreement did not contain a specific quantity and was not a requirements contract because "nothing in the written agreement binds Acemco to purchase its steel exclusively from Olympic."[30]

Three years after *Acemco*, the U.S. District Court for the Eastern District of Michigan, in *GRM Corp v Miniature Precision Components, Inc*,[31] noted the inconsistency between *Plastech Engineered Prods* and *Acemco*. In *GRM*, the court found that *Plastech Engineered Prods* was more persuasive, and held that exclusivity was not required. The court explained that nothing in the text of Section 2-306 appears to require that a requirements contract be exclusive, that a jury *could* find that the

Because exclusivity can be found by explicit provisions, implications, course of dealing, or extrinsic evidence, leaving the question of exclusivity to the jury is not unusual.

parties entered into a requirements contract, and that the supplier's decision to in-source production could therefore constitute a breach of contract.[32]

Because exclusivity can be found by explicit provisions, implications, course of dealing, or extrinsic evidence, leaving the question of exclusivity to the jury is not unusual. In the recent decision of *Saginaw Office Serv, Inc v Bank of America, NA* concerning the interpretation of an alleged common law (*i.e.*, non-UCC) requirements contract, the same court, similar to its decision in *GRM*, cited *Acemco* and *GRM*, and left the issue of exclusivity for the jury.[33]

In sum, despite a number of decisions, whether a requirements contract requires exclusivity or at least a minimum stated purchase, remains undecided in Michigan. This poses risks and opportunities for both the buyer and seller.

Practical Implications for Leverage in the Supply-Chain

Suppliers and their customers will continue to operate on this smoky battlefield until a controlling Michigan decision is issued. If a controlling Michigan decision were to follow the *Acemco* line of cases, and hold that requirements contract must be exclusive, suppliers in contracts without exclusivity or a minimum purchase would instantly have an "out." Because those contracts would not be enforceable in excess of their committed quantities, the suppliers could attempt to renegotiate commercial terms (pricing, volume, payment terms, etc.) by leveraging its just-in-time supply, and threatening to terminate.

If, on the other hand, the *Plastech Engineered Prods* line were followed, and exclusivity was not required to form a requirements contract, the leverage of customers would increase enormously. From the buyer's perspective, this would simply be affirming its power to enforce a long-term supply commitment as written. From the supplier's perspective, this would allow the buyer to string the supplier along with reduced production levels. A buyer could build an inventory bank of parts while it sources to an alternate supplier with more favorable terms (or, as the buyer in *GRM* decided, while it in-sources production). The supplier would have no remedy for the buyer's re-sourcing of all or a portion of its requirements to a competitor.

Suppliers Increasingly Contract with Customers Outside Michigan

The law of states other than Michigan is becoming increasingly important to the automotive industry. While what used to be known as the "The Big Three" domestic automakers (General Motors, Ford, and Chrysler) continue to be based in Michigan, the "transplant" automakers have established their North American headquarters in other states (Honda in Ohio, Toyota in Kentucky, Nissan in Tennessee, BMW in South Carolina, and Mercedes Benz in Alabama). Suppliers, in turn, have established a significant presence in other states.

Because the customers all have choice-of-law clauses invoking the law of their home states, the law of other states are increasingly determinative. Therefore, counsel advising suppliers to these automakers need to have a clear understanding as to which state's law will govern the interpretation and enforceability of their supply contracts. Absent a contractual choice-of-law clause, Michigan courts will apply the law of the state that "has the most significant relationship to the transaction."[34] As discussed above, this could be problematic for a Michigan customer whose out-of-state supplier has decided to cease its supply of just-in-time specially manufactured automotive components under a requirements contract that does not provide for a specific quantity, minimum quantity, or exclusivity. For example, a court may refuse to enforce a supply contract that provides for an estimated 1,000,000 parts for a year, plus or minus 20%, but does not contain either exclusivity or a guaranteed minimum purchase.

The law of states other than Michigan is becoming increasingly important to the automotive industry.

Most States Require Some Form of Exclusivity

Analysis of cases from other states reveals that most appear to hold that a requirements contract must expressly or implicitly require the buyer to purchase, at the least, a minimum amount goods exclusively from the seller.[35]

1. Arizona: *AGA S'holders, LLC v CSK Auto, Inc*, 589 F Supp 2d 1175, 1180 (D Ariz 2008) ("[a] requirements contract 'obligates the buyer to buy all of its requirements for goods of a particular kind from the seller.'") (citations omitted);
2. Arkansas: *Stacks v F & S Petroleum Co*, 6 Ark App 327, 641 SW2d 726, 727 (1982) ("a requirements contract

is simply an agreement by the buyer to buy his good faith requirements of goods exclusively from the seller");

3. Florida: *Greene v General Foods Corp*, 517 F2d 635, 640 (5th Cir 1975) (applying Florida law) (based on buyer's testimony that it did not intend to purchase exclusively from seller, contracts were not requirements contracts);
4. Georgia: *Billings Cottonseed, Inc v Albany Oil Mill, Inc*, 173 Ga App 825, 328 SE2d 426, 429-30 (1985) (relying on *Propane Indus, Inc,* supra, and stating "[a] true requirements contract obligates the buyer to purchase exclusively from the seller all the goods needed for particular use contemplated by the parties[.]");
5. Idaho: *Harvey v Fearless Farris Wholesale, Inc*, 589 F2d 451, 461 (9th Cir 1979) (applying Idaho law) (It is elementary that a requirements contract is one in which the buyer 'expressly or implicitly promises he will obtain his goods or services from the (seller) exclusively.");
6. Illinois: *Brooklyn Bagel Boys, Inc v Earthgrains Refrigerated Dough Prods*, 212 F3d 373, 377-80 (7th Cir 2000) ("[u]nder Illinois law, however, an essential element of a requirements contract is the promise by the buyer to purchase all of its requirements, or at least a minimum quantity, from the seller");
7. Indiana: *Zemco Mfg, Inc v Navistar Int'l Corp*, 186 F3d 815, 817-18 (7th Cir 1999) (applying Indiana law) (court looked to usage of trade and the course of dealing to determine intent as to exclusivity and held that, "[a] requirements contract is one in which the purchaser agrees to buy all of its needs of a specified material exclusively from a particular supplier[.]");
8. Kansas: *Fisherman Surgical Instruments v Tri-Anim Health Serv*, 502 F Supp 1170, 1177 (D Kansas 2007) ("For a requirements contract to be valid, the buyer must promise to buy the goods exclusively from the seller");
9. Kentucky: *Johnson Controls, Inc v Anson Stamping Co*, No 3:97 CV-500-S, 2000 US Dist LEXIS 22602 at *10 (WD Ky Oct 19, 2000) (holding purported requirements contract invalid because "[n]o exclusivity is present in the Supply Agreement or any of the other documents submitted by Anson");
10. Massachusetts: *Waste Stream Envtl, Inc v Lynn Water and Sewer Comm'n*, 15 Mass L Rptr 723 (Super Ct 2003) ("[c]ontracts lacking a quantity term are valid under both the common law and the UCC because the party setting volume agrees to deal exclusively with the other contracting party:);
11. Minnesota: *Porous Media Corp v Midland Brake, Inc*, 220 F3d 954, 960 (8th Cir 2000) (applying Minnesota law) ("[a] requirement contract is defined 'as a contract in which the seller promises to supply all the specific goods or which the buyer may need during a certain period…in exchange for the promise of the buyer to obtain his required goods or services exclusively from the seller.");
12. Missouri: *Essco Geometric v Harvard Indus*, 46 F3d 718, 728-29 (8th Cir 1995) (applying Missouri law) ("[a]s defined by the Missouri Supreme Court, a 'requirements contract' is 'one which one party promises to supply all the specific goods or services which the other party may need during a certain period… and the other party promises that he will obtain his required goods or services from the first party *exclusively*'");
13. Mississippi: *G.B. "Boots" Smith Corp v Cobb*, 860 So2d 774, 777 (Miss 2003) ("'[a]n essential element of a requirements contract is the promise of the buyer to purchase exclusively from the seller either the buyer's entire requirements or up to a specified amount'");
14. New Hampshire: *PMC Corp v Houston Wire & Cable Co*, 147 NH 685 (2002) ("Because a requirements contract depends on exclusivity to determine the quantity, there can be no valid requirements contract without it. However, 'despite the presence of another supplier, the contract may be sufficiently exclusive'" and a promise to purchase a "major

[M]ost jurisdictions hold that failure to affirmatively state that a buyer is obligated to purchase its requirements from the seller puts the contract at risk of being unenforceable for lack of mutuality or consideration.

share" may be sufficiently exclusive) (citations omitted);

15. New York: *Corning Inc v VWR Int'l, Inc*, No 05-cv-6532 CJS, 2007 US Dist LEXIS 18611 (WDNY Mar 15, 2007) (relying on *PMC Corp*, *supra,* and holding that sufficient exclusivity exists where buyer must purchase exclusivity for resale to certain customer groups up to a certain amount);
16. Ohio: *Orwell Natural Gas Co, Inc v PCC Airfoils, LLC*, 189 Ohio App 3d 90, 94, 937 NE2d 609 (2010) (construing a service contract, non-UCC case); *Elite Enters, Inc v Liberty Steel Prods*, No. 1:08-CV-157, 2009 US Dist LEXIS 105729 at *19-21 (ND Ind Nov 12, 2009) (applying Ohio law) (suggesting that a requirements contract requires exclusivity or a minimum amount);
17. Oregon: *Boydstun Metal Works, Inc v Cottrell, Inc*, 519 F Supp 2d 1119, 1133 (D Or 2007) ("[a] requirements contract differs from an indefinite quantity contract in that an indefinite quantity contract requires the buyer to purchase a minimum quantity from the seller, whereas a requirements contract obligates the buyer to purchase all of its required goods from the seller"); *Wilsonville Concrete Prods v Todd Bldg Co,* 281 Or 345, 574 P2d 1112, 1115 (1978) ("a requirements contract is simply an agreement by the buyer to buy his good faith requirements of goods exclusively from the seller.");
18. South Carolina: *Stevens Aviation, Inc v Dyncorp Int'l LLC*, 394 SC 300, 715 SE2d 655 at *309-311 (2011) ("[t]o create an enforceable requirements contract under the applicable law, a contract need not include the word 'exclusive' or minimum quantity terms; rather, the seller merely must have 'the exclusive right and legal obligation to fill all of the buyer's needs for the goods or services described in the contract…");
19. Texas: *Merritt-Campbell, Inc v RxR Prods, Inc*, 164 F3d 957, 963-64 (5th Cir 1999) (applying Texas law and holding "[a]n essential element of a requirements contract is the promise of the buyer to purchase exclusively from the seller either the buyer's entire requirements or up to a specified amount");
20. Washington: *Modern Sys Tech Corp v United States*, 979 F2d 200, 205 (1992) ("it is the very essence of a requirements contract…that the buyer agree to turn to the supplier for all of its needs. If there is not a commitment for all needs, then the relation is not different from an indefinite quantitites contract with no required minimum, the very type of relation that the Supreme Court held…could not be a contract."); *Brem-Rock, Inc v Warnack*, 28 Wn App 483, 624 P2d 220, 224 (1981) (applying Washington law) ("[a] requirements contract has been defined as one in which the buyer expressly or implicitly promises that he will obtain his goods or services from (the seller) exclusively.")

In several of the decisions listed above, the courts relied on *Propane Indus, Inc*, supra, just as the Michigan Court of Appeals did in *Benedict Mfg Co*.

Moreover, there are other states in which the caselaw appears to be as uncertain as Michigan's. For example, in Iowa, its court of appeals, held that "[n]othing in the statutory language of section 554.2306, or the in official comments to that section, suggest that exclusivity is a prerequisite to the establishment of a requirements contract." However, this court noted that "even if exclusivity were to be regarded as an element of a requirements contract, this requirement can be satisfied if the buyer contract to purchase up to a specified amount exclusively from the seller."[36]

The federal court for the Eastern District of California held that "demanding exclusivity for all requirements contract is contrary to the plain language of California Commercial Code Section 2-306." Yet, as in the Iowa case, the court found that contract enforceable after finding that it obligated the buyer to purchase a "minimum quanity."[37]

Some non-UCC cases have enforced contracts for less than "all."[38] And there is academic support for enforcing contracts without exclusivity.[39]

While the caselaw and authorities can be dizzying, the takeaway is this: requirements contracts should either be exclusive or provide for a minimum quantity to be pur-

Because Michigan-based automotive suppliers are increasingly supplying to customers based in other states, counsel should carefully review supply contracts and their choice-of-law clauses.

chased, or they are at significant risk of being found unenforceable.

Specified Minimums or Options Appear Enough to Replace Exclusivity

Whether stating a specific numeric percentage of requirements constitutes an adequate minimum quantity is another complex issue, and the answer may differ among the states. The "minimum quantity" concept is why some buyers include a minimum number of goods to be purchased in their terms and conditions. And if a minimum requirement is stated, can the buyer still enforce the contract up to 100% of its requirements? It remains a question whether the seller is obligated in such cases to only be able to enforce the contract up to the minimum.[40] For nearly a decade, Chrysler's quantity term stated that it would purchase "65-100%" of its requirements from suppliers. Chrysler apparently lost confidence in the enforceability of this term, because when it revised its terms and conditions in 2010, this term was eliminated. Still, the rule appears clear that stating a guaranteed minimum quantity to be purchased makes the contract enforceable.

For a similar reason, many buyers include in their terms and conditions of purchase an "option" to pay supplier some nominal consideration, such as $1 or $10. This forms what buyer hope courts will view as "contingency" consideration, in case it is found that a non-exclusive requirements contract lacks consideration. While suppliers may see this as putting legal form over business substance, it is black-letter law that courts do not consider the adequacy of consideration, and in *Johnson Controls, supra,* the court expressly approved of this approach.

Recommendations

Given this uncertain legal environment in Michigan with respect to requirements contracts, how should lawyers advise their manufacturer clients to increase their chances of prevailing in (or better yet, precluding) supply chain disputes concerning enforceability? A few fundamental lessons emerge:

1. Buyer's counsel should review buyer's standard purchase orders and their incorporated terms and conditions, and provide guidance on what language to include when the buyer intends to form a requirements contract.
2. Supplier's counsel should review purchase orders and their incorporated terms and conditions, before those suppliers immediately accept them, either expressly or by starting performance.
3. Counsel should ascertain which state law governs their clients' contracts. While the law governing contracts for the sale of goods is in many respects uniform, there are important differences from state to state.
4. Mind the quantity issue closely. The absence of a specific or a minimum quantity term may render the contract unenforceable, unless it is a requirements contract obligating the buyer to purchase "all" of its requirements.
5. If a specific quantity term is missing, lawyers should consider whether the contact explicitly requires the supplier to manufacture and deliver "all" of the customer's "requirements." If not, the lawyer should determine if exclusivity can be implied through course of dealing or course of performance. As discussed above, unless the contract includes these terms, it may be vulnerable to a finding that it violates the statute of frauds or lacks mutuality or consideration.

Conclusion

Supply contracts, particularly those associated with the automobile industry, are critical to maintaining a secure supply chain, but suppliers are often anxious to exit contracts that become unprofitable. Their enforceability is therefore a recurring and crucial question.

Whether open quantity or "requirements" contracts require that a buyer promise to purchase its needs exclusively from a specific supplier is an open question in Michigan. Most states in the U.S. require exclusivity, at least up to a specified quantity. Because Michigan-based automotive suppliers increasingly supply to customers based in other states, counsel should carefully review supply contracts and their choice-of-law clauses.

Suppliers and their counsel must understand their rights and obligations under their contracts. As noted by the courts, the tensions in the supply chain will only continue.

NOTES

1. These tensions are inherent throughout the automotive supply chain. As one court has observed, "The allocation of risk in cases like this involving so-called 'just in time' inventory management will probably continue to be the subject of continuing negotiation and litigation." *Metal One America, Inc v Center Mfg, Inc*, No 1:04-CV-431, 2005 US Dist LEXIS 40304 at *23 (WD Mich Aug 10, 2005).

2. In most circumstances, volume fluctuations and rising costs of production, by themselves do not constitute a sufficient basis to terminate an automotive supply contract because of "impracticability" under UCC § 2-615. These types of disputes, while not the focus of this article, are discussed in Daniel N. Sharkey, *The "Car Wars" in Court: Steel, Plastics, Terms and Other Fronts in Automotive Supply Litigation*, 87 Michigan Bar Journal 12 (December 2008).

3. S. Smith, *A New Approach to the Identification and Enforcement of Open Quantity Contracts: Reforming the Law of Exclusivity and Good Faith*, 43 Valparaiso Law Rev No 3 (2009).

4. UCC § 2-306(1).

5. *Aleris Aluminum Canada, LP v Valeo, Inc*, 718 F Supp 2d 825 (ED Mich 2010).

6. *Great Northern Packaging, Inc v General Tire & Rubber Co*, 154 Mich App 777, 787, 399 NW2d 408 ("the term 'blanket order' expresses a quantity term, albeit an imprecise one"); *Detroit Radiant Prods Co v BSH Home Appliances Corp*, 473 F3d. 623 (6th Cir 2007) (applying Michigan law) ("a blanket purchase order does not oblige [the seller] to manufacture or ship any parts") (internal quotations and citations omitted). *See also Acemco, Inc. v Olympic Steel Lafayette*, No 256638, 2005 Mich App LEXIS 2656 at *15 (Oct 27, 2005) (unpublished) (the term "blanket" in a referenced document outside the purchase order contract was not sufficient to act as a quantity term to form a requirements contract).

7. *Johnson Controls, Inc v TRW Vehicle Safety Sys,* 491 F Supp 2d 707, 717-718 (ED Mich 2007).

8. *Dedoes Indus v Target Steel*, No 254413, 2005 Mich App LEXIS 1309 at *4 (May 24, 2005) (unpublished).

9. *Acemco, supra*; *Advanced Plastics Corp, v White Consolidated Indus, Inc*, No 93-2155, 1995 US App LEXIS 1047 (6th Cir Jan 18, 1995); *Propane Indus, Inc v General Motors Corp*, 429 F Supp 214, 219-221 (WD Mo 1977).

10. *Benedict Mfg Co v Aeroquip Corp*, No 242563, 2004 Mich App LEXIS 1874 at n 5 (July 8, 2004) (emphasis added) (unpublished).

11. 429 F Supp 214 (WD Mo 1977).

12. *Id.* at 219-221.

13. *Id.* at 219 (emphasis added).

14. *Id.*

15. 90 F Supp 2d 861, 874 (ED Mich 2000).

16. *Id.* at 865.

17. *Id.* at 864.

18. *Id.* at 865.

19. *Id.* at 873.

20. *Id.* at 873-874.

21. 872 F2d 187 (6th Cir 1989),

22. 90 F Supp 2d at 874.

23. *Id.* at 873.

24. 872 F2d at 188.

25. *Cyril Bath Co v Winters Indus*, 892 F2d 465, 467 (6th Cir 1989) (upholding a requirements contract where buyer was obligated to purchase "at least up to the number specified, subject to good faith variation in buyer's requirements.").

26. No 252532, 2005 Mich App LEXIS 853 at *19 (Mar 31, 2005) (unpublished).

27. *Acemco, supra*, *2

28. *Id.* at *6-7.

29. *Id.*

30. *Id.* at *8.

31. *GRM Corp v Miniature Precision Components, Inc*, No 06-15231-BC, 2008 US Dist LEXIS 1128 (ED Mich Jan 8, 2008).

32. *Id.* at *5.

33. *Saginaw Office Serv, Inc v Bank of America, NA*, No 09-CV-13889, 2011 US Dist LEXIS 34340, *13-14 n 3 (ED Mich Mar 30, 2011).

34. *Chrysler Corp v Skyline Indus Servs*, 448 Mich 113, 121, 528 NW2d 698 (1995).

35. An important caveat: some states hold that a contract that does not require exclusivity but obligates the buyer to purchase a minimum quantity is not a requirements contract at all, but is instead an enforceable contract for that quantity.

36. *Hoover's Hatchery, Inc v Utgaard*, 447 NW2d 684, 688 (Iowa Ct App 1989).

37. *Amber Chem, Inc v Reilly Indus*, No 1:06-CV-06090, 2007 US Dist LEXIS 14451 (ED Cal Feb 14, 2007).

38. *E.g., Norfolk Southern Ry Co v Basell USA, Inc,* 512 F3d 86 (3d Cir 2008) and *First Union Nat'l Bank v Steele Software Sys Corp,* 154 Md App 97, 838 A2d 404 (2003).

39. Martin, Nathalie, *Protecting Buyers and Sellers on Open-Quantity Contracts Under UCC Section 2-306(1): Tips for Contract Drafters* (July 7, 2008) ("…the contract should not rise or fall on this one fact (exclusivity)).

40. *Schweiger Constr Co v United States,* 49 Fed Cl 188 (2001).

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Michigan's Emergency Financial Manager Law and Its Impact on Creditors of Municipalities and School Districts

By Patrick E. Mears and John T. Gregg

Introduction

On February 29, 2012, a Michigan citizens' group opposed to the state of Michigan's emergency financial manager law (the Local Government and School District Fiscal Accountability Act,[1] or "the Act"), filed petitions to place the issue of the Act's rejection on the state ballot in November. These petitions and the signatures on them will be reviewed by the Board of State Canvassers to determine if the petitions and signatures comply with applicable Michigan law.[2] If the Board validates the form of the petitions and determines that they contain valid signatures of 161,305 registered voters,[3] then the Act will be immediately deemed not "effective"[4] unless the Act, after being placed on the ballot for a voter referendum, is later "approved by a majority of the electors voting thereon" on November 5, 2012.[5]

Thus, the political drama continues to unfold over whether this statute, enacted by a Republican legislature in March, 2011 at the behest of a recently elected Republican governor, Rick Snyder, will survive the political process. The statute permits the governor to appoint emergency financial managers for municipal governments[6] and school districts and gives the managers broad powers to reject, modify, and terminate contracts and even specific terms and conditions of contracts between municipalities/school districts and third parties (including collective bargaining agreements). Because of these possible impacts, the Act has polarized politicians and the public. Fiscal conservatives tend to support the statute as a means to stabilize the finances of local governments and school districts in severe financial distress short of seeking relief under Chapter 9 of the Federal Bankruptcy Code.[7] On the other hand, unions, city officials, and employees have attacked the Act and the requirements of emergency financial managers appointed thereunder as "dictatorships" that run roughshod over the democratic rights of elected officials and common citizens.[8]

To fully understand how the Act works and to assess these comments and criticisms made in a politically charged atmosphere, the history of the Act, as well as its predecessor statutes, and the specific powers and duties imposed upon emergency financial managers must be carefully examined.

Constitutional Limitations on Emergency Financial Managers

The United States Constitution in Article 1, Section 8, provides that only the United States Congress may enact uniform laws for the states on the subject of bankruptcies. Thus, no state may enact laws on the subject of bankruptcy when federal laws governing bankruptcy are in force, as they are today. In addition, no state may enact laws impairing "the Obligation of Contracts." U.S. Constitution, Article 1, Section 10, Clause 1. As addressed in detail in this article, any state law negatively impacting the contractual rights of a private party must be in furtherance of a valid state purpose and satisfy other conditions to be considered constitutional.[9] Michigan's Constitution, in Article I, Section 10, contains an identical prohibition. As discussed below, by importing legal concepts of receivership into the Act, the Michigan legislature comes close in the Act to a bankruptcy-type law, which is a province that may only be occupied by the United States Congress. In addition, the Act may run afoul of the constitutional prohibition against states impairing contractual obligations by permitting emergency financial managers to modify, reject, and/or terminate contracts between local governments/school boards and third

parties and to alter particular terms and conditions of these contracts.

Predecessor Statutes

An emergency financial manager statute was first enacted by the Michigan legislature in 1988.[10] The enactment of this statutory predecessor of the Act was stimulated by financial difficulties being experienced by the city of Ecorse in southern Wayne County in the mid-1980s. The 1988 legislation authorized the governor to appoint emergency financial managers for local governments and school boards and contained a number of provisions now embodied in the Act, such as the commissioning of a preliminary review of a "local government financial problem" and the appointment of a review team upon a finding that a "serious problem may exist within the local government." Although this prior statute granted broad powers to emergency financial managers, it did not permit managers to reject, modify, or terminate existing contracts between the local governments and third parties. In 1990, the state legislature expanded on the 1988 legislation,[11] but even these provisions did not purport to affect executory contracts between a local government and third parties.[12]

Under the 1990 legislation, Governor Snyder's predecessors appointed emergency financial managers for the cities of Hamtramck, Flint, Highland Park, Pontiac, and Ecorse, the village of Three Oaks, as well as for the Detroit Public Schools.[13] Because the Act specifically provides for the continuation of emergency financial managers appointed under this predecessor statute, the managers for Ecorse (Joyce A. Parker), Pontiac (Louis Schlimmel), Benton Harbor (Joseph L. Harris), and the Detroit Public Schools (Robert Bobb, succeeded by Roy Roberts) are still operating as such.[14]

Hamtramck's experience under this predecessor statute is instructive and interesting. In 2000, former Michigan governor, John Engler, appointed Louis Schlimmel as emergency financial manager for this city, which is surrounded by the city of Detroit except for a small common border on the west that is shared with the city of Highland Park. The ethnic makeup of Hamtramck in the first three-quarters of the twentieth century was overwhelmingly Polish, and employment opportunities abounded for the city's population in nearby automotive plants. However, as the strength of the Detroit automotive industry declined in the late-twentieth and early twenty-first centuries, so did the fortunes of Hamtramck. Automobile plants were shuttered, many long-time residents moved away, and the city's tax base precipitously declined.

In 2005, the voters of Hamtramck approved a new city charter, and, two years later, the emergency manager's tenure and the receivership imposed by the predecessor act were terminated on account of the alleviation of the city's financial distress. Nevertheless, in December 2010, Hamtramck was involved in a dispute over its claimed entitlement to taxes collected by the city of Detroit and Hamtramck's refusal to pay water and sewage charges owed to Detroit. As a result of the financial squeeze, the mayor of Hamtramck sought the permission of then Michigan Governor Jennifer Granholm to commence a bankruptcy case under Chapter 9 of the Bankruptcy Code. Governor Granholm, however, denied this request. Thereafter, Hamtramck and Detroit settled their disputes and resolved that financial crisis, at least for the time being.

An emergency financial manager statute was first enacted by the Michigan legislature in 1988.

Local Government and School District Fiscal Accountability Act

Enactment and Effective Date—Legislative Findings

The Local Government and School District Fiscal Accountability Act, MCL 141.1501 *et seq.*, was enacted as 2012 Public Act 4 and took immediate effect on March 16, 2011.

Section 3 of the Act, MCL 141.1503, contained the Michigan legislature's findings on the need for this legislation. This section begins by stating that the "health, safety and welfare" of Michigan citizens would be "materially and adversely affected by the insolvency of local governments." The legislature further found that it is a "valid public purpose" for Michigan "to assist a local government in a condition of financial stress or financial emergency."

The Process for Appointment of Emergency Managers

Conduct of Preliminary Review

To place a "local government" into receivership and appoint an emergency financial manager for that body, the "state financial authority" of a "local government" (i.e., either a municipal government or a school

district)[15] may conduct a preliminary review to determine whether a financial problem exists for the local government involved. In making this determination, at least one or more of 18 enumerated conditions must exist.[16] These conditions include (i) a request of the governing body or chief administrative officer of a local government for a preliminary review; (ii) a written request of a creditor whose claim remains unpaid for six months and which claim exceeds the greater of $10,000 or 1 percent of the annual general fund budget of the local government involved; (iii) a written notice received by the state financial authority that the local government has failed to pay wages, salaries, or other compensation due to employees or benefits due to retirees for "a period of 7 days after the scheduled date of payment"; (iv) a written notice received by the state financial authority of a "default in a bond or note payment or a violation of 1 or more bond or note covenants"; and (v) any other "facts or circumstances that in the state treasurer's sole discretion for a municipal government are indicative of municipal financial stress, or, that in the superintendent of public instruction's sole discretion for a school district are indicative of school district financial stress."[17]

If the state treasurer, in the case of a municipal government, or the superintendent of public instruction, in the case of a school district, determines that it is appropriate to make a preliminary review of a local government's financial condition, then the local government must be given written notice of that determination.[18] All such reviews must be completed no later than 30 days after they begin, and all local government officials must cooperate with the persons making this review.[19]

MCL 141.1514 contains the definitions of "financial stress" and "financial emergency" that are critical to the governor's decision whether to appoint an emergency manager.

Appointment of Review Team

If the preliminary review includes a finding of "probable financial stress," then the governor must appoint a "review team." The members of a review team will differ when the subject of the review is a municipal government or a school district.[20] After appointment, the review team is empowered to examine the books and records of the local government and may enter into a consent agreement with the "chief administrative officer"[21] of the local government.[22] A consent agreement may contain undertakings by the local government to relieve financial stress or a financial emergency short of placing the local government in receivership and appointing an emergency financial manager.[23]

After performing its work and meeting with the local government to discuss the results of its investigation, the review team must report its findings to the governor.[24] The report must be delivered to the governor by the review team within 60 days of its appointment, although the governor may grant one 30-day extension of this deadline.[25] This report must indicate whether any of one or more of 15 specified conditions have occurred or are likely to occur, including (i) a default on payment of principal or interest on bonded obligations; (ii) failure to transfer on a timely basis taxes withheld on employee income; and (iii) failure to eliminate any existing deficit in any of the local government's funds on a timely basis.[26] In its report to the governor, the review team must include one of these four possible conclusions specified by the statute:

- the local government is not in "financial stress" or is in a condition of "mild financial stress;"
- the local government is in "severe financial stress" but a consent agreement containing a plan to resolve the problem has been adopted;
- the local government is in severe financial stress and no consent agreement has been adopted; or
- a "financial emergency" exists and no satisfactory plan exists to resolve it.[27]

What Constitutes "Financial Stress" and "Financial Emergency"

MCL 141.1514 contains the definitions of "financial stress" and "financial emergency" that are critical to the governor's decision whether to appoint an emergency manager. First, a local government will be deemed to be in a condition of "no financial stress" or "mild financial stress" if the review team's report concludes that none of the factors listed in MCL 141.1513(3) (e.g., a municipal bond default; failure to pay wages, salaries, and/or retirement benefits within seven days of their due date; and the existence of a structural operating deficit) exist or are likely to occur "within the current or next succeeding fiscal year."[28] If any of these factors are present, a determination of "no financial stress" or "mild financial stress" may nevertheless

be made if the existence of these factors does not "threaten the local government's capabilities to provide necessary governmental services essential to public health, safety, and welfare."[29]

A condition of "severe financial stress" with respect to a local government will be deemed to exist if one of the following two conditions exists. First, the review team's report concludes that one or more of the factors specified in MCL 141.1513(3) are present or are likely to occur within the current or next fiscal year and, if they are not addressed, "may threaten the local government's future capability to provide necessary government services essential to the public health, safety and welfare."[30] Second, the local government's chief administrative officer recommends that the local government be considered to be in severe financial distress.[31]

For a local government to be considered to be in a state of "financial emergency," at least one of the following must occur:

- the review team's report concludes that at least two of the factors listed in MCL 141.1513(3) exist or are likely to occur within the current fiscal year and threaten the local government's ability to provide necessary governmental services essential to the public health, safety, and welfare;
- the local government failed to deliver to the review team "timely and accurate information" to permit the team to complete its report;
- the local government failed to comply "in all material respects" (i) with either a continuing operations plan or recovery plan contained in a "consent agreement," or (ii) with the provisions of an "approved deficit elimination plan" or an agreement relating to such a plan;
- the local government is in breach of a consent agreement;
- the local government is in severe financial distress and a consent agreement has not been adopted; or,
- the chief administrative officer of the local government, acting upon the existence or likely occurrence of at least one of the factors listed in MCL 141.1513(3), recommends that a financial emergency be declared and the state treasurer agrees with that recommendation.[32]

Declaration of Receivership and Appointment of Emergency Manager

By no later than ten days after the governor receives the review team's report, the governor must make one of the following four determinations:

- the local government is not in severe financial stress;
- the local government is in severe financial stress but a consent agreement containing a plan to resolve that stress has been adopted;
- a local government financial emergency exists and "no satisfactory plan exists to resolve the emergency"; or
- the local government entered into a consent agreement containing an operations plan or recovery plan to resolve a financial problem but materially breached that agreement.[33]

If the governor determines, after considering the review team's report, that a financial emergency exists and that determination is later confirmed as described in MCL 141.1515(2), then the governor must "declare that local government in receivership" and "shall appoint an emergency manager" to act for the local government.[34] The Act grants to emergency managers "broad powers in receivership to rectify the financial emergency and to assure the fiscal accountability of the local government and the local government's capacity to provide or cause to be provided necessary governmental services essential to the public health, safety, and welfare."[35]

During the pendency of the receivership, the governing body and the chief administrative officer of the local government are prohibited from exercising any of the powers of their offices except as may be specifically permitted in writing by the emergency manager.[36] In addition, all "local elected and appointed officials and employees, agents and contractors" of the local government in receivership are directed to follow orders that the manager deems necessary to accomplish the provisions of the Act.[37] If any recipient of such an order fails to carry out its directives, the manager may, in certain circumstances, prohibit the recipient's access to the local government's "office, facilities, electronic mail and internal information systems."[38] In

If the governor determines… that a financial emergency exists…, then the governor must "declare that local government in receivership" and "shall appoint an emergency manager" to act for the local government.

addition, a local government official may be removed from office if he or she fails to abide by the requirements of the Act.[39]

Challenge and Appeal Rights of Local Governments

A local government may challenge the governor's finding that a financial emergency exists by requesting a hearing on this issue to be conducted by the state financial authority or its designee.[40] This request for a hearing must be made within seven days after the governor provides the local government's governing body and chief administrative officer with written notification of the determination that a financial emergency exists accompanied by (i) findings of fact supporting the determination; (ii) a "concise and explicit statement of the underlying facts supporting the factual findings;" and (iii) notice of the local government's right for a hearing on its challenge to the determination.[41] If a hearing is requested, the governor, acting "in his or her sole discretion based upon the record," must either "confirm or revoke, in writing, the determination of the existence of a financial emergency."[42] If the governor confirms the determination of the emergency's existence, then he or she must deliver to the local government's governing body and chief administrative officer the findings of fact "of the continuing or newly developed conditions or events" justifying confirmation of the financial emergency determination and a "concise and explicit statement of the underlying facts supporting these factual findings."[43]

On confirmation of a determination that a financial emergency exists, the local government may appeal that determination to the Ingham County Circuit Court, which has original and exclusive jurisdiction of the appeal.[44] To file and perfect such an appeal, the governing body must adopt a resolution authorizing the appeal by a vote of two-thirds of that body's elected and serving members and file its appeal papers with the Ingham County Circuit Court.[45] The scope of this court's review of such an appeal, however, is extremely limited. The court may only set aside the governor's determination that a financial emergency exists under the following two circumstances: (i) the determination is not supported by "competent, material and substantial evidence on the whole record;" or (ii) the determination was "arbitrary, capricious, or clearly an abuse or unwarranted exercise of discretion."[46]

A local government may challenge the governor's finding that a financial emergency exists by requesting a hearing on this issue to be conducted by the state financial authority or its designee.

Consent Agreements: Alternatives to Appointment of Emergency Managers

In General

The Act prescribes an alternative to the governor's appointment of an emergency manager to alleviate a financial emergency—the device of a "consent agreement." In general, a consent agreement negotiated and signed by a local government is similar to a "workout agreement" entered into by a financially distressed business with its creditors to stabilize and improve the distressed company's financial condition. Consent agreements may contain remedial measures "to address the local financial problem and provide for the financial stability of the local government."[47] Consent agreements may also include either a "continuing operations plan" or a "recovery plan" (discussed below) and may also provide for the use of "state financial management and technical assistance" to address the local financial problem.[48] In order for a consent agreement to become effective, it must be approved by resolution of the governing body of the local government and by the appropriate state financial authority.[49] All consent agreements must provide that, upon the occurrence of a "material uncured breach" of its provisions, the state treasurer may place the local government in receivership.[50]

Continuing Operations Plans

If the state financial authority so requires, a consent agreement must contain either a "continuing operations plan" or a "recovery plan."[51] If a continuing operations plan is mandated, the local government must prepare and file that plan with the state treasurer.[52] Thereafter, the state financial authority may accept or reject the plan, and, if it is rejected, the local government must address the state financial authority's concerns in an amended plan filed within 30 days of its rejection.[53] Continuing operations plans must be updated in writing annually.[54] Such a plan must contain at a minimum, the following specific provisions:

- a detailed projected budget of revenue and expenses over a minimum period of three fiscal years, which projections must demonstrate that no deficit will result during that peri-

od and any existing deficits will be eliminated during that time;

- a cash flow projection for the budget period;
- an operating plan for the budget period assuring fiscal accountability;
- a plan demonstrating reasonable and necessary maintenance and capital expenditures;
- an evaluation of costs for pension and postemployment health care obligations of the local government and how these costs will be addressed during the budget period; and
- a requirement of submitting quarterly compliance reports to the state financial authority showing compliance with the continuing operations plan.[55]

Recovery Plans

If a recovery plan is mandated by the state financial authority to be included in a consent agreement, that authority is required to develop and adopt the plan for approval by the local government.[56] If the local government adopts the recovery plan, it must file annual updates to the plan.[57] A recovery plan is required to include the same requirements for continuing operations plans[58] plus provisions describing procedures for cash control and cash management including, but not limited to, procedures for the "timely collection, securing, depositing, balancing, and expending cash."[59]

Other Provisions of a Consent Agreement—Release of Local Government from Consent Agreement

A consent agreement may grant to the chief administrative officer, chief financial officer, the governing body, or other officers of the local government one or more of the powers granted to an emergency manager for a period of time and on terms and conditions determined by state treasurer.[60] Nevertheless, any such grant may not include the power to reject, terminate, or modify terms and conditions of a collective bargaining agreement, discussed in more detail below.[61] Local governments may retain a consultant to assist in achieving the "goals and objectives of the consent agreement."[62] Finally, the state financial authority may release a local government from a consent agreement upon that authority's determination that the local government has complied with the agreement's terms and conditions.[63]

Emergency Managers

Qualifications for Appointment; Compensation

To be appointed as an emergency manager, the candidate must be an individual with a minimum of five years' experience and "demonstrable expertise in business, financial, or local and state budgetary matters."[64] The individual may, but is not required to, be a resident of the local government involved.[65] The emergency manager generally serves "at the pleasure of the governor" but may be impeached and convicted by the legislature.[66] An emergency manager's compensation and reimbursement for expenses will be paid by the local government pursuant to the terms of a written contract approved by the state treasurer.[67] The emergency manager must submit quarterly reports to the state treasurer concerning the financial condition of the local government in receivership.[68] Finally, an emergency manager may appoint staff and hire professionals as he or she "considers necessary to fulfill his or her appointment."[69]

Development and Submission of Financial and Operating Plan

Emergency managers are required to develop and are permitted to later amend a "written financial and operating plan" for the local government involved.[70] These plans must provide for the following actions:

- Conducting the local government's operations "within the resources available according to the emergency manager's revenue estimate."
- Paying in full all scheduled debt service requirements on all bonds, notes, and municipal securities and "all other uncontested legal obligations."
- Modifying, rejecting, terminating, and re-negotiating contracts.[71]
- Timely depositing all required payments for the local government's pension funds.
- Preparing academic and educational plans for school districts.
- Performing all other necessary and appropriate actions.

Emergency managers are required to develop and are permitted to later amend a "written financial and operating plan" for the local government involved.

This plan must be submitted by the emergency manager to the state treasurer by no later than 45 days after the manager's appointment. Within 30 days after this plan is submitted to the state treasurer, the manager must conduct a "public informational meeting on the plan and any modifications to the plan."[72]

Other Enumerated Powers of Emergency Managers

In General

Section 19 of the Act contains a long laundry list of the powers of the emergency manager with respect to the local government in receivership. The Act gives managers the powers to:

- "Amend, revise, approve or disapprove the local government's budget" and may "limit the total amount appropriated or expended."[73]
- Receive and disburse for the local government "all federal, state and local funds earmarked for the local government."[74]
- Examine all records and books of account of the local government and require witnesses to appear and produce "books, papers, contracts, and other documents relevant to an analysis of the financial condition of the local government."[75]
- Make, approve, or disapprove any appropriation, contract, expenditure or loan, the creation of any new position, or the filling of any vacancy in a position by any appointing authority.[76]
- Authorize the borrowing of money by the local government "as provided by law."[77]
- Enter into settlements with creditors concerning unpaid debts of the local government.[78]
- Sell, lease, convey, assign, or otherwise use or transfer assets, liabilities, functions, or responsibilities of the local government subject to certain limitations.[79] Unless the emergency manager's operating plan provides for the potential sale of an asset and estimates its value, the state treasurer must approve the sale of a local government asset with a value in excess of $50,000.[80]

During the period of the local government's receivership, the authority of the chief administrative officer and the governing body to exercise powers on behalf of the local government under applicable law, charter, and ordinance is suspended and transferred to the emergency manager.[81]

If the local government in receivership is a school district, MCL 141.1520 grants additional, specific powers to the emergency managers. These additional powers include the following:

- To negotiate, re-negotiate, approve, and enter into contracts.[82]
- To receive and disburse on the district's behalf all federal, state, and local funds earmarked for the district.
- To sell, assign, transfer, or otherwise use school district assets to pay indebtedness or otherwise assure the districts fiscal accountability provided that such actions do not "impair the education of pupils in the school district." This power includes the closing of schools or other school buildings in the district.[83]

Broad Powers Over Contracts Including Collective Bargaining Agreements

The Act grants to emergency managers extensive powers to "reject, modify or terminate 1 or more conditions of an existing contract."[84] An identical or similar provision was not contained in the Act's two statutory predecessors, Public Act 101 of 1988 and Public Act 72 of 1990. This newly granted power of emergency mangers does not have any statutory restrictions or limitations governing its exercise. Unlike the similar power granted to bankruptcy trustees by section 365 of the Bankruptcy Code to assume or reject executory contracts, there is no requirement of prior judicial approval of the exercise of this power by either an emergency manager or a local government official acting under such authority granted in a consent agreement. In addition, this power is actually greater than a bankruptcy trustee's power to reject and assume executory contracts because the Act permits an emergency manager to modify the terms of an existing contract. Caselaw developed by the federal courts under section 365 of the Bankruptcy Code and its predecessor statute does not permit a bankruptcy trustee to modify the terms of an executory contract

The Act grants to emergency managers extensive powers to "reject, modify or terminate 1 or more conditions of an existing contract." An identical or similar provision was not contained in the Act's two statutory predecessors[.]

in connection with its assumption in the absence of the nondebtor party's consent.[85]

In addition, the Act specifically authorizes an emergency manager to be the "sole agent" of the local government in collective bargaining negotiations with its employees or representatives and to approve any collective bargaining agreement arising therefrom.[86] The Act, however, goes one step further and permits an emergency manager to "reject, modify or terminate one or more terms and conditions of an existing collective bargaining agreement" provided that certain conditions are first satisfied pursuant to a determination by the emergency manager and the state treasurer.[87] These conditions are as follows:

- the financial emergency has created a situation where it is "reasonable and necessary for the state to intercede to serve a significant and legitimate public purpose;"
- the proposal to reject, modify, or terminate one or more terms of the collective bargaining agreement is "reasonable and necessary to deal with a broad, generalized economic program;"
- the proposal is "directly related to and designed to address the financial emergency for the benefit of the public as a whole;" and,
- the proposal is "temporary and does not target specific classes of employees."[88]

This power to reject, terminate or modify certain terms and conditions of a collective bargaining agreement may only be exercised by an emergency manager; this power cannot be delegated to a local government officer or governing body in a consent agreement.[89] Unlike the provisions of section 1113 of the federal Bankruptcy Code, pursuant to which a bankruptcy court may approve the proposed assumption or rejection of collective bargaining agreements in Chapter 11 cases, this power of an emergency manager does not require judicial approval before it may be exercised, nor does it require an emergency financial manager to attempt to negotiate in good faith prior to any modification or rejection.

Elimination of Compensation Due to Chief Administrative Officer and Members of Governing Body

Upon the imposition of a receivership for a local government and while that receivership continues, the "salary, wages or other compensation and other benefits" payable to the chief administrative officer of the local government and the members of the local government's governing body are immediately "eliminated."[90] This elimination does not, however, affect vested pension benefits but will affect the accrual of post-employment benefits.[91] These eliminated wages, salaries, and benefits may later be restored by the emergency manager.[92]

Authorization to Seek Bankruptcy Relief

An emergency manager of a local government may recommend to the governor and state treasurer that the local government be authorized to file a petition under Chapter 9 of the Bankruptcy Code provided that the manager believes that "no reasonable alternative to rectify the financial emergency… exists."[93] If the governor approves this recommendation, the governor shall then advise the state treasurer and emergency manager in writing of this decision.[94] On receipt of this authorization, the local government, acting through the emergency manager, may file a Chapter 9 petition with the proper bankruptcy court, thereby commencing a bankruptcy case.[95] During the pendency of this Chapter 9 case, the emergency manager is empowered "to act exclusively on the local government's behalf."[96]

This power to reject, terminate or modify certain terms and conditions of a collective bargaining agreement may only be exercised by an emergency manager[.]

Termination of the Receivership

Once the emergency manger has determined that the local government's financial problems have been addressed and rectified, the manager will make such a declaration in one of his or her quarterly reports to the state treasurer.[97] This finding will be subject to the concurrence of the state treasurer and, if a school district is involved, the concurrence of the state superintendent of public instruction.[98]

Before the receivership of a local government can be terminated, the emergency manager is required to "adopt and implement a 2-year budget, including all contractual and employment agreements, for the local government commencing with the termination of receivership."[99] This budget may not be amended by the governing body of the local government after the receivership is terminated in absence of the state treasurer's ap-

proval.[100] In addition, the governing body is prohibited from revising "any order or ordinance implemented by the emergency manager during his or her term prior to 1 year after the termination of receivership."[101]

Once the financial emergency affecting the local government is rectified, the emergency manager will cease to continue in that capacity.[102] The local government will be removed from receivership upon the correction of the financial conditions "in a sustainable fashion as determined by the state treasurer" in accordance with the Act.[103]

The Immediate Impact of the Act

A number of receiverships for local governments have been imposed on local governments since the passage of the Act in March 2011. The city of Flint, which has never recovered from the initial shocks to the domestic auto industry beginning in the 1980s, is now governed by an emergency manager, Michael K. Brown, appointed by Governor Snyder on December 1, 2011. The Highland Park School District is also subject to receivership and governance by an emergency financial manager, Jack Martin, a certified public accountant and former chief financial officer of the U.S. Department of Education. According to media reports, the Muskegon Heights School District is reportedly engaged in talks with the state over the possible imposition of a receivership. A preliminary review determined in January that "possible financial stress" existed in this school district. Finally, the city of Detroit may become the next municipal government to become the subject of a receivership under the Act. A preliminary review conducted under the Act recently concluded that there was "probable financial stress" in Detroit's city government—the city suffers from a deficit in its general fund in the approximate amount of $200 million. The ten-person review team appointed by Governor Snyder for Detroit was expected to deliver its recommendation for Detroit to the governor by March 28, 2012.[104] However, at the date of this writing, Detroit Mayor Dave Bing and Governor Snyder are reportedly considering the use of a consent agreement by the city of Detroit to address its economic ills.[105]

A state law that is enacted due to a pending emergency is a factor used to establish whether the impairment is reasonable and necessary.

Issues and Concerns Arising from Local Government Receiverships Under the Act

Constitutional Limitations on Emergency Financial Managers

Contracts Clause

State legislatures are empowered with authority to enact statutes during emergencies pursuant to their police powers. In certain instances though, a state's exercise of its police power will conflict with constitutional limitations, including the Contracts Clause, which provides that "No State…shall…pass any…Law impairing the Obligations of Contracts."[106] Thus, courts are frequently called on "to reconcile the strictures of the Contracts Clause with the essential attributes of sovereign power necessarily reserved by the States to safeguard the welfare of their citizens."[107]

When determining whether an act of a state legislature violates the Contracts Clause, courts have first reviewed whether the state law has operated as a substantial impairment of a contractual relationship.[108] If a substantial impairment exists, courts will then examine whether a significant and legitimate public purpose exists that justifies the state law.[109] Finally, if a significant and legitimate public purpose exists, courts will determine if the impairment is reasonable and necessary.[110]

When a state seeks to impair its own contracts, the state law is arguably subject to greater scrutiny under the Contracts Clause than a state law impairing contracts between private parties.[111] It is therefore inappropriate for a court to give complete deference to the legislature's assessment as to whether the impairment is reasonable and necessary when the state's own interests are at issue.[112]

A state law that is enacted due to a pending emergency is a factor used to establish whether the impairment is reasonable and necessary.[113] Therefore, a state law impairing a contract between a state entity and a private party may be justified when a financial crisis exists.[114] In such circumstances, courts will consider, among other things, the following: (i) the severity of the fiscal emergency,[115] (ii) the foreseeability of the economic problem,[116] (iii) the availability of alternatives,[117] (iv) the duration of the impairment,[118] and (v) the

proportionate share of the burden placed on the target of the impairment.[119]

It remains to be seen whether the Act runs afoul of the constitutional prohibition against states impairing contractual obligations by permitting emergency financial managers to modify, reject, and/or terminate contracts, including collective bargaining agreements, between local governments/school boards and third parties and to alter particular terms and conditions of these contracts. Commentators have suggested that the Act impermissibly allows for the wholesale rejection of contracts without first considering alternatives.[120] In addition, critics have noted that the Act fails to adequately set forth the amount of time for modifications to, and rejections of, collective bargaining agreements or the length of time a local government or school district could be subject to receivership, which these critics point out is potentially indefinite.[121] Finally, critics have also suggested that the Act does not present specific findings of a financial emergency.[122]

At least three challenges to the Act based on its constitutionality have been brought.[123] To date though, the courts have yet to render a decision regarding the constitutionality of the Act. In the forthcoming months, it is likely that public employees and perhaps even private creditors will seek with great intensity to have the Act declared unconstitutional.

Uniform Bankruptcy Laws

The United States Constitution in Article 1, Section 8, provides that only the United States Congress may establish uniform laws on the subject of bankruptcies in the United States.[124] Thus, no state may enact laws on the subject of bankruptcy when federal laws governing bankruptcy are in force, as they are today.[125] In general, state laws have been preempted by federal bankruptcy law where the state laws contain discharge provisions.[126] Although several decisions of the United States Supreme Court seemingly rely on the presence (or the lack thereof) of a discharge provision when determining preemption, the court has also intimated that state insolvency laws could be preempted where they create confusion with federal bankruptcy laws:

> The national purpose to establish uniformity necessarily excludes state regulation. It is apparent, without comparison in detail of the provisions of the Bankruptcy Act with those of the [state] statute, that intolerable inconsistencies and confusion would result if that insolvency law be given effect while the national act is in force. Congress did not intend to give insolvent debtors seeking discharge, or their creditors seeking to collect claims, choice between the relief provided by the Bankruptcy Act and that specified in state insolvency laws. States may not pass or enforce laws to interfere with or complement the Bankruptcy Act or to provide additional or auxiliary regulations.[127]

As discussed below, by importing legal concepts of receivership into the Act, the Michigan legislature arguably comes close in the Act to a bankruptcy-type law, which is a province that may only be occupied by the United States Congress.

The Concept of Receivership Imported into the Act

The Act clearly states that the determination by the governor that a local government is the subject of a financial emergency and the governor's appointment of an emergency manager imposes a "receivership" on the local government. The Act uses the term, "receivership," not less than 21 times. Because this term is a technical one that has "acquired a peculiar and appropriate meaning in the law," the term must be "construed and understood according to the common and approved usage" of that term.[128] Receivership law in Michigan, however, is not very well defined. The general receivership statute, MCL 600.2926, contains only general direction as to when a court may appoint a receiver and the caselaw decided thereunder and its statutory predecessors is sometimes vague and even contradictory.[129] In addition, neither the general receivership statute nor the court decisions decided thereunder delineate the proper powers of a receiver under Michigan law.[130] These powers are normally listed in orders appointing receivers in particular cases and in subsequent orders entered in the receivership actions. Thus, there should be ample room for dispute among litigants on the scope of the implied powers of the emergency manager granted by the legislature.[131]

[C]ritics have noted that the Act fails to adequately set forth the amount of time for modifications to, and rejections of, collective bargaining agreements or the length of time a local government or school district could be subject to receivership, which…is potentially indefinite.

NOTES

1. MCL 141.1501 *et seq*.

2. MCL 168.471, *et seq*.

3. In order for a ballot referendum for the rejection of a law to be placed on the general election ballot in Michigan, petitions seeking this referendum and containing the signatures of registered voters totaling at least 5% of the total vote cast for all candidates for governor in the last preceding general election must be timely filed with the State. This threshold number of required signatures is now 161,305.

4. The meaning of the word, "effective," as used in Article 2, Section 9 of the Michigan Constitution, is not further defined or explained therein. One opinion of the Michigan Court of Appeals equates this word with "suspended" and "inchoate." *Farm Bureau Mut. Ins Co v Commissioner of Ins*, 204 Mich App 361, 514 NW2d 547 (1994). In the interim between the invocation of the referendum power and the certification of the election, the state legislature may nevertheless enact a replacement statute or reenact the same statute that is subject to the referendum. *Reynolds v Martin*, 240 Mich App 84, 610 NW2d 597 (2000).

5. Michigan Constitution, Article 2, Section 9.

6. A "municipal government" is defined in the Act as a "city, a village, a township, a charter township, a county, an authority established by law or a public utility owned by a city, village, township or county." MCL 141.1505(g).

7. 11 USC 901-946. Chapter 9 of the Bankruptcy Code is exclusively designed for insolvent municipalities, authorized by state law or a state officer or organization to seek Chapter 9 relief by means of a confirmed plan for adjustment of debts. 11 USC 109(c).

8. See, e.g., http://abcnews.go.com/Business/bankrupt-cities-benton-harbor-mi-emergency-financial-managers/ story?id=13422258. See also the recent local commentary authored by United States Congressman John Conyers (D-Michigan) entitled "Aim for a fair fix of emergency manager law" published in the March 1, 2012 issue of the Detroit Free Press at page 15A.

9. See, e.g., *Energy Reserves Group, Inc v Kansas Power & Light Co*, 459 US 400 (1983); *United States Trust Co v New Jersey*, 431 US 1 (1977).

10. 1988 PA 101.

11. 1990 PA 72, codified as MCL 141.1201, *et seq*.

12. *See*, *e.g.*, MCL 141.1221, 141.1241. *See also, Savage v City of Pontiac*, 743 F Supp 2d 678 (ED Mich 2010).

13. See generally Citizens Research Council of Michigan, *Financial Emergencies in Michigan Local Governments*, Rep. No. 362 (April 2010).

14. MCL 141.1530.

15. The "state financial authority" for a local government is the State Treasurer of Michigan. The "state financial authority" for a school district is Michigan's Superintendent of Public Instruction. MCL 141.1505(k).

16. MCL 141.1512(1).

17. MCL 141.1512(1) (a), (b), (e), (f), (r).

18. MCL 141.1512(2).

19. *Id.*

20. MCL 141.1512(3), (4).

21. The Act defines "chief administrative officer" as either (i) the manager of a village or, if one is not employed, the president of the village; (ii) the city manager or, if one is not employed, the city mayor; (iii) the township manager or the manager or superintendent of a charter township, or if not is not employed, the township supervisor; and (iv) the elected county executive or appointed county manager. If either of these positions do not exist, the chairperson of the county's board of commissioners. MCL 141.1505(a).

22. MCL 141.1513(1)(a)-(c).

23. MCL 141.1513(1)(c).

24. MCL 141.1513(2), (3).

25. MCL 141.1513(3).

26. MCL 141.1513(3).

27. MCL 141.1513(4).

28. MCL 141.1514(1).

29. *Id.*

30. MCL 141.1514(2)(a).

31. MCL 141.1514(2)(b).

32. MCL 141.1514(3).

33. MCL 141.1515(1).

34. MCL 141.1515(4).

35. *Id.*

36. *Id.*

37. MCL 141.1517(1), 141.1526.

38. MCL 141.1517(2).

39. MCL 141.1526(2).

40. MCL 141.1515(2).

41. *Id.*

42. *Id.*

43. *Id.*

44. MCL 141.1515(3).

45. *Id.*

46. *Id.*

47. MCL 141.1513(1)(c).

48. *Id.*

49. *Id.*

50. *Id.*

51. MCL 141.1514a(1).

52. MCL 141.1514a(2).

53. *Id.*

54. *Id.*

55. MCL 141.1514a(3).

56. MCL 141.1514a(5).

57. *Id.*

58. MCL 141.1514a(3).

59. MCL 141.1514a(6).

60. MCL 141.1514a(9).

61. *Id.*

62. MCL 141.1514a(11).

63. MCL 141.1514a(12).

64. MCL 141.1515(a), (c).

65. MCL 141.1515(b).

66. MCL 141.1515(d).

67. MCL 141.1515(5)(e). For example, the compensation of Joyce Parker, Ecorse's emergency manager, is $132,000 per year.

68. MCL 141.1515(7), 141.1522.

69. MCL 141.1515(6).

70. MCL 141.1518(1).

71. See MCL 141.1519.

72. MCL 141.1518 (4).

73. MCL 141.1519(1)(b).

74. MCL 141.1510(1)(c).

75. MCL 141.1519(1)(f).

76. MCL 141.1519(1)(g).

77. MCL 141.1519(1)(u).

78. MCL 141.1519(1)(w), (x).

79. MCL 141.1519(r).

80. MCL 141.1520a.

81. MCL 141.1519(2).

82. MCL 141.1520(a).

83. MCL 141.1520(d).

84. MCL 141.1519(j). Presumably, this provision permits an emergency manager to reject and terminate existing contracts in their entirety by rejecting and terminating all of their terms and conditions.

85. See, e.g., *In re Italian Cook Oil Corp*, 190 F2d 994 (3d Cir 1951) and its progeny.

86. MCL 141.1519(1)(l).

87. MCL 141.1519(k).

88. *Id.*

89. MCL 141.1514a(9).

90. MCL 141.1519a.

91. *Id.*

92. *Id.*

93. MCL 141.1523(1).

94. *Id.*

95. *Id.*

96. *Id.* See generally John T. Gregg, *Eligibility of Michigan Municipalities for Relief Under Chapter 9 of the Bankruptcy Code*, Federal Bar Association for the Western District of Michigan Bankruptcy Newsletter (June 2011).

97. MCL 141.1524.

98. *Id.*

99. MCL 141.1527(1).

100. MCL 141.1527(2).

101. *Id.*

102. MCL 141.1515(8)(b).

103. MCL 141.1515(9).

104. "Emergency manager alone can't save Detroit: City's financial outlook called 'hopeless'," http://www.freep.com/article/20120306/NEWS05/203060404.

105. "Bing says state cash vital to turnaround," Detroit News, March 10, 2012, p. 3A; "Bing and Snyder consider having the state help run Belle Isle," Detroit Free Press, March 10, 2012, p. 2A.

106. US Const., Art. 1, Sec. 10, Cl. 1; see *Home Bldg & Loan Ass'n v Blaisdell*, 290 US 398 (1934).

107. *United States Trust Co v New Jersey*, 431 US 1, 20 (1977).

108. See, e.g., *Energy Reserves Group, Inc v Kansas Power & Light Co*, 459 US 400 (1983).

109. See, e.g., *Energy Reserves Group, Inc v Kansas Power & Light Co*, 459 US 400 (1983); *United States Trust Co v New Jersey*, 431 US 1 (1977); *Buffalo Teachers Fed'n v Tobe*, 464 F3d 362 (2d Cir 2006) (considering whether state law impairs provisions of collective bargaining agreement).

110. *Allied Structural Steel Co v Spannaus*, 438 US 234, 244-45 (1978); see *Energy Reserves Group, Inc v Kansas Power & Light Co*, 459 US 400 (1983) (citing *United States Trust Co v New Jersey*, 431 US 1 (1977)).

111. *United States Trust Co v New Jersey*, 431 US 1 (1977); *Energy Reserves Group, Inc v Kansas Power & Light Co*, 459 US 400 (1983); but see also *Keystone Bituminous Coal Ass'n v DeBenedictis*, 480 US 470 (1987) (Court will not "second guess" a legislature's judgment as to the appropriate means of accomplishing a legitimate purpose).

112. *United States Trust Co v New Jersey*, 431 US 1 (1977); *Buffalo Teachers Fed'n v Tobe*, 464 F3d 362 (2d Cir 2006).

113. See, e.g., *Allied Structural Steel Co v Spannaus*, 438 US 234 (1978); *United States Trust Co v New Jersey*, 431 US 1 (1977).

114. *Faitoute Iron & Steel Co v Asbury Park*, 316 US 502 (1942) (alteration of municipal bond contract warranted under circumstances); *Home Bldg & Loan Ass'n v Blaisdell*, 290 US 398 (1934) (economic crisis justified impairment of contract); *Ropico, Inc v New York*, 425 F Supp 970 (SDNY 1976) (legislation to address New York City's financial crisis was temporary measure causing only a limited adjustment of rights); see *Subway-Surface Supervisors Ass'n v New York City Transit Auth*, 44 NY2d 101, 375 NE2d 384 (1978) (finding wage control law modifying collective bargaining agreement was reasonable and necessary in light of financial crisis); but see *In re Jefferson County,* No 11-05736-TBB, 2012 Bankr LEXIS 40, *139 (Bankr ND Ala Jan 6, 2012) ("Outside of bankruptcy, non-consensual alteration of contracted debt is, at the very least, severely restricted, if not impossible.").

115. *Buffalo Teachers Fed'n v Tobe*, 464 F3d 362, 373 (2d Cir 2006).

116. See *AFSCME, Local 2957 v City of Benton*, 513 F3d 874, 882 (8th Cir 2008) (local government failed to demonstrate significant economic interest and no unprecedented emergency existed to justify modification of collective bargaining agreement); *Sonoma County Org of Pub Employees v County of Sonoma*, 23 Cal 3d 296, 591 P2d 1 (1979) (government failed to satisfy burden that fiscal emergency existed).

117. *Buffalo Teachers Fed'n v Tobe*, 464 F3d 362, 371 (2d Cir 2006).

118. *Id.* at 371-72; see *Subway-Surface Supervisors Ass'n v New York City Transit Auth*, 44 NY2d 101, 375 NE2d 384, 390-91 (1978)

119. See *Buffalo Teachers Fed'n v Tobe*, 464 F3d 362, 371 (2d Cir. 2006); but see *Baltimore Teachers Union v Mayor of Baltimore*, 6 F3d 1012, 1021 (4th Cir 1993) (recognizing public employees may be required to first suffer consequences of fiscal crisis).

120. See, e.g., Kenneth N. Klee, *Emergency Financial Manager Town Hall*, Feb. 21, 2012 (predicting that the Act would be unconstitutional under the *Spannaus* test).

121. *Id.*

122. *Id.*

123. *General Retir Sys v Snyder*, No 11–11686, 2011 US Dist LEXIS 111658 (ED Mich Sept 29, 2011) (dismissed on ripeness grounds); *Michigan AFSCME Council 25 v Snyder*, Case No 11-13582 (ED Mich) (alleging violations of contracts clause, takings clause and due process clause of United States Constitution); *Detroit Fed'n of Teachers, American Fed'n of Teachers Local 231 v Roberts, Jr.*, Case No 11-13392 (ED Mich) (alleging violation of contracts clause and takings clause of United States Constitution).

124. US Const., Art. I, Section 8.

125. *Sturges v Crowninshield*, 17 US 122 (1819); compare *Stellwagen v Clum*, 245 US 605(1918) (state preference law not preempted by Bankruptcy Act because law not in contradiction with, but rather was in aid of, federal bankruptcy law) with *Sherwood Partners Inc v Lycos, Inc*, 394 F3d 1198 (9th Cir 2005) (Bankruptcy Code preempts preference avoidance portion of California's assignment for benefit of creditors law).

126. See *Stellwagen v Clum*, 245 US 605(1918); *Pobreslo v Joseph M. Boyd Co*, 287 US 518 (1933); *International Shoe Co v Pinkus*, 278 US 261 (1929).

127. *International Shoe Co v Pinkus*, 278 US 261, 265 (1929); see *In re Wisconsin Builders Supply Co*, 239 F2d 649 (7th Cir 1956), *cert. denied*, 353 US 985 (1957) (noting that emphasis on discharge as the criterion of federal bankruptcy law is misguided).

128. MCL 8.3a. See also *In re Childress Trust*, 194 Mich App 319, 486 NW2d 141 (1992).

129. See, e.g., Patrick E. Mears and Dustin Daniels, *Sales of Receivership Assets Free and Clear of Liens and Interests*, 38 Michigan Real Prop Rev 112 (Fall 2011).

130. See, e.g. *Cohen v Cohen*, 125 Mich App 206, 335 NW2d 661 (1983).

131. See *Woodcliffe v Frechette*, 254 Mich 328, 236 NW 799 (1931).

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Case Digests

Income Tax—Apportionment of Income from Multiple Businesses

Malpass v Department of Treasury, Nos 299057, 299058, 299059, 2011 Mich App LEXIS 2157 (Dec 6, 2011). Plaintiffs own and control East Jordan Iron Works, Inc. (EJIW), a Michigan corporation that operates a foundry with its corporate offices, resident agent, and principal place of business in East Jordan, Michigan. In 1999, plaintiffs established Ardmore Foundry, Inc. (Ardmore), which is also a Michigan corporation with its resident agent located at the same address in East Jordan. However, Ardmore's sole business is the ownership and operation of a foundry and distribution center known as EJIW-Ardmore Foundry, located in Ardmore, Oklahoma. All of Ardmore's stock is owned directly, or through trust, by members of the Malpass family. Both EJIW and Ardmore elected to be treated as S corporations for federal tax purposes. In the years 2001 to 2003, plaintiffs filed their Michigan individual income tax returns "treating the business income from EJIW and Ardmore as from separate, non-unitary businesses." Consequently, plaintiffs apportioned their business income from EJIW attributable to Michigan and included it as income on their Michigan individual income tax returns. The losses incurred by Ardmore were attributed to Oklahoma and added back into plaintiffs' adjusted gross income for Michigan individual income tax purposes. Plaintiffs later filed amended individual income tax returns for the years 2001 to 2003. In their amended returns, plaintiffs treated EJIW and Ardmore as a unitary business and applied the Michigan apportionment factors to both companies as a unitary business. In so doing, plaintiffs sought to offset gains earned by EJIW with losses incurred by Ardmore. Through their amended returns, plaintiffs requested refunds totaling over one million dollars.

The Michigan Department of Treasury ("Department") denied plaintiffs' amended returns, and each plaintiff filed an appeal in the court of claims requesting reversal. The Department moved for summary disposition and argued that the Michigan Income Tax Act (ITA) does not allow the unitary business principle to be applied to individual income tax situations. The Department also argued that there is no basis under the ITA for plaintiffs to use a combined filing method based on the unitary business principles. The court of claims granted summary disposition to plaintiffs, stating that although the Michigan Legislature had not explicitly referenced the unitary business principle in the ITA, it nonetheless adopted the principle into the act. The court of claims observed that the language of MCL 206.115 is so broad that it does not distinguish between unitary and non-unitary businesses. However, the court recognized that the ITA's apportionment formula can only be constitutionally applied to a unitary business. Because it ruled that plaintiffs' businesses are unitary, the court allowed apportionment and ordered the Department to make the requested refunds.

The court of appeals reversed, holding that the court of claims erred when it ruled that the unitary business principle allows plaintiffs to apportion their business income from Ardmore to Michigan. To determine whether there is a unitary business, the court looks at (1) economic realities, (2) functional integration, (3) centralized management, (4) economies of scale, and (5) substantial mutual interdependence. Although there is no doubt that Ardmore and EJIW have many characteristics of a unitary business, they remained separate and legally distinct business entities, and nothing in the ITA allows for combined entity reporting. If business income is earned from entities that do not operate in a unitary fashion, then the income must be apportioned at the entity level, with each entity analyzed separately. While this approach may be constitutionally permissible, it would cause MCL 206.115 to be applied inconsistently as to different taxpayers. In contrast, a consistent approach would be to apportion all business income at the entity level. That way, if the business conducts multistate activity, the income will be apportioned accordingly. If the business has no nexus to Michigan, none of that income will be attributed to Michigan because its property factor, payroll factor, and sales factor will all be zero.

Despite the unitary characteristic of EJIW and Ardmore, they are separate legal entities, and there is no provision in the ITA that allows individuals to combine their business income from separate businesses and then use a combined apportionment formula on the total. AC, Rule 206.12(3) provides that business income is allocated or apportioned to the state in which the activity took place. Therefore, if a resident earns business income that is derived from another state, it is allocated to that state. However, if the business income is attributable to Michigan and one or more other states, AC, R 206.12(4) provides that it is apportioned as required under MCL 206.115. As applied to this case, plaintiffs' income from Ardmore (which included losses) is attributed to the state in which the activity took place—Oklahoma. AC, R 206.12(3). Because the losses sustained by Ardmore are not attributable to Michigan, they are not allocated or apportioned to Michigan and are added back to plaintiffs' adjusted gross income. Since the plaintiffs in this case received business income from two separate businesses, they must apportion at the entity level. Allowing the plaintiffs to combine all their business income from separate entities and then apportion it based on the apportionment factors, or alternately requiring other similarly situated taxpayers to do so whether or not the result would be favorable to them, would raise due process concerns and cause the ITA to be applied inconsistently.

Mortgages—Recovery on Deficiency after Foreclosure

Wells Fargo Bank, NA v Cherryland Mall P'ship, No 304682, 2011 Mich App LEXIS 2360 (Dec 27, 2011). In October 2002, Cherryland obtained an $8.7 million commercial mortgage-backed security (CMBS) loan with Archon Financial, LP (Archon) using property it owned in Garfield Town-

ship, Michigan (Cherryland Mall) as collateral. Another defendant (Schostak) was the guarantor on the loan. At closing, Cherryland executed the mortgage, note, and assignment, along with other documents, and Schostak signed the guaranty. Archon transferred the Cherryland loan and the attendant loan documents to plaintiff bank, and the loan was made a part of a real estate mortgage investment conduit (REMIC) trust, which is governed by a pooling and servicing agreement. Plaintiff is the trustee of the REMIC trust that contains the Cherryland loan as part of its pool of CMBS loans. In 2009, Cherryland failed to make the August 1, 2009 mortgage payment. Plaintiff ultimately commenced foreclosure by advertisement and the sheriff's sale was conducted on August 18, 2010. Plaintiff was the successful bidder with a bid of $6 million, leaving a deficiency of roughly $2.1 million. On August 19, 2010, the day after the foreclosure sale, plaintiff filed suit against Cherryland to enforce the loan documents, later adding Schostak as a defendant as the guarantor of the loan and asserting that it was entitled to recover damages in the amount of the loan deficiency from Cherryland and Schostak because Cherryland's insolvency constituted a failure to maintain its single purpose entity (SPE) status.

On January 31, 2011, plaintiff filed multiple summary disposition motions and a motion to disgorge attorney fees. Motion number 1 sought judgment against Schostak, as the guarantor, for the entire loan deficiency on the ground that Cherryland's insolvency was a failure to maintain its SPE status. Motion number 2 also sought judgment against Schostak as the guarantor for the entire loan deficiency, but on the ground that Cherryland entered into unfair transactions with an affiliate, which was also an alleged failure to maintain SPE status. Motion number 4 also sought judgment against Schostak as the guarantor, for $61,958, for a distribution Cherryland made to its owners in 2010. Motion number 5 requested that defendants' attorneys disgorge $34,371 in attorney fees that they received from Cherryland. The trial court ruled in favor of plaintiff on motion numbers 1, 4, and 5, but in favor of defendants on motion number 2. The final judgment was then entered. Defendants appealed two of the trial court's rulings: (1) on motion number 1, finding Schostak, as guarantor, liable for the entire loan deficiency because the trial court concluded that insolvency was a violation of Cherryland's SPE status; and (2) on motion number 4, only the attorney fee award of $260,000.

On appeal defendants contended that the mortgage was extinguished on its foreclosure, thereby barring plaintiff's lawsuit because it was initiated after the foreclosure sale, at which time the mortgage and, thus its terms and conditions, no longer existed. The court of appeals noted, however, that the Michigan Supreme Court has long held that actions at law are permissible for deficiencies on foreclosures by advertisement, and that the basis of the deficiency action is not the mortgage but the note. In this case the terms of the note provided a basis for plaintiff to bring a deficiency action.

Defendants next contended that the trial court erred in holding them liable for the deficiency on the basis of a violation of the SPE requirements. They argued that either the mortgage was unambiguously nonrecourse and insolvency was not a violation of Cherryland's SPE status, or that the mortgage was ambiguous and that the extrinsic evidence presented showed that solvency was not required to maintain SPE status. However, based on the rules of contract interpretation and the persuasive authority of decisions of other courts that have interpreted nearly identical loan documents, the court of appeals agreed with the trial court that the mortgage, as incorporated into the note, unambiguously required Cherryland to remain solvent to maintain its SPE status. When it became insolvent, Cherryland violated the SPE requirements, which resulted in the loan becoming fully recourse.

Index of Articles

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