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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, Robert T. Wilson, The Michigan Business Law Journal, 150 W. Jefferson, Suite 900, Detroit, Michigan 48226-4430, (248) 258-1616, or through Daniel D. Kopka, Research Attorney, the Institute of Continuing Legal Education, 1020 Greene Street, Ann Arbor, Michigan, 48109-1444, (734) 936-3432.

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 (a) provides a forum to facilitate service and commitment and to promote ethical conduct and collegiality within the practice; (b) expands the resources of business lawyers by providing educational, networking, and mentoring opportunities; and (c) reviews and promotes improvements to business legislation and regulations.

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From the Desk of the Chairperson

By Michael S. Khoury

By the time you read this journal, my term as Chair of the State Bar of Michigan Business Law Section will be coming to an end. It has been an exciting year, and I have been honored to serve the Section in this role. As I have also heard from many former chairs, people also tend to relish the title of "Former Chair." In looking back over the year, I hope you have seen ongoing progress in service to the Section membership; this has been the legacy of each chair that has served before me. We each try to add something new to the Section while preserving the best of what has come before us.

In thinking about the prior year, one event has stood out in my mind. At the Annual Meeting in September 2007, the Section was privileged to give the Stephen H. Schulman award to Vernon Hampton of Dickinson Wright, and Charles McCallum of Warner Norcross & Judd. While I have only recently had the privilege of getting to know Vern Hampton, I've known Charlie McCallum for many years through both this Section and the American Bar Association Business Law Section, of which Charlie is currently the Chair.

Charlie's comments at our Annual Meeting discussed the theme of professionalism. With his permission, I am reproducing an abridged version of the text of his remarks.

* * * *

Professionalism: What Is It?

By Charles E. McCallum[1]

I am honored and proud to receive the Schulman Award, and humbled to join the ranks of the other awardees. When I spoke at the Annual Meeting Luncheon of the ABA Section of Business Law last month, after my predecessor had handed me the gavel, I outlined two major themes the Section would be addressing during my year as its Chair: the globalization of the business law practice, and professionalism in the practice of business law. A number of Section members have since come to me and expressed support for a renewed emphasis on professionalism.

What Is Professionalism, Anyway?

The essential attributes of professionalism define an important set of obligations that are correlative to the privileges and status we enjoy as lawyers. If we fail in those obligations then we lose, our clients lose, and society loses. Those attributes are, for most of us, a good part of the reason we entered the practice of law. They are the elements that give us the greatest satisfaction with our professional lives.

I believe that there are seven key attributes of any profession, and in particular of the legal profession:

1. Dedication to serving clients before self
2. Dedication to serving the public interest, improving the law, and improving the profession
3. Devotion to honesty, integrity, and good character
4. Passion for excellence
5. Practice in context
6. Development of a specialized body of knowledge and skills, freely shared with other professionals
7. Independence and self-regulation

- ***Serving clients***, helping others, is at the core of our professional being. Good lawyers daily subordinate their personal lives to the needs of their clients, not simply to log on more billable time but for the satisfaction of being needed, being wanted, and being appreciated. I have suggested that the motto of the legal profession might well be the Latin word *servimus*, which means "We serve." The best lawyers are compulsive about client service. They can't help themselves.
- ***Serving the public interest*** is also an essential part of our professional lives. It is because of our duties to the public that we may not knowingly assist a client to commit a crime or a fraud, nor knowingly mislead a tribunal or another party in the course of a representation. We are, as declared in the Model Rules of Professional Conduct, "public citizens," with a duty to seek to improve the law, to improve the profession, and to improve access to justice.
- ***Good character*** is prized among us. We value honesty and integrity and want them to be our reputation. We want to be trusted, and we want to be able to trust our peers. We want our word to be our bond.
- ***Excellence*** is, for most of us, a lifelong goal. The ranks of lawyers are filled with overachievers and perfectionists. "Good enough" is not often heard from a good lawyer.
- ***Context*** is also important to us. We aspire to be more than simple technicians. We want our work to be meaningful and useful to the client, and in order for it to be so, and for us to see it as such, we have to understand the overall con-

text in which our services are rendered, the "big picture." Indeed, our professional responsibilities require that we not turn a blind eye to the context in which our assistance is sought.

- ***Specialized knowledge and skills*** are the tools of our profession. Lawyering is an exercise of the intellect and interpersonal skills. We are by nature problem-solvers, and we enjoy not just the solution but the exercise of reaching that solution. We appreciate and admire good writing, sound reasoning, skillful advocacy, and adroitness at negotiations.
- ***Independence and self-regulation*** of our profession define a final characteristic of lawyers, a fierce independence. We have chosen our profession in part because it allows us to, indeed mandates that we should, exercise independent professional judgment on behalf of our clients. We adhere to a code of professional ethics, and insist, through self-regulation, that other lawyers do so as well.

The Risks to Professionalism

There are risks to professionalism. I will talk about two of them: misplaced priorities and loss of moral compass.

Misplaced Priorities

I tell my children that money is a good measure of a man's wealth, but a poor measure of his worth. To a considerable degree, justifiable criticism of lawyers has arisen out of misplaced priorities, with the desire for money or fame distorting priorities and causing lawyers to lose sight of their duties…to the client, to the public interest, to the law, to the administration of justice.

I don't mean to imply that there is anything wrong in making a good living, indeed, in making a lot of money in the practice of law. But it cannot be our primary focus. As David Maister, a keen observer of the practice, has said, "Being a professional is neither about money nor about professional fulfillment. Both of these are consequences of an unqualified dedication to excellence in serving clients and their needs." Maister likes to ask lawyers why they do what they do. If one of the answers is not "I like helping people," he then knows he is talking to a professional in trouble.

A recent report of a New York City Bar Task Force notes the danger in misplaced priorities:

> Another change in the profession…has been its evolution toward a more competitive, bottom line orientation, with client relationships often in play and critical to the compensation of partners. This environment creates pressures on law firms and lawyers to acquiesce in questionable client conduct rather than place the client relationship at risk by pressing unwelcome advice.

It is a matter of emphasis. Law firm consultants, and some law firm leadership, have been facilitators of the misplacement of emphasis.

Loss of Moral Compass

There is a moral dimension to the practice of law. This is recognized when the Model Rules of Professional Conduct say that lawyers are guided by "personal conscience" and must exercise "sensitive professional and moral judgment."

The pursuit of money is not the only thing that can cause loss of one's moral compass. A desire for recognition and excessive pride verging on hubris can also tempt a lawyer to detach himself from his moral grounding. Some lawyers are openly cynical about lofty motives and embrace the notion that to do the right thing may not be smart. But the great majority of lawyers do believe that honesty is the best policy. We should not be shy and hesitant to admit that belief, but proud to proclaim it.

What Should We Do?

David Maister observes that professionalism is "predominantly an attitude, not a set of competencies. A real professional is a technician who cares." True professionalism, he says, implies "a pride in work, a commitment to quality, a dedication to the interests of the client, and a sincere desire to help." How can we recharge it?

The first thing we can do is individually re-commit to the ideals of our profession. We should talk about those ideals with others, especially young lawyers. In addition, I suggest that every lawyer:

- *Become a volunteer.* Any number of community organizations would benefit from our services. Pick a place to volunteer that is of interest. Perhaps it is a church. Or a school board. Or an arts group. Or an animal shelter. I once counseled a young lawyer who said, "You know, I don't really like symphony music or art museums. How can I be a volunteer?" I asked him what he did like, and he said that he liked to fish and hunt. I suggested that the local chapter of Trout Unlimited would likely welcome a young lawyer willing to take on the job of, say, revising their bylaws.
- *Get active in the organized bar.* As to this I am here preaching to the choir. But while all of you participate actively in the work of the organized bar, I would venture to guess that many of your colleagues do not, and that, in some cases, firm management actively or passively discourages it. Active involvement in the work of the organized bar gives us unparalleled opportunities to meet and know other outstanding professionals. It enriches your

life. It is an activity that permits us to serve clients, society, the law, and the profession.

The goals defined by the seven professional attributes I have discussed are lofty ones. Some scoff at lofty goals. But no one ever attained greatness by aiming low.

* * * *

Charlie's remarks remind all of us about the privilege we have to serve our clients and society as a whole, as well as the responsibility that entails. I hope that each of you considers the themes expressed by Charlie in your everyday practice, and I wish each of you the best of luck.

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Changes to the Nonprofit Corporation Act

Public Act 9 of 2008 amended the Nonprofit Corporation Act, effective February 29, 2008, to add provisions regarding electronic transactions and remote communications. The amendment defines "electronic transmission" or "electronically transmitted" as any form of communication that meets all of the following:

- It does not involve the physical transmission of paper.
- It creates a record that may be retained and retrieved by the recipient.
- It may be directly reproduced in paper form by the recipient through an automated process.[1]

Section 151[2] is the same as section 151 of the Business Corporation Act[3] and permits the Corporation Division to provide written notice by electronic transmission regarding pending documents if the document was originally submitted by electronic transmission.

Some of the amendments are different from the provisions in the Business Corporation Act and require action by the nonprofit corporation. A nonprofit corporation may opt in by providing in its articles or bylaws that members or shareholders may participate in meetings by conference telephone or remote communication, subject to guidelines and procedures adopted by the board. When a nonprofit corporation adopts a provision to permit such meetings, a shareholder or member not physically present at a meeting of shareholders or members may participate by means of remote communication and is considered present in person and can vote if all of the following are met:

- The corporation implements reasonable measures to verify that each person considered present and permitted to vote at the meeting by means of remote communication is a shareholder or member.
- The corporation implements reasonable measures to provide each shareholder or member a reasonable opportunity to participate in the meeting and to vote on matters submitted to the shareholders or members, including an opportunity to read or hear the proceedings of the meeting concurrently with the proceedings.
- If a shareholder or member votes or takes other action at the meeting by means of remote communication, a record of the vote or other action is maintained by the corporation.
- A shareholder or member may be present and vote at an adjourned meeting of the shareholders or members by a means of remote communication if he or she was permitted to be present and vote by means of remote communication in the original meeting notice.

The amendments provide that when notice is required or permitted by act to be in writing, electronic transmission is written notice. Section 404(1)(a) of the act[4] provides for written notice to be given "by written notice, given personally, by mail or by electronic transmission." Section 404(1) of the Business Corporation Act[5] is broader and permits that "[n]otice may be given personally, by mail, or by electronic transmission." Both the Nonprofit Corporation Act and the Business Corporation Act provide in section 143 that any notice or communication electronically transmitted must be "in a manner authorized by the person."[6]

The amendments to section 441(1)[7] provide that "[a] vote may be cast either orally or in writing, unless otherwise provided in the bylaws. In addition, the bylaws may provide for voting by electronic transmission." If the corporation provides in its articles for participation in a meeting by remote communication and complies with section 405(4), it is unclear whether section 441(1) will require the corporation to also adopt a bylaw authorizing voting by electronic transmission. The conflict is avoided in the Business Corporation Act because there is no reference in section 441 to bylaws providing for voting by electronic transmission and, therefore, section 405 of the Business Corporation Act would control.[8]

If a nonprofit corporation provides for voting by electronic transmission, written consents may also be given by electronic transmission. A nonprofit corporation may take action by unanimous written consent, without a meeting, and they may also provide in their articles for action by written consent of a minimum number of shareholders or members required if voting at a meeting. Section 407 of the act provides that when giving consent by electronic transmission, the date of electronic transmission is considered the date the consent was signed.[9] A consent given by electronic transmission is delivered when reproduced in paper form, and the paper form is delivered to a corporation's principal office in this state or to an officer or agent of the corporation.

Section 451 of the Nonprofit Corporation Act is similar to section 451 of the Business Corporation Act and permits a corporation to authorize in its articles for voting "in person, by proxy, or by electronic transmission" for election of directors. The amendments permit the board of directors or a committee of the board to participate in a meeting by conference telephone or remote communication. Action may be taken by written consent without a meeting if all members of the board then in office or of the committee consent to the action in writing or by electronic transmission.

Existing nonprofit corporations should review the amendments and determine if they would like to adopt any of the new procedures. An amendment to the articles or bylaws will be necessary to provide for meetings by remote communication. In addition, an amendment to the articles or bylaws will be needed to provide for voting by electronic transmission. New corporations can include the provisions in their articles and bylaws at the time of formation.

If the corporation wishes to implement these changes the board will need to adopt guidelines and procedures for remote communications, participation by remote communication, and voting. In addition, the corporation should keep a record of the manners of electronic notice and communication each shareholder or member has authorized the corporation to

use for contacting each shareholder or member.

Additional amendments to the Nonprofit Corporation Act are included in HB 5681, introduced on January 31, 2008. The bill would add a definition for "charitable corporation" to section 106. Addition of a new subsection (3) to section 404 of the act would clarify that an adjourned meeting may only conduct business that could have been conducted at the original meeting if notice of the adjourned meeting is not given.

HB 5681 amends section 505 of the act to increase the minimum size of the board of directors to three members. A new subsection (5) provides that 180 days after the effective date of the act, the boards of all existing corporations must consist of at least three directors. An amendment to section 548 permits a charitable purpose corporation to provide a loan to guarantee an obligation of an officer or director who is "also a client of the corporation and the loan or guaranty is necessary to carry out the corporation's charitable purpose."

There is no amendment to section 301(3) of the act,[10] which provides "[a] corporation shall not pay dividends or distribute any part of its assets, income, or profit to its shareholders, members, directors, or officers, except" as provided in section 301(3). It is unclear how the restrictions in section 301(3) will be affected by section 548(4).

An amendment to section 611(4) adds a reference to voting by electronic transmission. Voting by shareholder or members by electronic transmission on an amendment will only be effective if the corporation has opted in under section 405 of the act and complies with the other requirements of the act to vote by electronic transmission.

The bill contains an amendment to section 922 of the act to require any charitable purpose corporation dissolved by operation of law for failure to file an annual report to provide notice of the dissolution to the attorney general within 60 days after the date of the dissolution. The provision also provides the dissolved charitable purpose corporation "shall not dispose of any of its assets without written approval of the attorney general."

HB 5681 passed the House on April 29, 2008. It has been referred to the Senate committee on Economic Development and Regulatory Reform. The bill, legislative analysis, and status are available on the Michigan Legislature's Web site at http://legislature.mi.gov/doc.aspx?2008-HB-5681.

Beneficial Owners of Corporations and LLCs

On May 1, 2008, the "Incorporation Transparency and Law Enforcement Assistance Act" sponsored by U.S. Senators Levin, Coleman, and Obama was introduced. The bill requires each state to require corporations and LLCs to report names and addresses of beneficial owners to the state no later than the beginning of fiscal year 2011. The supporters indicate the legislation is necessary because corporations and LLCs are being used to launder money and finance terrorist activities. Senator Levin stated the bill is necessary to "bring the United States into compliance with the FATF standard by requiring the States to obtain beneficial ownership information for the corporations formed under their laws. It would ensure that the United States met its international commitment to comply with FATF anti-money laundering standards."

More information about the legislation is available at http://levin.senate.gov/newsroom/release.cfm?id=297089. The bill is available at http://levin.senate.gov/newsroom/supporting/2008/bill.Incorporation.050108.pdf.

Additional information, including a report from the National Association of Secretaries of State Task Force, is available on the International Association of Commercial Administrators Web site at http://www.iaca.org/node/115.

Miller v Allstate Insurance Co

On July 2, 2008, the Michigan Supreme Court decided the case of *Miller v Allstate Insurance Co,* http://courtofappeals.mijud.net/documents/OPINIONS/FINAL/SCT/20080702_S134393_97_MillervAllstate2Apr08-op.pdf.

The Court held that Allstate lacked standing to challenge the corporate status of PT Works because only the Attorney General has authority to pursue a claim that a corporation is improperly incorporated. The Court did not consider or decide whether physical therapists must organize under the Professional Service Corporation Act.

In light of the Supreme Court decision, effective immediately, the Corporation Division will resume its longstanding practice of requiring only corporations, consistent with OAG, 1989-1990, No 6592, p 166 (July 10, 1989). http://www.ag.state.mi.us/opinion/datafiles/1980s/op06592.htm.

NOTES

1. MCL 450.2106(3).
2. MCL 450.2151.
3. MCL 450.1151.
4. MCL 450.2404(1)(a).
5. MCL 450.1404(1).
6. MCL 450.2143 and MCL 450.1143.
7. MCL 450.2441(1).
8. MCL 450.1441(1) and 450.1405.
9. MCL 450.2407.
10. MCL 450.2301(3).

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By Paul L.B. McKenney

Your Changing Work Force, Independent Contractors and the Tax Laws: The Stars Are Realigning

For many years, the Internal Revenue Service exploited the proverbial low-hanging fruit in audits of business enterprises: the tax classification of workers that management has treated as independent contractors and not as employees for Internal Revenue Code ("Code") purposes. Congress responded to the billions of dollars these audits have brought into government coffers by increasing budgets for such examinations.

The tax consequences of workers being reclassified, years after the fact, from an independent contractor status to an employee are severe. In addition to the employer's 7.65 percent social security obligation (and the employer's 1.45 percent for Medicare on the excess over the annual limit), the employee's similar shares have not been withheld. Furthermore, federal income tax has not been withheld. There are also ERISA, state tax law, and workers' compensation consequences arising from worker classification. By way of employer mitigation, there is a mechanism for the employer to effectively obtain a credit for each employee that gives the Internal Revenue Service a statement showing that he or she did report the monies and pay employment and income tax. That is cumbersome and not always practical with many employees.

Section 530, Businesses' Friend

Many employers have avoided reclassification as to different groups of employees by arguing that they qualified under a safe harbor known as section 530 relief. This relief is only available to employers, and not to employees. Section 530 is not a relief provision under the Code, but rather, it is section 530 of the 1978 Tax Act, originally a temporary measure. Congress made it permanent in the 1982 Act, and has periodically tinkered with it. Section 530 relief basically allows the taxpayer to treat qualifying workers as independent contractors if the industry practice was to categorize such workers as independent contractors, and there was a "reasonable basis" to treat them as independent contractors under common law principles. Then relief is construed liberally in favor of the taxpayer. There has to have been consistent treatment of such workers and substantially similar workers, and Form 1099s had to have been issued. If section 530 applies, then the relief, independent contractor tax status, must be applied to both a) the audit years and b) going forward. Section 530 also banned the issuance of regulations and guidance. As a practical matter, this safe harbor saved many business taxpayers large sums.

Serious bipartisan legislation has been introduced in Congress and has the backing of both presidential candidates. Since this is revenue positive from the federal government's perspective, given the structural deficits, it is likely that the legislation will pass.

Although there are minor technical differences among the major proposed bills, they would essentially gut section 530 as we know it. They would all eliminate the key provision that allows employers to rely upon industry practices as a basis for independent contractor status. The limited number of employers that could still survive that gauntlet would then face another problem. The bills would allow the Internal Revenue Service to prospectively treat the individual as an employee. For the last three decades, under section 530, if a taxpayer qualified under the safe harbor, it could continue to treat the worker as an independent contractor rather than as an employee. Proposed legislation would also lift the ban on regulations and published Treasury guidance and make other changes.

What Steps Should Businesses Take?

It is strongly recommended that businesses undertake serious and realistic reviews of various workers' job status on their own, before the IRS does it for them. Many sophisticated employers have self-audits undertaken by counsel. Accountants may assist in the review process, but the accounting firm should be retained under a *Kovel*[1] letter by which the attorneys retain the accountants as their technical assistants. This preserves the attorney-client privilege for the results of the report. Such taxpayer-spawned analysis inevitably will recommend some changes for various workers. There are decades of wisdom and experience supporting the use of *Kovel* letters in this and many other circumstances.

Why Should the Businesses Make Any Changes?

Businesses are caught somewhere between the dog and the fire hydrant. On one hand, the economy is migrating toward a mobile technological work force, including telecommuting and part-time workers. There has been a shift in the work force away from the traditional employment model toward independent contractor arrangements. Conversely, with the impending repeal of section 530 relief, the rules for judging the status become much more favorable to the Internal Revenue Service. What employers can do for those who under current law may have had some section 530 protection, as well as for those workers for whom there would be none, is shift the arrangement from independent contractor to employee status. While this may have costs to the employer in terms of employment taxes, pension coverage, and the like, it is better to renegotiate the terms with the workers, mindful of the certain tax consequences, than

play the audit lottery with the government. We should remind clients that this is one area where the ounce of prevention is less costly than the pound of cure.

NOTES

1. *United States v Kovel*, 296 F2d 918 (2d Cir 1961).

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By Michael S. Khoury and Sarah S. Weston

Best Practices in Electronic Contracting

After the enactment by Congress of the Electronic Signatures in Global and National Commerce Act (E-Sign[1]) and the enactment by Michigan and other states of the Uniform Electronic Transaction Act[2], the use of electronic contracting has become commonplace. However, it has also become clear that basic contract rules have been taken for granted. A recent 9th Circuit Court decision is illustrative of the need to consider appropriate practices in electronic contracting. In the case of *Douglas v US District Court for Central District of California*[3], the court dealt with the issue of the effectiveness of modified contract terms. In the *Douglas* case, a telecommunications provider changed the terms of its service by posting modified contract terms on its Web site. When a dispute arose, it sought to bind the customer to the modified terms but could not show that *Douglas* had received notice of the modified contract provisions or had the opportunity to assent to or reject the terms. The court held that parties to a contract have no obligation to check terms posted on a Web site and that contract terms cannot be unilaterally modified without obtaining the other party's consent. The *Douglas* decision reminds us that basic contract principles apply equally to electronic contracts, and the following article discusses some of the current views on best practices.

Electronic Contracting Practices

It's a safe bet to say that almost every business lawyer has at least one client that has either bought or sold something online. The growth of e-commerce predictably led to the increasing use of electronic contracts, but laws or regulations to guide lawyers, or their clients, on acceptable contracting principles lagged behind.

It is important to remember that most electronic contracting laws do not affect the substantive law of contracts. Rather, their general purpose is to validate electronic contracts, signatures, and records without changing the substantive application of such contracts. Set forth below is a summary of best practices for online contracts using a typical buyer/seller arrangement with your client acting as the seller who is requesting third-party buyers to purchase its widgets online. Your seller-client wants you to draft the online sales contract for the widgets. Here are some recommendations on basic electronic contract principles.

Typical Contract Rules Apply

Just because a contract exists only online instead of on paper, all the normal substantive contract rules still apply. This means you still have to consider principles of offer and acceptance, the statute of frauds, consideration, and all other basic contract rules when advising your client.

Provide the Opportunity to Review Terms

For a contracting party to functionally agree to electronic contracts, the buyer must be able to access and review the terms.

- **Automatic Access to Terms**: In order to signify the buyer's acceptance to the contract, the buyer should be prompted to click a button or icon that clearly indicates to the buyer that it will be bound by the terms of the contract. This can be accomplished by using a button saying "I Agree," "I Accept," or a similar term of acceptance. Before the buyer signifies acceptance of the contract, however, the better practice is to require that the contract terms either appear automatically on the buyer's screen, or the buyer must be required to click on an icon or hyperlink that accesses the terms. In other words, the buyer must be able to read every term to which he or she will be bound before he or she agrees to such terms.
- **Ease of Access**: The agreement should be displayed on the buyer's screen so as to give the buyer sufficient opportunity to review the contract terms before proceeding. The buyer should be able to read the terms at his or her own pace and should not be timed out. If the terms occupy more than one computer screen, the buyer should be able to navigate forwards and backwards within the terms by scrolling or changing pages.
- **Subsequent Access**: Once the buyer reviews the terms, those terms should remain accessible to the buyer for further reference. The buyer must be able to either save or print the contract terms.

Display Terms Clearly

- **Format and Content**: The terms of the contract should be clear, readable, and in legible font both on the screen and in hardcopy format if the buyer should choose to print the contract.
- **Consistent Information**: Information provided to the buyer elsewhere on the seller's Web site or in marketing materials should not contradict the agreement terms.

Determine Assent

- **Notice of Consequences of Assent:** Immediately preceding the place where the buyer signifies agreement, there should be a statement drawing the buyer's attention to the effect of the agreement, such as: "By clicking 'Yes' below, you acknowledge that you have read, understand, and agree to be bound by the terms above" or "These terms are a legal contract that will bind you as soon as you click the following assent button."
- **Mandatory Viewing of Terms**: The buyer should not have the

option of hitting the "I Agree" button, or otherwise assenting to the contract terms, without having been presented with an opportunity to review the terms. The better practice is to require the buyer to scroll through to contract terms before giving assent. The seller can place the acceptance button at the end of the contract, at least requiring the buyer to navigate past the terms before assenting.

- **Clear Words and Method of Assent**: The words of assent to the terms should be clear and unambiguous, such as "I Agree."
- **Clear Method of Assent**: The method of signifying assent should be clear. Examples include providing buttons such as "Yes" or "I Agree" (in response to a question of "Do you agree?") or requiring buyers to type in specified words such as "I Agree."

Provide an Opportunity to Correct Errors

The assent process should provide a reasonable method to avoid, or to detect and correct, errors likely to be made by the buyer in the assent process. A summary of the terms of the contract that appears before the "I Agree" button is one such means.

Provide an Opportunity to Reject Terms and Spell out the Consequences

- **Choice between Assent and Rejection**: The buyer should be given a clear choice between assenting to the terms of the contract and rejecting them and should be told the consequence of choosing rejection. The buyer should have the option to reject the terms at the end of the process when final assent is requested.
- **Clear Words of Rejection**: The buyer's rejection option should be as clear as the assent method, clicking a button or typing terms such as "I do not agree," "No," or "I decline."
- **Consequence of Rejection**: If the buyer rejects the agreement terms, that action should have the consequence of preventing the buyer from obtaining the benefit of the bargain he or she would have been entitled to if the buyer had accepted the terms of the contract. The buyer should not be able to complete the transaction without agreeing to the terms.

Keep Records to Prove Assent

- **Accurate Records**: The seller should maintain accurate records of the content and format of the electronic agreement process, documenting what steps the buyer had to take in order to gain access to particular items and what version of the agreement was in effect at the time. If necessary for proof, link the buyer's identity to his or her assent by maintaining accurate records of the buyer's identifying information, the buyer's electronic assent to the terms, and the version of the terms to which the buyer assented.
- **Accurate Record Retention**: Records must be retained in a format that accurately depicts the contract as it was created in the original contract and in a form that can be accurately reproduced and provided to anyone with a legal right to access the information.

Request the Buyer's Consent to Amend the Contract

The *Douglas* case reminds us that a seller providing services cannot change the terms of its contract simply by posting notice of an amendment to the contract on the seller's Web site. This is because parties have no duty to continually monitor the other party's Web site for possible changes to a contract. Best practices dictate that the seller requests and obtains a buyer's consent in order to amend the contract. Regardless of the terms of any particular contract, a seller must do something more than simply post an amended contract on its Web site to give "notice" to buyers of a contractual change.

Implementing these contract principles into your consultations with clients can help ensure your clients will begin their online relationship with a good start and guard against problems in the future.

NOTES

1. P.L. 106-229, 15 USC § 7001 et seq.
2. MCL 450.831 et seq.
3. 495 F3d 1062 (9th Cir. 2007).

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Managing Document Production in Complex Commercial Cases

By Scott T. Seabolt

Introduction

Managing complex commercial litigation can be one of the most challenging tasks facing in-house counsel. The resources devoted to these cases, both inside and outside of the company's legal department, can be significant. The most expensive, and often the most frustrating, aspect of this task involves the discovery work. Within the discovery process, the assembly and production of documents can present significant and expensive challenges.

In-house counsel should play a key role in managing the production of documents in a complex commercial case. The purpose of this article is to outline the steps that should be taken, including issuing the litigation hold notice, gathering responsive documents, and the critical step of reviewing and producing those documents. To the extent in-house counsel can be involved in each step of this process, significant savings in outside counsel fees can be realized. Additionally, efficiencies can be achieved that will also result in meaningful savings.

Issuing and Implementing an Effective Litigation Hold

The timely issuance of an effective litigation hold is a critical part of any document production process. Recognizing the importance of timely litigation holds, the 2006 amendments to the Federal Rules of Civil Procedure (FRCP) added "preserving discoverable information" to the list of topics to be covered during the initial conference of the parties under FRCP 26(f). This is not to say that litigants should wait until the initial conference before issuing a litigation hold notice. Rather, the notice should be issued as soon as the obligation to preserve relevant documents attaches.

The obligation to preserve relevant documents attaches when litigation is reasonably anticipated.[1] Litigation can be and frequently is reasonably anticipated before a lawsuit is filed. This is particularly true in the context of complex commercial litigation that often is preceded by a demand letter, a formal dispute resolution process, or less formal discussions and negotiations. The obligation to preserve relevant documents applies equally to plaintiffs and defendants, which means that when a party is considering initiating litigation, it also should be considering and taking steps to meet its preservation obligations.

There are many factors that should be considered in crafting and implementing an effective litigation hold notice. Some of the more important factors are summarized below. Time is of the essence in issuing a litigation hold notice, so these steps must be completed immediately once litigation is reasonably anticipated.

Identify the Issues in Dispute

A party is under a duty "to preserve what it knows, or reasonably should know, is relevant in the action, is reasonably calculated to lead to the discovery of admissible evidence, is reasonably likely to be requested during discovery and/or is the subject of a pending discovery request."[2] Thus, in order to implement an effective litigation hold, it is critical to identify and develop a list of the legal and factual issues at the outset of the case. Complex commercial litigation tends to be fluid with new legal and factual issues arising throughout the proceedings. Accordingly, the list of legal and factual issues should be reviewed and updated throughout the case.

For Each Issue, Identify the Categories of Documents That May Contain Potentially Relevant Data or Information

Different legal and factual issues may involve different categories of relevant documents. For example, questions of contract formation and interpretation may involve certain categories of documents, while questions of trade secret misappropriation may involve entirely different categories of documents. If the issues are contract formation and interpretation, potentially relevant categories of documents may include contract drafts, previous agreements, correspondence between the commercial functions, documents showing the parties' course of performance, etc. If

the issue is misappropriation of trade secrets, potentially relevant categories of documents may include product specifications, R&D documents, correspondence between engineers, etc. Just as most complex commercial matters tend to involve myriad legal and factual issues, most complex commercial matters also involve numerous categories of documents from numerous custodians in multiple functional areas within an organization. Identifying the various categories of documents relevant to each issue and the functional areas in which those documents reside is critical to implementing an effective litigation hold.

Identifying the various categories of documents relevant to each issue and the functional areas in which those documents reside is critical to implementing an effective litigation hold.

For Each Category of Documents, Determine Where the Documents are Located and Develop a List of Custodians

No two companies have the exact same information system or document management process. And truly "paperless" companies are not very common (at least not yet). Thus, most complex commercial cases generally involve vast amounts of electronically stored information and some amount of hard copy documents. In determining where specific categories of documents are located, it often is helpful to involve a member of the IT staff, as well as members of the functional areas affected by the litigation hold. These individuals can help to explain where and in what form certain categories of documents are located, e.g., servers, network drives, shared drives, local drives, portable media, legacy systems, hard copy files, microfilm/microfiche, off-site storage, etc. These individuals also can help to identify the custodians for each category of documents. The list of custodians generally should include individuals directly involved in the underlying dispute, as well as individuals who may not have been directly involved in the underlying dispute, but who are responsible for maintaining certain categories of relevant documents, whether electronic or hard copy.

Prepare and Issue the Litigation Hold

The litigation hold notice itself should be treated as a document protected by the attorney client privilege and the attorney work product doctrine and, therefore, should be issued by a person falling within the ambit of the privilege. The contents of the notice will vary from case to case and organization to organization based, in part, on what was learned in steps 1-3 above. In general, the notice should provide an overview of the underlying dispute, list the categories of documents covered by the notice, explain that the notice covers both hard copy documents and electronically stored information, and instruct custodians not to discard, delete, destroy, or alter documents falling within the scope of the notice. The notice should further explain that the "hold" instruction will remain in force until further written notice from the organization's counsel is received.

In preparing a litigation hold notice, consideration should be given to where and for how long electronic information is stored. For example, a company may have an information system in which e-mails are retained in users' in-boxes for a limited period of time and then automatically deleted. If the company has such a system in place, consideration should be given to additional steps that may be taken to ensure that relevant e-mails are not deleted from users' in-boxes. With some information systems, the automatic delete operation can be suspended or modified for specific users affected by a litigation hold. If this is not practicable, users affected by the litigation hold can be instructed to place relevant e-mails in a folder that is not subject to an automatic delete operation or to take other appropriate steps to ensure that relevant e-mails are not lost.

The 2006 amendments to the Federal Rules include a safe harbor provision in FRCP 37(f) which states, "[a]bsent exceptional circumstances, a court may not impose sanctions under these rules on a party for failing to provide electronically stored information lost as a result of the routine, good faith operation of an electronic information system." The practical boundaries of this Rule are yet to be determined, and relying on FRCP 37(f), which operates retrospectively, as a guide to issuing litigation hold notices may be a dubious practice. Moreover, the other 2006 amendments to the Federal Rules, particularly FRCP 26(f), were designed at least in part to avoid disputes under the safe harbor provision by forcing parties to reach an understanding early in litigation as to what has been done and what should be done to preserve relevant documents.

Obtain Written Confirmation and Keep a List

In complex commercial cases, the litigation hold notice may be issued to dozens of custodians. Moreover, as cases evolve and new

issues arise and new categories of documents are identified, amended or supplemental notices may be necessary. Consequently, it is critical to keep track of who received what notices and when. To this end, it also can be helpful to have each custodian certify in writing that she/he read, understood, and complied with the contents of the notice.

Gathering Responsive Documents

The first step in gathering responsive documents is to determine the scope of what is being gathered. Are documents being gathered pursuant to some initial disclosure obligation,[3] or as part of general case development, or in response to specific document requests from an opposing party? What is the scope of the documents being requested? Does the litigation hold notice need to be amended or supplemented in light of what is being requested? Were the documents currently requested already gathered as part of an earlier document sweep? This last question is particularly important and requires careful consideration. Attorneys and clients sometimes assume too hastily that documents responsive to a particular request were covered by an earlier request or were included in initial disclosures. Assumptions like this are dangerous and can prove to be costly if they turn out to be incorrect.

For most employees (particularly those who do not happen to be lawyers), litigation is an unwanted distraction from one's day job. Nowhere is this more apparent than in the document gathering process. For the most part, the proliferation of electronically stored information has made the process of gathering documents more arduous, not less. Gone are the days when an employee's file consisted of a few folders tucked neatly in a filing cabinet. In addition to searching hard copy files, gathering relevant documents today can involve scouring e-mails, hard drives, and shared drives, searching Word, Excel, PowerPoint, and other electronic files, sorting databases used by purchasing, engineering, quality, accounting, or other functions, etc. To most employees, the prospect of spending several hours scouring electronically stored information and sifting through hard copy files, all the while reliving a dispute they would rather forget, simply is not appealing.

For litigators, however, performing a thorough document sweep is critical to an effective representation. Recognizing the significance of electronic discovery in litigation today, the 2006 amendments to the Federal Rules specifically added the "disclosure or discovery of electronically stored information" to the list of topics to be covered during the initial conference of the parties under FRCP 26(f). Pulling folders from a filing cabinet simply is not sufficient today. And it is important to get it right the first time. Filling gaps in an incomplete document sweep can be as time-consuming and as expensive as the original document sweep.

There is no panacea for the tedium of gathering documents. It is a pain, and it probably always will be. To mitigate the pain, litigants sometimes try to leverage their technology to gather responsive documents. For example, rather than asking individual users to gather responsive e-mails, it may be possible to search, isolate, and harvest relevant e-mails directly from a server. It may be possible to search, isolate, and harvest other electronic files from hard drives or shared drives without imposing on individual users. In appropriate circumstances, leveraging technology to gather electronically stored information can be less disruptive to an organization, though it also can be expensive.

Before employing one of these methods, it is advisable to retain a third-party consultant specializing in electronic discovery. Working with the company's IT staff and other functions, the third-party consultant can help to identify the best method for searching, isolating, and harvesting electronically stored information. Before conducting the search, it also is a good idea to consult with opposing counsel and agree on the search terms to be used and the form of production. For example, will reports be provided showing the searches performed and the results? Will electronic documents be produced in native format or in searchable TIFF or PDF formats? Will metadata be produced for electronic documents? Answers to these questions can affect how the search is conducted and how electronic documents are harvested and prepared for review.

In gathering documents, consideration should be given to sources of electronically stored information that are not "reasonably accessible." The 2006 amendments to the Federal Rules added a provision to FRCP 26(b)(2)(B) that "[a] party need not provide discovery of electronically stored information from sources that the party identifies as not reasonably accessible because of undue

The proliferation of electronically stored information has made the process of gathering documents more arduous, not less.

burden or cost." The objecting party bears the burden of demonstrating that the information is not reasonably accessible. The objection can be overcome on a showing of good cause by the requesting party, but the court may specify conditions for the discovery, such as cost sharing or shifting.

Whatever the method employed for gathering documents, it is important to maintain a meticulous list of what sources were searched, how they were searched, and when. It also is helpful to have each custodian certify in writing that he or she has conducted a reasonably diligent search of the identified records, both hard copy and electronic, and has produced all responsive documents located through the search. As documents are gathered, it is important to keep track of when documents were received and from what sources. This information may be helpful in filling gaps in the production, responding to subsequent requests, diffusing discovery battles, identifying witnesses, and preparing witnesses for depositions.

Even with the benefit of technology, reviewing documents remains an expensive and time-consuming proposition.

Reviewing and Producing Documents

Reviewing large volumes of documents for responsiveness, privilege, and confidentiality is a time-consuming and expensive proposition. Litigants often try to leverage technology to reduce this expense. Large document productions generally are handled using document review programs. Using these programs, documents can be uploaded to an electronic database and then searched and reviewed for responsiveness, privilege, and confidentiality. Fields can be added to facilitate searching, such as authors, recipients, dates, document type, etc. Documents also can be coded based on issues or subject matter. Employing useful coding conventions requires careful consideration of the issues in the case, but it can make the development of the case much more efficient in the long run.

In some instances, a party may choose to conduct an automated privilege review using fields or search terms, rather than conducting a manual review. This can save time and money, but it introduces an element of risk because the search functions on most document review programs are not 100 percent accurate. FRCP 26(b)(5)(B), introduced in December 2006, adds a claw back provision for the inadvertent disclosure of privileged documents. However, FRCP 26(b)(5)(B) does not address the question of whether an inadvertent disclosure nevertheless may constitute a waiver of the privilege. Consequently, whether conducting a privilege review manually or through automated search functions, parties should consider including a provision in their protective order that the inadvertent disclosure of privileged documents does not constitute a waiver of privilege.

In reviewing documents, it also is important to consider questions of confidentiality. If there is sensitive information included in the documents, as there usually is in complex matters, the parties should enter into a protective order detailing how confidential documents will be treated during and after the litigation. Ideally, this should be done before the documents are reviewed so the documents can be designated appropriately as they are reviewed. There are numerous considerations that go into negotiating a protective order. The sensitivities vary from case-to-case. Some of the more common considerations are: a) whether there should be a single "confidential" designation or other designations for "restricted confidential" or "Attorney Eyes Only" documents; b) whether there are any limits on what a party can designate as "confidential" or "restricted confidential"; c) who are the persons with whom designated documents can be shared; d) whether designated documents should be filed under seal with the court or made part of the public record; e) what is the mechanism for challenging a party's designations; f) if a designation is challenged, who will have the burden of proof, the moving party or the designating party; and g) what will be done with the documents after the litigation is concluded.

Documents should be produced with bates-stamps, bar coding or some other document numbering convention. Most document review programs have automated numbering functions. The producing party should keep a careful record of what was produced and when. This can help to avoid or diffuse subsequent discovery battles.

Even with the benefit of technology, reviewing documents remains an expensive and time-consuming proposition. The greatest benefits of document review programs generally are experienced later in the case, such as in creating timelines, preparing witness files, identifying exhibits for depositions, preparing subject-matter files, and performing other tasks that require isolating specific documents quickly. In complex cases involv-

ing hundreds-of-thousands or even millions of pages of documents, utilizing document review software is perhaps the only practical solution. But the effectiveness of this solution necessarily depends on investing the time and money on the front end to have the documents loaded, reviewed, and coded properly.

Repeat the Process

A mistake some lawyers and clients make is assuming that document production ends after the first major production is complete. This is an incorrect assumption. Document production is an ongoing process. Whenever a new document request is served, the process needs to be repeated at least to the point of determining whether or not the newly requested documents were gathered and produced previously. Even if there is only one set of document requests served in a case, steps need to be taken periodically throughout the case to ensure that it was done properly the first time and that nothing was missed. This can be accomplished through follow-up notices, witness interviews, deposition preparation, etc.

Some attorneys may have experienced a situation where a witness, in the middle of a deposition, suddenly remembers a new set of documents that he or she forgot to turn over. For the attorney defending the deposition, this is an uncomfortable situation. In preparing witnesses for deposition, it generally is a good idea to ensure that the witness received and complied with the document sweep notices. Even if it is learned during the preparation session that the witness forgot to turn over some relevant material, it generally is better to discover this before the deposition when you may have an opportunity to rectify the situation without potentially dire consequences. In any event, attorneys and clients should remain vigilant about document production throughout the case.

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NOTES

1. *Zubulake v UBS Warburg LLC*, 220 FRD 212, 217 (SDNY 2003).

2. *Id.*

3. To eliminate any doubt, the 2006 amendments to the Federal Rules of Civil Procedure specifically added "electronically stored information" to the categories of information covered by the initial disclosure obligations under FRCP 26(a)(1)(a)(ii).

The Enforceability of Requirements Contracts in the Automotive Industry: Do Your Agreements Pass Scrutiny?

By Thomas S. Bishoff and Jeffrey R. Miller

Introduction

The automotive industry supply chain historically has been structured on long-term supply agreements with either fixed-price terms or scheduled price reductions over the life of a part or program. As the supplier base continues to experience eroding profit margins, however, suppliers are finding it more difficult economically to maintain production under those agreements. Faced with this problem, suppliers increasingly are asserting legal challenges to the enforceability of their long-term agreements, typically seeking to have those agreements declared invalid to force negotiation of new agreements with higher prices. One issue that has gained considerable attention recently is the validity of open quantity "requirements" contracts under Michigan law.

The example of a supplier looking to invalidate an agreement due to rising raw material costs is illustrative. Your client, a Tier 1 supplier of automotive suspension components, calls you and presents the following factual scenario:

The client manufactures a suspension assembly that it sells to its Original Equipment Manufacturer (OEM) customer for use in a popular sport utility vehicle under a fixed-price long-term agreement. The client purchases various steel components included in the assembly from its Tier 2 supplier, which, in turn, purchases raw steel from its own supplier. The client is one year into a multi-year fixed-price purchase order contract with its Tier 2 supplier, which includes an open "blanket" quantity term and obligates your client to purchase parts only upon the issuance of periodic production releases. Due to increases in the cost of steel, the Tier 2 supplier faces significantly higher production costs and has approached your client seeking to pass along steel surcharges. Knowing that its OEM customer would be reluctant to absorb a corresponding price increase, your client rejects the Tier 2's proposal, citing the parties' fixed-price agreement. In response, the Tier 2 threatens to stop accepting additional production releases and cease production. Despite having performed for a period of time, the Tier 2 argues that the contract is invalid because it does not define a specific quantity of goods and obligates the Tier 2 to produce only the quantities specified in the individual production releases it accepts. Faced with the prospect of not being able to meet its supply obligations to its customer, your client asks for a legal analysis of the supply agreement's enforceability as a long-term requirements contract. What issues do you consider and advice do you give?

This article examines these questions, focusing on Michigan law as it applies to the enforceability of requirements contracts. It also considers common arguments made by litigants seeking to invalidate requirements contracts and lessons learned from reported decisions for those drafting or negotiating automotive supply agreements. Although this article examines these issues in the context of the automotive industry, the legal analysis is applicable to any requirements contracts under the Uniform Commercial Code (UCC).

The UCC Authorizes Parties to Contract for a Requirements-Based Quantity of Goods

One consequence of utilizing long-term supply agreements that follow the life of a part or program is that parties cannot adequately predict the quantities of parts that will be required to meet OEM production demand over time. Part demand naturally fluctuates with vehicle demand, which is notoriously difficult to predict. After all, it may not make sense for an OEM to enter into a ten-year agreement to purchase 10,000 ethanol-fuel engines for a truck line when consumer

demand might quickly shift to electric hybrid or other alternative energy platforms.

The UCC provides an alternative that allows parties to enter into binding long-term agreements that account for fluctuating demand. Under UCC 2-306, parties to a sale of goods contract are authorized to define quantity in a supply agreement as the buyer's good faith "requirements" (or, alternatively, as the seller's good faith "output") for the goods:

> A term which measures the quantity by the output of the seller or the requirements of the buyer means such actual output or requirements as may occur in good faith, except that no quantity unreasonably disproportionate to any stated estimate or in the absence of a stated estimate to any normal or otherwise comparable prior output or requirements may be tendered or demanded.[1]

Because requirements-based quantity terms are uncertain and often moving targets, parties looking to challenge the validity of a purported requirements contract increasingly have asked courts and arbitrators to scrutinize quantity language. Such legal challenges routinely call into question whether an enforceable quantity term exists and, if so, whether that term supports mutuality of obligation. Other forms of legal challenges concede the enforceability of a requirements contract on its face but assert breach claims premised upon a party's actions to evade performance of the obligation to meet the buyer's requirements.

The Statute of Frauds as the First Line of Defense

Satisfying the UCC statute of frauds is a threshold issue to the enforceability of any contract for the sale of goods, but one that typically does not carry much teeth. Under UCC 2-201, a contract valued in excess of $1,000 satisfies the statute of frauds as long as it is in writing and contains an express quantity term.[2] The Michigan Supreme Court has held that "Section 2-201 does not require that the terms of a contract for the sale of goods, *other than the quantity term*, be expressed in writing."[3] Accordingly, a supply agreement that defines quantity but leaves all other terms open, including price, delivery terms, and payment instructions, should pass muster under the statute of frauds. The UCC provides that open terms other than quantity can be added subsequently by a court, either through the UCC's enumerated gap-filling provisions or by parol evidence of usage of trade, course of dealing, and course of performance.[4]

Because the statute is satisfied where a quantity term is stated, a disputed issue is often whether a term qualifies as a quantity term. As to this issue, the burden is minimal. Only where a written contract is totally silent as to quantity will the contract be held *per se* unenforceable under the statute of frauds.[5] A contract that contains some statement of quantity, even one that is ambiguous, generally satisfies the statute of frauds.[6] For example, the Michigan Court of Appeals held that the word "all" in a contract defining quantity as "all wood sawable" was sufficient to satisfy the statute of frauds by stating a quantity.[7] In addition, the term "blanket order" has been held sufficient to connote a quantity in an automotive supply agreement, although ambiguous as to the scope of its obligation.[8] Similarly, a term defining quantity according to individual production releases has also been held sufficient.[9] Given the minimal burden imposed by the statute of frauds, purported requirements contracts rarely rise or fall on this issue.

A Requirements-Based Quantity Term Must Support Mutuality of Obligation

The more challenging and heavily-litigated issue is whether an express quantity term is sufficient to satisfy the obligations imposed by UCC 2-306 for a valid requirements contract. As the Michigan Supreme Court has held, "[a] writing that satisfies [the statute of frauds] does not prove the terms of a contract; such a writing merely removes the statutory bar to the enforcement of the contract…."[10] An enforceable requirements contract must contain a quantity term that not only satisfies UCC 2-306's definition for such a contract, but also is specific enough to support consideration and mutuality of obligation.[11] In other words, enforceability depends on whether a quantity term is sufficient to impose a binding obligation on the seller to sell and the buyer to buy its requirements for the goods at issue during the term of the contract.[12] Absent a firm obligation on both parties, the contract may be deemed illusory and unenforceable.

All things being equal, a contract that defines quantity as "100% of the buyer's re-

The UCC provides an alternative that allows parties to enter into binding long-term agreements that account for fluctuating demand.

quirements" expresses the parties' unambiguous intent to enter into a requirements contract. Requirements contracts are routinely upheld where the parties use unambiguous "requirements" language. For example, in *Plastech Engineered Products v Grand Haven Plastics, Inc*, the court held that purchase orders stating that "[s]cheduled Purchase Order to cover 100% Johnson Controls requirements" were enforceable as requirements contracts.[13] Similarly, in *QC Onics Ventures, LP v Johnson Controls, Inc*, a quantity term stating that the "scheduled Purchase Order to cover 100% requirements" was likewise held to support a valid requirements contract.[14]

Unfortunately, parties in long-term automotive supply agreements often fail to use similarly unambiguous language to define quantity. Instead, parties often rely on blanket quantity purchase order contracts. Such contracts typically define quantity as a "blanket quantity" and provide, either within the purchase order or in separate incorporated terms, that the seller is obligated only to deliver parts when the buyer realizes demand for specific quantities and issues individual production releases. This practice faced less scrutiny when the supply chain enjoyed healthier profit margins. Increasingly, however, sellers have begun to question whether blanket-quantity contracts actually impose the mutuality of obligation necessary to enforce a requirements contract. The last ten years have seen numerous courts consider this issue with mixed results.

Michigan law is not well-settled on the enforceability of purported requirements contracts with ambiguous quantity terms.

Michigan Law Applying UCC 2-306 Is Not Well Settled

Michigan law is not well-settled on the enforceability of purported requirements contracts with ambiguous quantity terms. Many courts have recognized that requirements contracts are the norm in the automotive industry and have addressed legal issues with that frame of reference. *Chainworks, Inc v Webco Indus, Inc* is a leading case.[15] In that case a steel supplier sought to evade performance under an unprofitable, fixed-price blanket purchase order contract by arguing that the purchase order itself did not constitute a contract but, rather, individual contracts were formed each time the supplier accepted and shipped against production releases. The court rejected that theory, holding that the purchase order constituted one requirements contract for its entire duration.[16] The court recognized that the production releases did not define the scope of the parties' obligation, but only provided the mechanism for delivery. Therefore, the contract language referring to the production releases was not a quantity term. The court found that the quantity term stating, "[t]his is a requirements based blanket order," was sufficient to express the parties' intent to enter into a requirements contract.[17]

Similarly, in *General Motors Corp v Paramount Metal Products Co*, the seller sought to invalidate purchase orders governing the supply of automotive seat frames arguing, among other things, that the purchase orders lacked mutuality of obligation because they were not exclusive and only became enforceable on the acceptance of production releases.[18] The court rejected both arguments. It held that nothing in the UCC mandates that requirements contracts be exclusive and found no contract language evidencing an intent that the production releases, rather than the purchase orders themselves, would define the quantity obligation.[19]

While not an automotive industry case, *Metal One America, Inc v Center Manufacturing, Inc* is in accord.[20] In this case the seller sought to enforce a purported requirements contract after the buyer closed its plant and unilaterally sought to terminate the contract. Like many other courts before it, the court rejected the theory that individual contracts were formed as each production release was accepted. Instead, the court found an enforceable requirements contract based principally on parol evidence, including the parties' course of performing under the broader supply agreement and the buyer's history of purchasing all of its requirements from the seller.[21]

As the heading of this section suggests, however, there is a body of caselaw finding to the contrary. These cases have more closely scrutinized the express contract language and have held that more is required to support a finding of mutuality of obligation. For example, in *Acemco, Inc v Olympic Steel Lafayette, Inc*, the court held that a supply agreement stating "[d]uring the term of this Agreement, the Seller agrees to sell to the Buyer such quantities of the Products as the Buyer may specify in its purchase orders, which the buyer may deliver at its discretion" did not contain a quantity term of any kind, ambiguous or unambiguous, and, therefore, was not a valid requirements contract.[22] The court found the purported quantity term

to be discretionary and consideration to be lacking.[23]

In *Advanced Plastics Corp v White Consolidated Indus, Inc*, the court rejected the argument that the following default term included in the buyer's general terms and conditions was sufficient to support a requirements contract because it gave the buyer discretion in its performance: "Seller agrees to furnish Buyer's requirements for the goods or services covered by this Purchase Order to the extent of, and in accordance with, the delivery schedule set forth therein, or, if no such schedule is set forth, then pursuant to Buyer's written instruction."[24] The court found this default term insufficient because the contract documents expressly provided that the buyer was only obligated to purchase those parts for which it issued production releases or other instructions. There was no quantity language obligating the buyer to "purchase all of its needs or requirements from" the seller.[25]

The unreported decision in *Schefenacker Vision Systems, USA, Inc v Depco International Inc* goes even farther. That decision held that purchase orders are, as a general rule, offers to purchase that are only accepted once a production release is issued.[26] The court held that where a supply agreement does not expressly define the quantity obligation as the buyer's requirements but, instead, specifies that quantities are to be determined according to production releases, the agreement is not enforceable as a requirements contract.[27] The *Schefenacker* decision has not been cited with approval in any reported case.

The most recent decision to address these issues and consider all of the foregoing cases is *Johnson Controls, Inc v TRW Vehicle Safety Systems, Inc*.[28] Judge Zatkoff of the Eastern District of Michigan was faced with cross motions for summary judgment regarding the enforceability of purported purchase order requirements contracts. The court first held that the blanket purchase orders defining quantity simply as "AS REL," which was intended to designate quantities as specified in production releases, were sufficient to satisfy the statute of frauds.[29] The court then held that while the language could evidence a requirements contract "in light of the practice among automotive suppliers to enter into long-term, just-in-time production arrangements that rely on a fixed-price and a variable quantity, and provide flexibility to adjust to changing commercial conditions," the interpretation of the quantity term was properly left to a jury and parol evidence.[30]

Some Lessons Learned from Cases Considering Facial Challenges to the Enforceability of Requirements Contracts

Despite the thorough analysis of the issues in *Johnson Controls*, the law on facial challenges to ambiguous quantity terms remains unsettled. Nevertheless, several lessons can be learned from the caselaw that may help parties avoid similar disputes. The following should be considered when negotiating a requirements contract in the automotive industry or when faced with a legal challenge to an agreement.

Lesson No. 1 – Be Specific and Use "Requirements" Language

Open, ambiguous, or "blanket" quantity terms not tied specifically to "requirements" in supply agreements are easy targets for litigation. The clear lesson from the caselaw is that, while not mandatory for enforcement, quantity terms that specifically use the word "requirements" and do not include language providing either party discretion on performance go a long way towards minimizing the risk that a court may find a purported requirements contract invalid. There is ample authority holding that an agreement that specifies quantity as "100% (or some other defined percentage) of the buyer's requirements," is enough to support a finding of a valid requirements contract, even where delivery terms for shipments may be specified individually on production releases.

Lesson No. 2 – Document Your Contract Interpretation Position

Under the UCC, parol evidence is admissible to explain or supplement, but not contradict, contract terms.[31] In construing the enforceability of purported requirements contracts, courts regularly rely on parol evidence to define the intent of the parties. Course of performance is often considered the best evidence of the parties' intent. Accordingly, prior to and during performance of a requirements contract, parties should include language in correspondence that evidences their understanding of the contract as a valid and enforceable requirements contract. Letters, e-mails, and other documents may be critical evidence in a subsequent action where the

Under the UCC, parol evidence is admissible to explain or supplement, but not contradict, contract terms.

parties are asking a court or arbitrator to rule on the validity of a contract.

Lesson No. 3 – Utilize Over-Arching Supply Agreements

Frequently, purchase orders are at the heart of contractual supply arrangements in the automotive industry. Increasingly, however, parties are entering into over-arching supply agreements that provide greater detail regarding their rights and obligations than would typically be included in a purchase order. Such agreements are especially helpful where parties in a long-term relationship operate pursuant to numerous separate purchase orders or other contract documents that could be read together as constituting one contractual relationship. They are also helpful in addressing head-on issues that tend to be litigated in the context of the "battle of the forms."

Lesson No. 4 – Include Default Quantity Terms in Standard Terms and Conditions

Parties to supply relationships often incorporate standard terms and conditions into their purchase orders or other contract documents. To avoid ambiguity regarding the quantity obligation, sophisticated parties increasingly are including default or fallback quantity terms in their standard terms. Johnson Controls is an example of a Tier 1 supplier that has modified its Global Terms of Purchase to include the following default provision on quantity:

> Quantities listed in each [Purchase] Order as estimated are Buyer's best estimate of the quantities of Supplies it might purchase from Seller for the contract term specified in the Order. If no quantity is stated or if the quantity is stated as zero: (a) Seller is obligated to supply Buyer's stated requirements for the Supplies in quantities as specified by Buyer in Material Releases; (b) unless expressly stated on the face of the Order, Buyer is not required to purchase Supplies exclusively from Seller; and (c) Buyer is required to purchase no less than one piece or unit of each of the Supplies that are goods and no more than those quantities identified as firm orders in material authorization releases, manifests, broadcasts, or similar releases ("Material Releases") transmitted by Buyer to Seller.…[32]

While *Advanced Plastics, supra,* teaches that such a default provision will not always substitute for a well-defined and unambiguous requirement-based quantity term, when the scope of the quantity obligation is in question, a default quantity provision declaring quantity to be the buyer's requirements may constitute critical parol evidence supporting an intent to enter into a requirements contract.

Conclusion

Given the financial challenges faced by the automotive industry, it is reasonable to assume that legal challenges to the enforceability of long-term requirements contracts will continue. Parties wishing to cut-off such challenges before they develop into litigation, or at least strengthen their position in the event a lawsuit is filed, would be wise to avoid ambiguous quantity terms and, instead, negotiate quantity terms that support mutuality of obligation based on the buyer's requirements. Although the appeal of a quantity term that provides maximum flexibility to respond to market fluctuations may be advantageous at the time of contract formation, it is significantly less so when a court finds the contract containing such a quantity term to be illusory and unenforceable, and your client is faced with the prospect of having to absorb raw material price surcharges.

NOTES

1. MCL 440.2306.
2. MCL 440.2201(1); *see also id.* at Cmt No 1 ("The only term which must appear is the quantity term which need not be accurately stated but recovery is limited to the amount stated. The price, time and place of payment or delivery, the general quality of the goods, or any particular warranties may all be omitted.").
3. *Lorenz Supply Co v American Standard, Inc*, 419 Mich 610, 614-15 (1984) (emphasis added); *see also In re Frost*, 130 Mich App 556, 561 (1983).
4. MCL 440.2202.
5. *In re Frost*, 130 Mich App at 559.
6. *Id.*
7. *Id.*
8. *Great Northern Packaging, Inc v Gen Tire & Rubber Co*, 154 Mich App 777, 787 (1987) ("We conclude that the term 'blanket order' expresses a quantity term, albeit an imprecise one. Parol evidence may be taken on what quantity is intended by that term."); *see also GRM Corp v Miniature Precision Components, Inc*, 2007 US Dist LEXIS 16345, at *6 (ED Mich March 8, 2007) (holding that "blanket order" is a sufficient quantity term); *but see Acemco, Inc v Olympic Steel Lafayette, Inc*,

2005 Mich App LEXIS 2656, at *11-12 (Mich Ct App Oct 27, 2005) (holding that the term "blanket" on its own was not a quantity term because the term only appeared on a document that described the goods to be purchased, not in the agreement itself).

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

10. *Lorenz Supply Co*, 419 Mich at 615-16.

11. The Comments to UCC 2-306 make clear "a contract for output or requirements is not too indefinite since it is held to mean the actual good faith output or requirements of the particular party." MCL 440.2306 at Cmt No 2.

12. MCL 440.2306; *see also General Motors Corp v Paramount Metal Prods Co*, 90 F Supp 2d 861, 873-74 (ED Mich 2000).

13. *Plastech Engineered Prods v Grand Haven Plastics, Inc*, 2005 Mich App LEXIS 853, at *17-21 (Mich Ct App March 31, 2005).

14. *QC Onics Ventures, LP v Johnson Controls, Inc*, 2006 US Dist LEXIS 45189, at *24-28 (ND Ind June 21, 2006) (applying Michigan law).

15. *Chainworks, Inc v Webco Indus, Inc*, 2006 WL 461251 (WD Mich Feb 24, 2006).

16. *Id.* at *6.

17. *Id.*

18. *General Motors Corp v Paramount Metal Prods Co*, 90 F Supp 2d 861 (ED Mich 2000).

19.*Id.* at 873-74 ("The statute and official comments simply do not support Paramount's assertion that all requirements contracts are exclusive requirements contracts; a requirements contract may exist where 'all or some of' the purchaser's requirements are purchased from the seller.") (quoting *Precision Rubber Prods Corp v George McCarthy, Inc*, 872 F2d 187, 188 (6th Cir 1989)); *see also id.* ("A promise to buy of another person or company all or some of the commodity or service that the promissory may thereafter need or require in his business is not an illusory promise and such a promise is a sufficient consideration for a return promise.") (quoting Corbin, 1A Corbin on Contracts § 156 (1963)).

20. *Metal One America, Inc v Center Mfg, Inc*, 2005 US Dist LEXIS 40304 (WD Mich July 14, 2005).

21. *Id.* at *14.

22. *Acemco, Inc v Olympic Steel Lafayette, Inc*, 2005 Mich App LEXIS 2656, at *11-12 (Mich Ct App Oct 27, 2005) (holding that not only did quantity term fail to evidence a valid requirements contract, but it also failed under the statute of frauds because it "grants complete discretion to the buyer to deliver purchase orders containing any amount or no amount at its discretion without any other limiting feature").

23. *Id.*

24. *Advanced Plastics Corp v White Consol Indus, Inc*, 828 F Supp 484, 486 (ED Mich 1993), *aff'd* 47 F3d 1167 (6th Cir 1995).

25. *Id.* at 488 n.1.

26. *Schefenacker Vision Sys, USA, Inc v Depco Int'l, Inc*, Case No. 03-71183, Order Denying Plaintiff's Motion for Partial Summary Judgment at 8-9 (ED Mich May 17, 2004).

27. *Id.* at 10-11. *See also General Motors Corp v Steel Dynamics, Inc*, Case No. 04-056983, Ruling on Motion for Summary Disposition (Oakland County Cir Ct, Mich Aug 4, 2004) (holding that seller had no obligation to continue supplying steel to General Motors because alleged supply agreement failed under statute of frauds and had no mutuality of obligation); *DeDoes Indus, Inc v Target Steel, Inc*, 2005 WL 1224700 (Mich Ct App May 24, 2005) (holding that obligation set forth in price quotation for seller to supply the buyer's "steel needs" was insufficient for supply agreement to satisfy the statute of frauds).

28. *Johnson Controls, Inc v TRW Vehicle Safety Systems*, 491 F Supp 2d 707 (ED Mich 2007).

29. *Id.* at 717.

30. *Id.* at 719-20.

31. MCL 440.2202 ("Terms with respect to which the confirmatory memoranda of the parties agree or which are otherwise set forth in a writing intended by the parties as a final expression of their agreement with respect to such terms as are included therein may not be contradicted by evidence of any prior agreement or of a contemporaneous oral agreement but may be explained or supplemented (a) by course of dealing or usage of trade (section 1205) or by course of performance (section 2208); and (b) by evidence of consistent additional terms unless the court finds the writing to have been intended also as a complete and exclusive statement of the terms of the agreement.")

32. Johnson Controls' Global Terms of Purchase can be found on its Web site, http://www.johnsoncontrols.com.

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Contracting Is Easy – Drafting Is Hard[1]

By Vincent A. Wellman and Deirdre Golden

Introduction

In the fall of 2006, the authors collaborated to teach a Contract Drafting Seminar at Wayne State University Law School. We believe that this was the first such course to be offered at any law school in Michigan, and one of a small number to be found in the country. Although drafting courses are not yet common, we expect they are part of a trend in legal education to include more "skills" courses to help law students prepare for the challenges they will face as young lawyers.[2] Law schools are learning that law practice has changed. Our graduates are not likely to enjoy a long apprenticeship, where they can learn by watching their elders; instead, beginning lawyers will be assigned important tasks as soon as they are hired. Among these tasks will be drafting various agreements—if not full-fledged contracts, then perhaps engagement letters or discovery agreements.

We asked our students to perform many such drafting tasks; some were simple and others more complex. We are proud of how well they performed and how much they learned, and their success has motivated us to continue the seminar. One aim of this article is to document and praise these pioneers. We also aim to make some points about how to teach this kind of skill. To accomplish both these ambitions, we will sketch a confusing area of the law—in this case, the law of the battle of forms under Article 2 of the UCC—where we required the students to grapple with a complex problem, and where sophistication and insight is required to perform well. We then use this drafting challenge to illustrate some important lessons both for the craft of drafting and for the task of teaching that craft.

The Problem of Conflicting Terms in a Battle of Forms

In General

Two of our assignments required contracts for the sale of goods: first, on behalf of a prospective buyer and then on behalf of a seller. In each case, the students were asked to draft contracts that, as much as possible, would secure the terms desired by their hypothetical clients. One lesson they learned was that, in the kind of situation commonly described as a "battle of forms," it is nearly impossible to achieve this through drafting alone. For the most part, our students learned this lesson in the same hard way that it is learned by practitioners: by trying to achieve the impossible and then coming to realize that it cannot be done.

To varying extents, the students were already familiar with agreements for sale of goods. They had studied the text, and foibles, of several such agreements in their first year contracts course.[3] Beyond that basic introduction, some had jobs in businesses where such contracts were common, and others had struggled in their clerkships with such documents. Thus, they were accustomed to the basic idea of a contract that expressed the core terms of the deal (quantity, price, delivery, etc.) and also asserted a sometimes bewildering array of "Standard Terms and Conditions" that were thought important by the client or more senior lawyers.

For obvious reasons, sellers will often want to limit consequential damages and buyers will usually seek to avoid any such limitation, and the UCC drafting assignments asked the students to deal with this issue. Section 2-719 of the Code[4] allows the parties to limit consequential damages, or even foreclose them altogether, and includes a suggestion of the kind of language that, if included in their agreement, could accomplish that limitation.[5] But, as drafters everywhere recognize, it is one thing to know how to draft the appropriate limitation *once* the parties have indeed agreed to accept such a term, and quite another to negotiate so that the parties actually agree to include any such limitation.

UCC 2-207 Basics

Section 2-207[6] of the UCC has been cursed by generations of law students who have struggled to grasp its intricacies, but the section is important to their education because it has produced, in a limited arena, an important change in the rules of contract formation.

The section gives legal effect to a process by which, through an exchange of forms, the parties can struggle over the terms of their deal without actually negotiating those terms. Instead, an offeree can change some of the terms by sending its own form with terms that vary from those proposed by the offeror. Sometimes this process results in the offeree's preferred terms, and sometimes it can result in terms that are neither the offeror's nor the offeree's.

For example, the offeree's acceptance form might include an "additional" term to allow the buyer thirty-days credit before payment is due, where the seller's offer is silent on that question. Comment 3 to UCC 2-207 opines that, between merchants, this additional term would effect only a minor alteration in the deal and should be included in the final understanding of the agreement, even though the seller might have paid no attention to the term's inclusion in the buyer's form and might have given no indication of agreeing to its inclusion.

The section yields a different result if the offeree seeks to limit consequential damages. Suppose that the buyer has sent an order that qualifies as an offer, and the seller replies with an order acknowledgment that qualifies as a *"definite and seasonable expression of acceptance."* Suppose further that the acknowledgment adds a damages limitation, but the order was silent on the question. As a result, the seller's limitation on consequential damages would be another 'additional' term. Comment 4 to UCC 2-207 indicates that, in the view of the Code's drafters, such a limitation would "materially alter" the terms of the offer and would, therefore, not be included unless the offeror actually indicates assent to the proposed additional term. The case law concurs with this principle.[7]

Both the analysis and the result change if we consider a "different" rather than an "additional" term. To understand this, suppose that the buyer had asked for a specific quote, in response to which the seller issued a well-articulated offer to sell, which includes a limitation on consequentials. Suppose further that the buyer replies with its order, which in this scenario will operate as an acceptance, and that the order asserts the buyer's entitlement to consequential damages caused by the seller's breach. In Michigan, as in many states, the problem of different terms is handled according to the "knockout" doctrine, which means that neither the seller's nor buyer's proposed term is included in our final understanding of the parties' agreement.[8] Instead, the conflicting terms cancel each other, and the question of consequential damages would be resolved according to the Code's damage provisions. As a result, in our example, no limitation on consequentials would become part of the contract.[9]

Beyond the Basics

More complicated situations will require more thought and skill, including a deeper understanding of UCC 2-207 and the knockout doctrine. But in teaching drafting, the most difficult problem relates to the drafter's attitude rather than to any subtlety of law.

As we described earlier, UCC 2-207 allows one party to change some terms and conditions in the agreement *without* the other party's assent or even acknowledgment: an additional term can be added to the final contract (provided that the additional term does not materially alter the contract), or one of the Code's default terms can be substituted under the knockout doctrine for terms sought by one or the other of the parties. This legal result can lead to a drafter's unfortunate expectation that, by manipulating its forms, it can expect to impose its terms on the deal without having to secure the other party's assent. As it turns out, however, this expectation is almost always misplaced.

What would happen, for example, if the buyer has submitted an offer (whether in the form of a Purchase Order (PO) or otherwise), and the seller hopes to use its reply (an order acknowledgment or something comparable) to impose its own terms and conditions? In particular, let us again consider a limitation on consequential damages. A seller could recognize that the knockout doctrine will cancel out its damages limitation term if the order acknowledgment is treated as an acceptance with a different term and, therefore, might try to take advantage of the last clause of UCC 2-207(1), sometimes called the "proviso" clause: *"unless acceptance is expressly made conditional on assent to the additional or different terms."*[10] This clause provides for an exception to the rest of the subsection's procedures. One way to understand the potential impact of this clause on a drafter's thinking would be this: a seller might read this clause to indicate that, if its order acknowledgement stated clearly that its acceptance was "conditional" on the buyer's assent to the seller's different terms, it could impose those terms without regard to anything the buyer has said or may come

More complicated situations will require more thought and skill, including a deeper understanding of UCC 2-207 and the knockout doctrine.

to say. Put differently, it appears as if the seller could use its form to dominate the terms of the deal, and, in particular, foreclose any undesirable terms proposed by the buyer in its offer.

But here, as in so many contexts relating to UCC 2-207, appearances can be deceiving. The proviso clause does not convert the seller's order acknowledgment into an acceptance whose terms dominate the contract. Instead, including such a clause turns the seller's purported acceptance into a *counteroffer.* To be sure, if the buyer gives assent to the seller's proposal, then the seller's damages limitation term will become operative, but this is so for the usual reason—namely, the buyer has accepted the seller's offer. However, our analysis, and the caselaw, both indicate some important alternatives to this scenario, the most likely of which is usually not in the seller's interest. In particular, suppose that the buyer's reply insists that the buyer may recover consequentials. (After all, a buyer is just as likely as a seller to have a predrafted form for its use and is as likely as a seller to revert to its own form rather than to actually engage the other party in serious and thoughtful negotiations.) In such a case, the buyer's reply would likely be construed as a "definite and seasonable expression of acceptance" of the seller's counteroffer with a *different* term. As applied to this scenario, the knockout doctrine would again mean that the conflicting terms cancel each other, and the Code's default term regarding damages would be incorporated instead. In sum, the buyer's preferences could prevail if (but only if) the buyer's preferences are the same as the Code's default term, and the seller's preferences would *not* prevail.

There is a kind of paradoxical quality to this aspect of UCC 2-207.

A determined seller might attempt one further stratagem. That is, the seller might add yet more language to its order acknowledgment to say something like, "Seller will accept no contract on terms that are different from those contained in this form; any attempt to add or change the terms of this Order is inoperative and precludes the formation of a binding contract." The seller might well expect that if its counteroffer includes this strong assertion, or something like it, the seller can prevent any further iterations of the *attack-counterattack* character of the battle of the forms as outlined in UCC 2-207(1) and (2). Up to a point, the seller's thinking is sound. After all, if the seller's language is sufficiently clear and strong, it can establish that any reply by the buyer that attempts to vary the terms should not be deemed an acceptance at all and hence not a "definite and seasonable expression of acceptance," which is the predicate for UCC 2-207(1). And, if the buyer's reply is not an acceptance under UCC 2-207(1), then the other provisions of UCC 2-207 should not operate to recognize additional or different terms.

The problem for the seller, however, is that there's more to UCC 2-207 than just subsections (1) and (2). Subsection (3), in particular, can thwart the seller's ambitions in unanticipated ways. Suppose now that the buyer does not make further reply to the seller's strong language; in many cases the buyer sends no reply at all. The seller might want to treat the buyer's silence as acquiescence to all the terms of its counteroffer and then ship the goods (likely accompanied by a bill of lading that repeats the same terms and conditions—usually on the reverse—including the damages limitation). Suppose finally that the buyer accepts the goods and sends payment. In this situation, the caselaw often indicates that no contract has been formed by the parties' writings: the order acknowledgment was a counteroffer that does not create a contract unless it is accepted by the buyer, but, under the Code and at common law, silence is not ordinarily treated as acceptance.

The subsequent conduct—the seller's shipment and the buyer's acceptance of, and payment for, the goods—will not likely be treated as wholesale acceptance of the seller's terms. It will more likely be treated under UCC 2-207(3) as "recognizing a contract by conduct".[11] In such a case, subsection (3) stipulates that the parties' contract will consist of those terms on which the parties' writings agree, together with the Code's default terms. As a result, the seller will again be thwarted.

There is a kind of paradoxical quality to this aspect of UCC 2-207. The more forcefully the seller states the point that it will not agree to a contract on any terms that differ from its own, the more likely it is that the seller will be deemed not to have accepted the buyer's offer and, instead, to have made a counteroffer. That means in turn that the seller's contract fate is dependent on the buyer's subsequent conduct. On the one hand, if the buyer replies in ways that look like an acceptance, the law still permits the buyer to propose different terms; and while UCC 2-207 does not mean that the buyer will necessarily gain its

own preferences, the section does indicate that the seller can be prevented from securing its aims. On the other hand, if the buyer does not reply (or if the reply does not operate as an acceptance), then the seller's fate will depend on the subsequent conduct of both parties; and if any contract results from that conduct, with this scenario, UCC 2-207(3) usually means that the seller will again be thwarted. In sum, no amount of drafting, and no amount of cleverness in drafting, can ensure that the seller will get its terms.

Drafting Wisdom for Dealing with UCC 2-207 and How to Teach It

As we explained earlier, our seminar students had already struggled with UCC 2-207—in their studies and perhaps also in their work—but none of them had previously struggled with the drafting difficulties that are posed by the battle of forms. Some part of the seminar's class time, therefore, required a review of UCC 2-207 and its attendant caselaw. However, the biggest lesson for the students was discovering that there are limits to what can be done by a drafter, no matter how crafty.

One of the authors has written elsewhere about the too common assumption of some lawyers that there are "magic" phrases to be used in contract drafting: words or clauses that can function like a wizard's wand to accomplish the drafter's ambitions without regard to what else is found in the contract or what else has transpired between the parties.[12] We thought that this was an important point to make in the seminar, and throughout the semester we reminded the students that there are few, if any, magic clauses in drafting. The lessons about UCC 2-207 were in the same genre as the anti-magic reminders: it is dangerous to assume that a drafter can impose his or her client's terms on a contract for sales of goods, no matter how forcefully, or comprehensively, the drafter tries to make the point.

There are three other lessons that came with the students' struggles to deal with conflicting forms. These lessons were the inspiration for this essay because they bear on both the craft of drafting and the teaching of that craft and could therefore be shared with a larger audience.

Lesson #1 – There are resources available; don't be afraid to use them.

It is axiomatic that no one drafts an agreement entirely from scratch. Beginning lawyers should learn to find examples, samples, or models that can help them get started. Books of sample or form contracts are available in most law libraries or online, and many law offices have an archive (some better organized than others) of past agreements that can guide the neophyte drafter. When we designed the seminar, we assumed that our students would be expected to proceed in this fashion in their jobs, and it therefore seemed silly to expect them to proceed in some different manner in the seminar. Most texts that address contract drafting make the same point, and even if the texts did not acknowledge this fact, law office economics would soon impress the point on beginning lawyers.

We decided to include this aspect of practice as part of the seminar's structure. Thus, an early assignment asked the students to draft a simple residential real estate purchase agreement. As part of the background for that task, we provided them with forms from different real estate boards and invited them to look for wisdom in the pages of these forms or, for that matter, in any other forms that they could find. For this and subsequent assignments, they submitted not only their draft of the assigned contract but also a short commentary on why they did what they did. We encouraged them to look for various ideas and solutions and then, in their commentaries, to chronicle and evaluate the samples and ideas that they reviewed. For each successive assignment, we expected the students to find and review different possible forms and to tell us what they found, and what they thought about those possible models. Our larger aim was to help the students develop both the search strategies to find various models and the kind of judgment they would need to sort the good ideas from the bad; in our classroom instruction and our comments on their drafts, we worked to hone their critical abilities.

It is axiomatic that no one drafts an agreement entirely from scratch.

Lesson #2 – No matter how many resources you use, there is no substitute for a solid knowledge of the law.

Internet resources have of late become particularly rich and diverse, and many of our students were more adept than we at going online to find both examples and inspira-

tion for their work.[13] The easy availability of the Internet underscores our second lesson. Online resources are rich, but they are also notoriously unreliable: as a result, using what you find on the Internet raises the risk that you will be led astray. We wanted the students to take advantage of those resources, but how could we help them sort the good from the bad?

Separating wheat from chaff is the same challenge, whether the crop is harvested from the Internet or a book in the library or the files of a senior partner. Whatever the drafting context, it is essential that the drafter understand the relevant law. In the case of UCC 2-207, two points are crucial. In Michigan, and many other states, the first of these points is the knockout doctrine. The logic of this doctrine leads to the conclusion that no offer, whether to sell or buy, can control the terms of the resulting contract. Regardless of the offer's terms, and regardless of how the offer is phrased, an acceptance that includes conflicting terms can knockout terms that the offeror had hoped to secure. As we explained above, this result is usually more favorable to a buyer, but it can undermine both the buyer's and the seller's efforts to control the legal consequences of their deals. Even the proviso clause cannot help much on this score: the language favored by that clause converts the reply into a counteroffer, and a counteroffer is still an offer.[14] One sensible reaction to this fact is to rephrase a client's documents so that the client is in the position of *offeree* – to accept, or reject, the other party's offer. By placing the client in the position of the offeree, the drafter might hope to preserve the client's power to reject unacceptable terms. However, this expectation leads to trouble on the second crucial point of law. If this stratagem is available to the seller, it is also available to the buyer, and if both parties employ the stratagem, the end result is that neither party looks as if it is agreeing to the other's terms. Each party is saying, in effect, that it will not agree to the other's conflicting terms and will moreover reject any deal that is not on the terms it desires. In such a situation, the case-law applying UCC 2-207 shows a marked preference for treating the transaction as governed by UCC 2-207(3): no contract is formed by the writings, but, when the parties' conduct recognizes the existence of a contract, the conflicting provisions are, once again, cancelled.

Whatever the drafting context, it is essential that the drafter understand the relevant law.

There are other examples of the same kind, where not knowing the relevant law can lead to crucial mistakes in drafting. In fact, two provisions of Article 2 anticipate problems of just this sort. In UCC 2-316(1), the Code limits a parties' power to exclude warranties and, in the commentary, issues a general warning against drafters who try to exclude "all warranties, express or implied."[15] UCC 2-719(1)(b) can similarly undermine the efforts of the drafter who ignores the Code's provisions. UCC 2-719(1)(a) allows the parties to provide for remedies other than damages and may even limit the injured buyer to the repair or replacement of the nonconforming goods. However, subsection (1)(b) also specifies that "resort to a remedy as provided is optional unless the remedy is expressly agreed to be exclusive…" The contract drafter who doesn't appreciate subsection (1)(b) could spend valuable time crafting a limitation on damages, only to discover that the law will treat that limitation as only one possible remedy among others, and that the full range of damages allowed under the Code are, in fact, still available.

Lesson #3 — No matter how many resources you use, there is no substitute for common sense.

If we could, we would confront drafters who expect that their preprinted forms will control all the terms of the contract. We would ask them, "Do you really expect that contract law will allow you to impose all of your terms on the deal, without regard to the agreement of the other party?" Framed this way, the question admits of only one plausible answer: "No, of course not. Our law of contracts requires that the parties agree on the terms of their deal." But recognizing this fundamental premise of contract law *should* lead the drafter to understand that UCC 2-207 gives an offeree only limited powers to change the terms of the deal and gives neither party the power to exercise complete control over the deal's terms and conditions. Greater familiarity with UCC 2-207 should confirm this fundamental premise rather than obscure it.

There are other examples, along the same lines, where common sense could avoid disappointment, and we emphasized several of them to the seminar. Inserting an arbitration clause into an employee manual, for example, will not ensure that the parties will need to arbitrate—no matter how well drafted the arbitration clause—if the beginning page of

the manual asserts that nothing in the manual creates any contractual obligation for either party.[16] We wish, again, that we could confront the drafter of such a manual (and of some letters of intent) with the question, "Do you really expect to say that a writing has no legal effect and then, in the same breath, expect a court to enforce part of that writing?" Again, we expect that there can be only one answer to the question, and that recognizing the inconsistency will lead to a different and more satisfying approach by drafters of employee handbooks.

Common sense and the law of contract interpretation converge on the proposition that a contract has to be interpreted as a whole,[17] and one cannot decide what a contract requires, or permits, without knowing the whole contract. One clause of an agreement may state that the seller is responsible for the performance of its goods, but another part of the same agreement might condition the seller's performance on the buyer's providing appropriate information about its manufacturing needs. If the goods fail to perform, then a simple-minded analysis might focus on only the first provision and conclude that the seller is liable for the goods' failure, but knowledge of the condition precedent could change that initial conclusion: if the buyer did not provide appropriate data then failure of the goods was not in fact a breach of the contract.

This maxim of sound contact interpretation carries over to drafting: one cannot draft an adequate contract by just cobbling together a series of specific, isolated clauses. Consider, in this connection, those standard terms and conditions that assert that every transaction is governed by those standard terms. The drafter's efforts will fail if, in another paragraph of the same standard terms, it requires that each new order be accomplished by use of a prescribed form that includes a merger and integration clause asserting that the order is a complete and independent transaction. A moment's reflection should reveal the contradiction: if every new order is a complete and independent transaction, then the process of agreement that leads to some particular contract might *or might not* incorporate those standard terms. To put the point simply, shooting oneself in the foot is painful and embarrassing, and sound drafting accordingly requires that the drafter look at the whole instrument to avoid that result.

These are important lessons for every lawyer who works to provide forms for the sale of goods. For that matter, they are important lessons for every drafter. Teaching them is a challenge, although a rewarding one, when the students slowly grasp the insight that if they draft mindlessly, they will draft badly.

NOTES

1. The title of this essay invokes a famous joke in the entertainment industry, the punch line of which goes "Dying? Dying is easy. Comedy is hard."

2. In summer of 2005, a conference on the teaching of contract drafting was held at Northwestern University's law school. Such a conference is often the herald of growing trend in legal education.

3. When Wellman last taught UCC 2-207, it consumed a week's class time and more than 20 pages of the casebook.

4. *See* MCL 440.2719.

5. In creating the seminar, we decided that we would need to mix certain elements of substantive contract law with the necessary points about drafting. In considering the issues relating to a limitation on consequential damages, we needed to remind the students about the extent to which 2-719 allows the parties to include such a limitation, and the extent to which that section also undermines the efforts of the heedless drafter. See especially 2-719(1)(a). We also needed to warn them about the extent to which some drafters confuse provisions addressing damages with provisions that address warranties.

6. *See* MCL 440.2207.

7. *See, e.g., Leonard Pevar Co v Evans Products Co*, 524 F Supp 546, 32 UCC Rep Serv 720 (D Del 1981); *Eagle Signal Controls v Midwestern Elec Inc,* 521 NE2d 967 (Ind Ct App 3d Dist 1998); *Winter Panel Corp v Reichhold Chemicals, Inc*, 823 F Supp 963, 21 UCC Rep Serv 2d 533 (D Mass 1993).

8. *See, e.g., Challenge Mach Co v Mattison Mach Works*, 138 Mich App 15, 359 NW2d 232 (1984).

9. From one perspective, this rule appears to enshrine the buyer's preferences, but that appearance is artificial: the buyer gets its way *only if* its proposed term is the same as Article 2's 'default' term. So, in contrast, if the buyer had wanted both consequential damages and attorney's fees, the knockout doctrine would frustrate the buyer's ambitions as well as the Seller's.

10. MCL 440.2207(1).

11. *See, e.g., Goodyear Tire & Rubber Co v Dynamic Air, Inc*, 53 UCC Rep SErv 2d 778 (D Minn 2004).

12. See Vincent A Wellman, The Unfortunate Quest for Magic in Contract Drafting, 28 Wayne L Rev 1101 (2006)(hereafter "Quest for Magic").

13. In this connection, we were delighted to learn of a Web site for small business owners that addressed the UCC 2-207 problem, and got it right. Unfortunately, the Web site has been discontinued.

14. One of the leading books on contract drafting misses this vital point. We were especially pleased that one the seminar students caught this error and pointed it out to the class.

15. See 2-316, Comment 1, which explains that subsection (1) denies "effect to such language when inconsistent with language of express warranty and permit[s] the exclusion of implied warranties only by conspicuous language or other circumstances which protects the buyer from surprise."

16. *See Huertibise v Reliable Business Computers*, 452 Mich 405, 550 NW2d 243 (1996)(discussed in *Quest for Magic*, 28 Wayne L Rev at 1103-1106).

17. *See, e.g., Assoc Truck Lines, Inc v Baer*, 346 Mich 106, 77 NW2d 384 (1956).

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It's About Time – "Real-Time" Conflict Solutions Are Here

By Tracy L. Allen

"What do you mean 'there's a problem?' We don't have time for a problem. This has to be resolved ASAP."

This type of conversation is heard everyday. It matters not whether you are the in-house attorney, the general counsel, the employer, the provider, the supplier, or the complainant. With the increasing pace of global communication, the luxury of time has long passed.We are inundated with communications requiring immediate response. Business leaders dread being distracted from the focus of profit making. Understandably, they resent being thrown into conflicts. Unlike attorneys who are (often wrongly) presumed to thrive on conflict, clients thrive on staying competitive, keeping a quality productive work force in place, and satisfying customers.

So Little Time; So Much to Do.

Time has increasingly become a commodity. In the world of economics, it is now a bargaining chip as well as a tool. In his best selling book, *Blink: The Power of Thinking Without Thinking*,[1] Malcolm Gladwell introduces us to the concept of "thin-slicing." It relates to the brain's ability to shortcut information and process data flowing into the brain with rapid response. The "fight or flight" mentality rooted in the brain's neurological system is a prime example of how our own physiology supports Gladwell's contention.

The ability to "thin slice" has significant implications for use in analyzing and resolving conflict.[2] By activating the ability to make quick decisions based on selective data, one may avoid considerable unnecessary effort and achieve acceptable (or better) outcomes. The increasing need for speedy and effective interventions in the business world invites a wide range of strategies into very different circumstances. Understanding the role and value of time in business has led to the integration of multiple methods of dispute resolution into the world of commerce.

Ironically, the emergence of alternative dispute resolution (ADR) mechanisms to resolve conflict may reflect, in part, Gladwell's concept of thin-slicing. Rather than submit to the often laborious and expensive traditional litigation path of massive information exchange and sorting, mediation, for example, in and of itself is a forum for processing an appropriate volume of information necessary to reach a negotiated agreement. It usually comes before the trial, and thus, by definition, "all" the information has not been presented.

Today, "less is more" is no longer a negative notion. Whether it is in the midst of a long term information technology (IT) contract, a prevention tool in risk management, or a first step toward maintaining an employment relationship, many creative models and methods for engaging people in learning negotiations emerge because swift resolution is now a business necessity.

Real-Time Interventions

The twenty-first century market refers to these techniques as "real-time interventions." Many of these interventions incorporate a neutral, unrelated third party into the resolution process. This person usually has no stake in the outcome. Specifically designed to address an issue at its birth, a variety of objectives can be met with real-time interventions. The specific issues or concerns raised by the dispute are met head-on. There is the opportunity to avoid the fallout from the dispute, the ability to prevent repetition of the problem in the future, and the chance to solidify or improve communications while supporting or reinforcing (contractual) relationships. All of these avenues enhance the likelihood of meeting the ongoing needs of the affected parties while working through the problem with the assistance of the intervener.

Real-time interventions are many but they embrace a common theme—attention to the rights and interests of the affected parties.[3] Each is intended to be applied in immediate, real time, and not, for example, six months from now. By agreeing to enter into dialogue with a neutral "at the moment of impact," the affected parties are far more capable of analyzing their own individual rights and

interests as well as those of others in the relationship because the history of the dispute has yet to be written. More importantly, depending upon the type of real-time intervention selected, the process can be entered into without risk to future rights if full resolution is not achieved.

Creative Interventions

When trouble arises in a business relationship, it would seem logical that business solutions should be the first source of resolution. The original "Customer Complaint Department" was and remains a simple, elegant method for first attempts. In more sophisticated structures, customer complaint and customer service teams have replaced the company ombudsman. They are poised with knowledge of the corporate needs and methodologies but seek ways to sustain the relationships that drive the business model, which sometimes go awry. They find ways to balance the present circumstances of the problem with the future of the relationship.

When the trained "inside" third parties fail to achieve full resolution, the next step for many companies is frequently the "Legal Department." In small organizations, the Legal Department is outside counsel. In larger entities, the Legal Department is a more structured arm of the business team of the organization. Whether in or out, once an issue rises to this level of organizational attention, these newer real-time interventions can come into play.

Uniquely designed to fit each particular contractual or relational situation, real-time mediation can be a "one size fits all" concept.

Real-Time Mediation

Growing in popularity with the construct of real-time interventions is "real-time" mediation. Created in part out of necessity, a variety of industries are incorporating it into their business operations, negotiations, and third-party relationships. Uniquely designed to fit each particular contractual or relational situation, real-time mediation can be a "one size fits all" concept.

In its simplest form, real-time mediation is comprised of three ingredients: i) the recognition by all affected parties that if conflict arises in the course of the relationship, resolving some or all of it sooner than later has large economic and non-economic benefit for the disputants; ii) a system for immediate notice, action, and resolution that frequently includes privacy and confidentiality with respect to non-participants and third parties; and iii) agreeing in advance to the use of a neutral person (sometimes specifically identified), who will be promptly available to direct, manage, identify, and aid the interested parties in negotiations intended to reach resolution of the problem *now*.

Construction Industry Application

Real-time mediation makes sense in many industries but is perhaps most familiar to the construction industry. All over the country, construction law experts seek cost effective methods for preventing and resolving disputes, especially in the presently declining real estate market and construction industry. Anyone who has ever hired, sued, defended, or been a building contractor or subcontractor has a litany of stories to share with those in similar circumstances. The project was delayed, the materials weren't right, the workmanship was faulty, it's the other guy's fault, the waiver of lien is a complete defense, the notice of lien wasn't filed properly, they used the wrong materials, we shouldn't have to pay twice, etc. All of these complaints and defenses usually come at the onset or on the heels of legally intensive and expensive litigation. Sadly, lawyers often hear an owner saying, "I just wanted it right. If only the project manager had come to me and asked me…" Or, "they did it without asking."

Imagine the complexity of restoring an historic government building. The construction contracts were years in the making due to the public nature of the project. The aesthetic challenges to bring the 1800s back into the twenty-first century were significant and uncertain. Someone on the drafting team had the wherewithal to insist on "real-time mediation" provisions in all the contracts. As matters of conflict arose throughout the two-year restoration project, one of the three already identified and trained mediators headed to the job site to put out the fire. There were no lawsuits or arbitrations. There was no withholding of payment. No one walked off the job. Some items were "parked" to the side for further negotiation later in the project, but in the end, the change orders and alterations to the original specs were done by (mediated) agreement "on the spot," and no one sued for delay, mistake, wrongful payment, violation of Builder's Trust Fund, breach of warranty, treble damages, or attorney fees. Best of all for those involved, the challenges and solutions remained out of the public eye.

Real-time mediation was used in the Hong Kong Airport development over ten years ago. At that time, the project was touted

as the largest civil engineering project in the world. A detailed set of procedures was put in place to anticipate and then deal with disputes as they arose, with pre-appointed dispute resolvers. A similar concept was used in building the Channel Tunnel between England and France.

Real-time mediation in construction cases is no longer a novel notion or unique proposal. Standard form AIA contracts now frequently include not only provisions that define the real-time mediation process and what matters will be submitted to mediation, but also the identity of the neutral problem solver(s) who may be called on to aid in identifying and negotiating the solutions. The benefit of continuity that comes from using mediators familiar with the project, the efficiency of selecting persons knowledgeable in construction matters, and the ease of having already agreed upon persons readily available enhances the effectiveness of real-time mediation and significantly furthers the interests of the true stakeholders.

Other Forms of Real-Time Mediation

The good news is that real-time mediation has now made its way into many other relationships such as long term IT outsourcing contracts, employment disputes, healthcare, and risk management. The real-time strategies span a spectrum of approaches depending on the players. Certainly a quick evaluation by a neutral expert may go a long way in "educating" decision makers, but it does not always address the underlying motivations or needs of the affected parties. Guidance from the expert may only be a small part of what an aggrieved participant may be seeking. The human condition expects recognition, validation, acknowledgment, and respect. Real-time mediation has space for all of these aspects as well as the opportunity for the experts (be they lawyers or subject matter specialists) to participate. It is a methodology that has room for integrating multiple layers, or not. In some respects, a real-time mediation proposal is limited only by the creativity of the drafters and users.

In the field of healthcare, and risk management specifically, real-time mediation could be viewed as an outgrowth of the ombudsman. Working within an organizational framework, historically the ombudsman was seen as only slightly independent of the organization. His or her attention to the problem, while perhaps welcome, was viewed with a skeptical eye. In real-time mediation, the intervener or mediator is independent of all the participants and brings a very different role to the situation. An unhappy patient and a nurse practitioner, sitting down with a mediator only two days after an unexpected surgical result, has proven to be a risk worth taking for many medical facilities. National Naval Medical Center in Bethesda, Maryland developed a prototype for swift conflict resolution in 2001. Kaiser Permanente Medical Group, already a leader in creating alternative forums for resolving potential medical malpractice complaints, followed the lead. Rush Presbyterian Hospital in Chicago, Illinois has also developed a multi-step immediate response system that incorporates matching dispute resolution trained physicians and lawyers with patients and their families.[4]

The introduction of real-time mediation processes into the medical field has brought a more open forum for communications between patients and the health care system. The University of Michigan has discovered that using trained nurse-legal practitioners to communicate in real time with patients and physicians has expanded the quality of their risk management performance in significant and measurable ways.[5] An immediate response and attention to problems by trained listeners has created a new environment in the delivery of health care at the University. The real-time program has not only led to swifter and smaller financial resolutions but also been of benefit in dealing with the often more important aspects of a patient's complaint such as providing an immediate explanation, an apology, and an improvement in the systems and procedures within the medical facility.

Employment Arena

Using a similar humanistic approach, a number of employers have developed a multi-step, integrated conflict management protocol for employee complaints. Modeled in part on grievance procedures in labor union contracts, many of these systems are designed to come into play quickly in the life of the employee's dissatisfaction. In many instances, a disgruntled employee must take advantage of the opportunity for a neutral intervener as a pre-condition to filing any formal or legal complaint. These systems are grounded in due process, freedom from retaliation, and fairness. They are usually

The real-time strategies span a spectrum of approaches depending on the players.

multi-step processes beginning with a "go to" person or department for a first dialogue. Often they are designed to use internal and then external resources, with all steps of the process aimed at communicating and understanding displeasure and seeking resolution.

In employment matters, real-time mediation often comes at a second or third step, after an "open door" policy dialogue fails to solve the complaint. The program will have a pre-defined methodology for the selection and payment of the neutral intervener. The neutral may come from within the organization but be so distant from the source of the problem that he or she is perceived to be more of an ombudsman. Alternatively, the neutral may be entirely unrelated to the organization. In some instances, the neutral may be required to be a particular ethnicity or gender. He or she may also be required to be an employment law specialist. All steps have defined timelines intended to require action and reaction in "real time."

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In exploring the success of such programs within the workplace, it is evident that a variety of diverse and creative real-time systems have emerged that give credence to the notion that "now is better than later."[6] Shell Oil[7] and Giant Foods[8], for example, have discovered that moving from a company conflict-averse culture to one that encourages active problem solving *now* is an economic investment worth making.

Information Technology: The Unpredictability of the Long Term

Whether it is the ever changing nature of intellectual property or the length of many IT contracts, the IT industry has embraced real-time mediation. The legal drafters' challenge in creating an outsourcing agreement, for example, is complicated by the very factor of time. It is virtually impossible to draft an agreement that includes every possible situation that may arise in the course of the engagement, let alone how to control or manage each potential conflict. Historically, such issues and clauses were addressed in generalities and couched in vagueness within the written agreement. Even though huge sums of money were being spent over long periods of time, often everyone just signed the contract documents and held their breath.

Today, with virtually every business heavily reliant on IT, there is much at stake if something goes awry. Thus, it is not surprising that parties take extreme positions on contestable issues. The result, however, takes them further from their goals of maintaining a satisfactory relationship essential to the smooth functioning of each party's business. There is no luxury of time in many of these disputes, and the party with the greatest leverage often gains the undue economic and, perhaps, procedural advantage.

The alternative is to adopt mechanisms for dealing rationally with the disputes as they occur, in real-time mediation. The application of such a process creates a more balanced playing field for each party to the IT agreement. In the IT world, the initial engagement contract frequently identifies one to three persons with subject matter expertise who will be available on very short notice to help resolve technical and business issues as they arise. The intervention team may be comprised of an IT engineer, a financial analyst, and/or a design consultant. Depending on the nature of the dispute, the intervention may involve only one person from the team of experts. Team members may be called in to facilitate dialogue or to go even further and provide an evaluation or proposal for resolution that may or may not be binding on the parties to the agreement. They may even agree to use such recommendation in future legal proceedings, if resolution is not achieved, or to do just the opposite—not use it in litigation.

In IT matters, the advantages of using real-time mediation are many. It fosters problem resolution in a timely manner.[9] A forum can be created for voicing positions and proposals for immediate solution. It recognizes rights, duties, and positions in the context of a desire to preserve a relationship. It probably reduces costs of the conflict and yet, depending on how it is crafted, can leave open the usual other ADR processes or legal forums if real-time mediation fails to resolve all the issues.

The Lawyers' Challenge

In the face of conflict, there are many avenues back to the business of profit making. These opportunities exist because the interested parties know how to practice good business judgment and preventive, creative, and collaborative law. A true understanding of the clients' business interests and needs is the catalyst behind the inclusion of real-time intervention concepts into a contract. An appreciation of the carnage that can come from litigation, and a mindset to maintain

an efficient and economical attorney-client relationship, silences the notion that lawyers only create conflict to earn fees.

The advent of these real-time interventions should not be viewed by the legal community as an invasion of the client's right to sue or to seek justice. Real-time strategies will not be appropriate in every instance. There are times when a rights-based process is not only necessary, it may be the only methodology for preventing irreparable damage. Notwithstanding this obvious fact, however, there are lessons to be learned.

Instinctively, lawyers realize that most clients, while interested in their legal rights, have a greater interest (and need) in furthering their business and personal goals. As counselors, we must strike the appropriate balance between the legal rights and the driving interests of our clients. Real-time interventions exemplify the fact that low cost, efficiency, and relationships are most important to our clients.[10]

Real-time intervention, by definition, can be designed to explore and develop effective systems for clients that further their ability to maintain their competitive advantages, to engage a satisfied workforce, and to enhance their ability to provide high-value services to their customers. The time has come for the "real" dialogue between lawyers and clients to keep pace with 21st century practices and technology.

NOTES

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Receiverships in the Real Estate Setting

By Hon. Mark A. Goldsmith and Gregory J. DeMars

Introduction

Receivers are a valuable and varied construct of the law. Although receivers do not exercise judicial powers in the strict sense, they are not, on the other hand, limited to performing purely ministerial functions. Rather, they represent an administrative extension of the appointing court, with the power to affect substantially the rights, liabilities, and interests of all parties with whom they interact within the constraints of their appointment. A receivership may be flexibly designed to protect a broad array of both liberty[1] and property[2] interests. As such, these powerful appendages of the court may be created in many different contexts, reflecting the limitless types of disputes that roil humankind.[3]

This article focuses on receiverships in the real estate setting. In particular, we analyze the considerations that should be taken into account by real estate lenders, borrowers, and other stakeholders in determining whether to seek or oppose a receivership when a real estate lending relationship becomes financially distressed. In so doing, we also explore how courts typically analyze requests for appointment of a receiver under Michigan law. From this analysis, the parties can fashion strategies to advance their respective positions.

The Borrower and Lender's Clash of Interests

A principal concern of a real estate lender is the preservation of collateral. When financially distressed, the borrower may be unable or unwilling to take the measures necessary to preserve the collateral's value. Although borrowers will not typically intentionally take measures that diminish the collateral's value, they may lack the resources to make necessary repairs, retain effective management, or pay taxes and insurance. All such acts of neglect may have a significant impact on the value of collateral.

In many cases, the neglect will be part and parcel of the borrower's inability to maintain debt service. In these situations, the lender can avail itself of the usual remedies of workouts, foreclosures, deeds in lieu of foreclosure, and suits on the debt or guarantees. However, these options often take time to play out. A foreclosure by advertisement, for example, will require several weeks of publication, followed by a sale and expiration of the redemption period—approximately seven months—before the lender will be in complete control of the property.[4] Where the value of the property is plummeting due to the borrower's neglect, the lender simply does not have the luxury of time.

A receivership offers the lender the benefit of immediate possession and control of the property and the rents where applicable. Depending on the circumstances, a receiver can be appointed almost immediately upon the filing of a lawsuit, thereby putting someone in possession who will protect the lender's interests. The receiver will have broad powers, not only to prevent future deterioration of the property, but also to reverse prior bad management decisions.[5]

From the borrower's perspective, the appointment of a receiver may well prove a disaster. The borrower loses control of the property, including available cash flow. The receiver's compensation and expenses will be added to the mortgage debt, making the borrower's repayment task harder and the likelihood of any foreclosure deficiency greater. The borrower's credit rating will be adversely impacted. In all likelihood, defaults may automatically be triggered under covenants in loan documents with other lenders.

This clash of interests often provides the necessary impetus to a negotiated settlement between lender and borrower. However, when compromise cannot be achieved—or when time is needed to explore whether a compromise can be achieved—how will a court evaluate the lender's request for the appointment of a receiver? The careful lawyer must be aware of, and consider, a number of issues, including history, doctrine, and practice.

General Principles of Receivership Law

At the outset, it is important to recognize that receiverships are a creature of equity jurisdiction. In Michigan, it has long been

recognized that courts have inherent equitable authority to appoint receivers.[6] As such, Michigan follows the common law tradition, which stretches back several hundred years to the equitable authority of England's chancery courts to appoint receivers.[7]

This common law authority has been recognized in statutory law: "Circuit court judges in the exercise of their equitable powers, may appoint receivers in all cases pending where appointment is allowed by law."[8] Notably, this language has been construed as not constituting an independent grant of authority.[9] Rather, the phrase "where appointment is allowed by law" is a legislative acknowledgement of the court's power to appoint receivers in two distinct situations: (1) where a statute specifically provides for the appointment of a receiver, and (2) "where the facts and circumstances render the appointment of a receiver an appropriate exercise of the circuit court's equitable jurisdiction."[10]

Because equity provided a broad sweep of power for the appointment of receivers, it also fashioned restraints to avoid abuses. For this reason, the doctrine developed that the appointment of a receiver is considered a "drastic" remedy, and that receivers should be utilized only in extreme cases.[11] Further, a receivership should not be utilized where "less intrusive means" are available to achieve the relief requested. [12] As a further harness against an unbridled appointment power, courts are admonished to require some proof that prior efforts have been made to accomplish relief through means other than a receiver and that they have been found wanting.[13] Still another limiting principle is that receiverships must be ancillary to a legal action, unless otherwise allowed by statute or case law.[14] In other words, a party may not simply file a complaint requesting a receiver. Instead, the party must plead a cognizable cause of action and request a receiver as part of the relief.

In seeking appointment of a receiver, the lender's lawyer will emphasize the broad grant of power by which courts are given great authority to correct or prevent injustices. The borrower's lawyer will emphasize the wariness with which courts are admonished to approach appointment of a receiver. Obviously, the ultimate decision will depend on the sound exercise of the trial court's discretion.[15]

Waste

The circuit court's exercise of discretion is not performed in an historic vacuum. Courts have long recognized certain recurrent real estate contexts in which the appointment of a receiver is often deemed appropriate. One such context is waste—threatened or actual—of the real property. Any act that wrongfully diminishes the value of the collateral is considered waste.[16] Waste has traditionally been a circumstance justifying appointment of a receiver.[17]

However, what constitutes waste has been the subject of some dispute historically. Physical damage or neglect of property has unquestionably been deemed waste.[18] Less tangible assaults on property rights have also justified appointment of a receiver. For example, a receiver was appointed "for the purpose of preserving the property," where the mortgagee contended that a railway company's refusal to comply with the city's demand for track improvements would threaten the value of the mortgaged property as well as risk loss of the franchise to operate the railway.[19] Even mismanagement by the borrower of its affairs, without any allegations of bad faith, can justify appointment of a receiver to preserve the value of the collateral.[20]

A recurrent instance of waste in the real estate context is the non-payment of taxes and insurance. Over the years, the law's approach has evolved. Prior to 1937, the possibility that title to real property might be lost through a tax sale for non-payment of taxes was not considered a threat justifying appointment of a receiver unless the tax sale was imminent or likely to occur prior to the expiration of the statutory redemption period.[21] To address the threat that this common law principle posed to real estate lenders, the Michigan Legislature, in 1937, enacted a statute that permitted parties to define waste in their mortgage documents to include non-payment of taxes and insurance.[22] The statute expressly allowed the lender to seek appointment of a receiver, even when there was no imminent threat of a tax sale.[23]

Although the statute permits the parties to define waste in their mortgage documents, a court is not bound to appoint a receiver based simply on the parties agreement. Typically, courts will analyze a variety of factors to determine whether appointment of a receiver is appropriate, including: the amount of unpaid taxes and insurance; the length of the past due period; the value of the mort-

In seeking appointment of a receiver, the lender's lawyer will emphasize the broad grant of power by which courts are given great authority to correct or prevent injustices.

gaged property; the likelihood of a deficiency following sale; whether the deficiency is likely collectible from the mortgagor or guarantors; whether the mortgager has been guilty of misconduct or mismanagement, such as misappropriation of rents; and whether the mortgage documents provide for the appointment of a receiver (which they invariably do).

The waste statute also includes a broad grant of powers to the receiver: "Subject to the order of the court, the receiver may collect the rents and income from such property and shall exercise such control over such property as to such court may seem proper."[24] This sweeping language authorizes the court to place the receiver into a position of actively managing the property and collecting the income from the property in order to guard against threats to the value of the collateral occurring because of the failure to pay real estate taxes and/or insurance premiums.

Because a substantiated claim of statutory waste carries with it, as a practical matter, a certain presumption in favor of appointing a receiver, the lender's lawyer will avidly explore the availability of that ground as an initial matter. Non-statutory waste is typically a more debatable proposition and may require the opinion of an expert to support such grounds. Excessive deferred maintenance or mismanagement is often more of a judgment call, and thus a more difficult ground upon which to prevail in court. For the same reason, the borrower will seek to avoid statutory waste. To the extent a cash-strapped borrower must select which bills to pay and which expenses to defer, the borrower will make sure that taxes and insurance receive high priority on the payables ledger, thereby making it more difficult for the lender to prevail on a motion for appointment of a receiver.

MCL 554.231 authorizes the parties to enter into an assignment of rents, under which the borrower assigns the rents as security for the loan.

Assignment of Rents

Another route to the appointment of a receiver is by way of an assignment of rents. As noted above, the waste statute authorizes the appointment of a receiver for purposes of collecting the rent. However, even in the absence of statutory waste, the law permits the appointment of a receiver to collect the rents.

MCL 554.231 authorizes the parties to enter into an assignment of rents, under which the borrower assigns the rents as security for the loan.[25] The assignment is not a mortgage of the rents; thus, no foreclosure proceeding is required to perfect the lender's interest in the rents.[26] Rather, the assignment becomes effective against the borrower immediately upon default and without notice. The implication of this principle is that the rents become the property of the lender immediately upon default, rendering the borrower's use of the rents a conversion of the lender's property.[27]

While the rents become the lender's property immediately upon default, the assignment does not become effective against tenants until certain statutory requirements are fulfilled. Specifically, the lender must record a notice of the default under the mortgage with the register of deeds and serve a copy of the notice and the assignment on the occupiers of the mortgaged property.[28]

Although the statute does not, by its terms, provide for the appointment of a receiver, caselaw makes clear that where an assignment of rents is properly invoked the appointment of a receiver is appropriate. The seminal decision for appointment of a receiver in the context of collecting rents is *Smith v Mutual Benefit Life Ins Co*.[29]

In *Smith*, the court reviewed the history of assignments of rents, noting that prior to 1843, mortgagees were entitled to possession and collection of the rents until expiration of the redemption period. In that year, the Legislature enacted legislation that barred mortgagees from taking possession until their title had become absolute, i.e. until after expiration of the redemption period without the right to redemption having been exercised. In 1925, the Legislature reversed course as to trust mortgages (a form of bonds), allowing the mortgagee to take possession and collect rents before expiration of the redemption period. Similar legislation was enacted in 1953 with respect to real estate mortgages, the effect of which was to reinstate the pre-1843 state of the law, under which mortgagees could enter into possession before expiration of the redemption period and collect rents. After reviewing this history, the *Smith* court held that where a mortgagee has entered into an assignment of rents, it is entitled, in an appropriate case, to the appointment of a receiver to collect the rents (arguably pre- and post-foreclosure).

After default, the lender has a right to collect the rents (if the lending documents so provide) and may also have a persuasive case for seeking appointment of a receiver. Nonetheless, a careful examination of a number of issues is required before deciding to

invoke the assignment of rents and to seek appointment of a receiver.

One such issue is what the tenant's response will be to receiving a notice from the lender to pay it, rather than the landlord. As a practical matter, tenants may be confused by such a demand and may be slow or unwilling to pay a rival claimant for their rent check. Reduced cash flow may translate into further deterioration of the property and remove any hope of a work-out with the borrower. Even if tenants properly pay the lender, the result will be that the borrower will be stripped of funds and the lender will have to undertake the management responsibilities previously exercised by the borrower. These management expenses will have to be paid prior to the lender using the rents to pay off the mortgage debt. Where the borrower's management history is less than stellar, the lender's assumption of management may be welcome. However, if the property has not been mismanaged and there are no concerns about defalcations, the lender will have to think twice about replacing management.

If the lender determines that it is prudent to invoke the assignment of rents provision, the next decision is whether to seek appointment of a receiver. As a practical matter, in the absence of a demand from a court-appointed receiver for payment of rent, tenants may not pay rent at all. A receiver, as a court-appointed official, carries the court's official imprimatur and promotes payment in accordance with the law. Thus, a lender may determine that the expense of a court action, as well as the receiver's compensation and expenses, can be justified by the increased cash flow that the receiver will produce, or that such action is necessary to stop the "milking of rents."

On the other hand, as noted above, the borrower may well want to resist the appointment of a receiver for a number of valid reasons: losing possession and control of the property, damage to the borrower's credit, and the additional expense of the receiver's fees and expenses, which will likely become part of the mortgage debt. However, where the lender has decided to invoke the assignment of rents, the borrower may well want a receiver appointed because a receiver ensures that the rents are properly applied to insurance, taxes, maintenance, accrued interest on the debt, and any deficiency following foreclosure. Because the receiver is court appointed, the borrower can ensure some modicum of control by having the right to challenge the receiver's actions in court. Without a receiver, the lender has much more freedom of action in terms of applying the rents. Appointment of a receiver can also facilitate an orderly management of the property, while the lender and borrower negotiate a work-out, or until the foreclosure sale can be completed, or until the borrower can market the property and pay off the debt.

Expense

Assuming the statutory and/or equitable considerations warrant appointment of a receiver, the lender must still take into account the additional layer of expense that a receivership may entail.

Typically, mortgage documents provide that the receiver's fees and expenses will be paid by cash flow, if it is sufficient, or borne by the borrower and added to the mortgage debt. However, aside from contractual considerations, the law has developed several principles regarding a receiver's compensation that provide judicial gloss to the contract terms. A receiver is entitled to reasonable compensation as well as expenses necessarily incurred by the receiver, as determined in the discretion of the court.[30] The general rule is that fees and expenses will be a charge on the receivership property and be paid out of such property.[31] To the extent there is no receivership property, or it is inadequate to pay the receiver's fees and expenses, the receiver has an equitable claim for such fees and expenses against the party seeking the appointment of the receiver.[32]

Even where the receiver would otherwise be entitled to compensation, it is subject to disallowance. Where the receiver has a substantial interest in the property, it is not an abuse of discretion for the court to disallow compensation.[33] Where the receiver has neglected its duty—by failing to account for property or funds or by failing to file requisite reports—the court may disallow or reduce the receiver's claim for compensation.[34] Similarly, if the receiver is guilty of neglect of duty, compensation may be reduced or denied.[35]

Another expense consideration is less tangible, but nonetheless real: the liability exposure for a receiver's actions. If a receiver goes into possession, his actions may subject him—and, through principles of contract, the lender or an insurer—to potential liability. The following should be considered in evaluating this exposure risk.

Appointment of a receiver can also facilitate an orderly management of the property…

The law is not wholly clear on what standard of care applies to the receiver's actions. Older authority suggests that no special rules of substantive liability apply as a result of the receiver's status. For example, in *Gutsch v McIlhargey*[36], the court held that the receiver was personally liable for his torts (apparently conversion) when he had secured levy of replevin on property owned by the wife of the judgment debtor to satisfy a judgment owed by her husband. The court baldly stated that the receiver's "official character ought not to be a defense to his tortious action, or deprive parties of their rights."[37] Similarly, in *Kenney v Ranney*,[38] the court upheld an action in tort against a receiver who had been appointed in connection with the judicial foreclosure of a mortgage, even though the receiver claimed to have sold the plaintiff's property in the good faith belief that it was subject to the mortgage. The court held that it was no defense that the receiver believed that he had authority to sell the property.[39]

More recent cases have held that a receiver may be sued in tort only when it is alleged that he or she acted in bad faith.

More recent cases have held that a receiver may be sued in tort only when it is alleged that he or she acted in bad faith. In a recent published decision, *In Re Motion for Leave to Sue the Receiver of Venus Plaza Shopping Center*[40], the Michigan Court of Appeals affirmed the trial court's denial of leave to sue the receiver for failure to discharge his duty to operate the receivership property in accordance with the receivership order. The court held that the law required "an element of bad faith when suing court-appointed receivers for actions taken and events occurring during the receivership." In reaching its decision, the court relied on *In re Hudson,*[41] in which the Michigan Supreme Court had held that despite errors in judgment, the receiver had demonstrated good faith in arranging for a sale of receivership property and, consequently, was entitled to full fees and no exposure for personal liability.[42]

Venus Plaza does not expressly discuss the older line of cases, but it does point out that an "operating receiver" (i.e. one involved in the on-going operation of a business) is entitled to greater deference than a "passive receiver" (i.e. one who simply liquidates property).[43] It may be that the way to harmonize these cases is along the operating receiver/passive receiver divide.

Another issue bearing on liability exposure is the principle that a receiver may not be sued without leave of the appointing court. A receiver is deemed to be an officer of the court that appointed him.[44] As a consequence, it has long been the law that no one may bring suit against the receiver except with the permission of the appointing court.[45] Courts have stated, without much elaboration, that the justification for the rule is the avoidance of inconsistent verdicts and multiplicity of actions.[46] There is a contrary line of cases, not expressly overruled, holding that leave of court is not required where the suit alleges the receiver has committed a tort in the course of performing his duties, such as converting the plaintiff's property.[47]

Given the overwhelming authority supporting the principle that leave of court is required, anyone filing suit without first obtaining leave is likely to find the action dismissed. Further, the motion for leave to sue will give the receiver an opportunity to address the merits of the proposed suit, thereby enabling the receiver to launch a pre-emptive strike before having to defend a full-dress suit.

The lender considering the appointment of a receiver must take into account the expense of a receivership and available cash flow from the property. That expense includes the quantifiable, out-of-pocket expense of fees and costs, but also the exposure to possible receivership liability. The more extensive the receivership contemplated—in terms of time and management responsibilities—the greater the risk of exposure. For the borrower, the receiver's potential liability forms the basis for additional leverage in its negotiations with the lender.

Conclusion

The decision to seek or oppose a receivership is often not cut-and-dried. Lenders and borrowers must carefully analyze their respective interests and evaluate whether a receiver promotes or impedes those interests, including the risks that each course of action carries with it. Courts will have their own perspective, based on whether the circumstances of a particular case fall within statutorily cognizable categories or satisfy an individual judge's sense of fairness. Armed with history, the applicable law, and knowledge of the strategic choices at issue, the careful lawyer will assist the client in making an informed decision on whether a receivership is the best solution for a financially distressed relationship and in assessing the likelihood that a court will agree with that judgment.[48]

NOTES

1. For example, in *Wayne County Jail Inmates v Wayne County Chief Executive Officer*, 178 Mich App 634, 444 NW2d 549 (1989), a receiver was appointed to manage a county jail after many years of neglect and disregard of court-ordered reforms.

2. *See, eg, Cohen v Cohen*, 125 Mich App 206, 214, 335 NW2d 661 (1983) ("The primary purpose of a receiver is to preserve property and to dispose of it under the order of the court."), citing *Westgate v Westgate*, 294 Mich 88, 91, 292 NW 569 (1940).

3. Even a cursory review of statutory law confirms that receivers may be appointed in numerous areas of law, common and arcane: insurance, MCL 500.8121; veterans affairs, MCL 35.273; sewage disposal bonds, MCL 41.348; zoning, MCL 125.535; industrial development bonds, MCL 125.1257; cemeteries, MCL 328.233; hospitals, MCL 331.8e; consumer protection, MCL 445.910; banking, MCL 487.12406; divorce, MCL 552.27; condominiums, MCL 559.203b; prisoner reimbursement, MCL 800.404a…to name just a few.

4. A judicial foreclosure will take longer to complete – a minimum of 13 months – if there are no contested issues.

5. Even where the corporation is solvent, courts may appoint a receiver with the full power to act on behalf of the corporation. *See, eg, In re Detroit Properties Corp*, 254 Mich 523, 530, 236 NW 850 (1931)("'The receiver of a corporation, conducting its business, takes the place of the corporation and its officers for the purpose of performing the necessary corporate duties and functions, and has the same powers for such purposes….'") quoting 14-A C J p. 1005.

6. *Michigan Minerals Inc v Williams*, 306 Mich 515, 525-527, 11 NW2d 224 (1943); *Grand Rapids Trust Co v Carpenter*, 229 Mich 491, 493-494, 201 NW 448 (1924); Ralph v Shiawassee Circuit Judge, 100 Mich 164, 169, 58 NW 837 (1894); Corliss v Clinton Circuit Judge, 212 Mich 476, 483,180 NW 478 (1920); *National Bank of Commerce v Corliss*, 217 Mich 435, 437-438, 186 NW 717 (1922).

7. *Petitpren v Taylor School District*, 104 Mich App 283, 294, n9, 304 NW2d 224 (1981).

8. MCL 600.2926.

9. *Petitpren, supra* n 7, 104 Mich App at 294.

10. *Id.* The *Petitpren* decision is a good illustration of the broad reach of equity to appoint a receiver. In that case, the suspended superintendent of a school district brought suit seeking reinstatement. At a show cause hearing to determine whether the superintendent should be reinstated, the school district's counsel's argument included reference to the deteriorating financial condition of the school district, prompting the trial court to appoint a receiver. On appeal, the Court of Appeals upheld the trial court's broad authority to appoint a receiver, even though there was no specific statutory grant of authority. Although it ultimately reversed the lower court's ruling, it instructed that circuit courts have broad equitable jurisdiction to appoint receivers where the circumstances render the appointment "an appropriate exercise of the circuit court's equitable jurisdiction." *Id*. at 294.

11. *Michigan Minerals Inc v Williams,* supra n 6, 306 Mich at 525; *Jenks v Horton*, 96 Mich 13, 16; 55 NW 372 (1893); *Hosner v Brown*, 40 Mich App 515, 536, 199 NW2d 295 (1972); *Korash v Livonia*, 388 Mich 758, 202 NW2d 803 (1972).

12. The case often cited for this proposition is *People v Israelite House of David*, 246 Mich 606,225 NW 638 (1929), where the attorney general brought an action for abatement of a nuisance and appointment of a receiver to manage property that had been donated to a religious organization that the state alleged was perpetrating a fraud on unsuspecting adherents. The Supreme Court upheld an injunction to abate the nuisance of various improper activities, but held that a receivership should not be appointed, given that the injunction was sufficient to address the state's legitimate concerns.

13. *Petitpren, supra* n 7 illustrates this principle by its reversal of the receivership order entered in that case. The Court of Appeals found that the trial court had not attempted other methods to achieve financial stability for the school district "short of receivership nor was the possibility of other less drastic approaches adequately explored." 104 Mich App at 298.

14. *National Lumbermans Bank v Lake Shore Machinery Co*, 260 Mich 440, 443, 245 NW 494 (1932); *Francis Martin Inc v Lomas*, 62 Mich App 706, 710, 233 NW2d 702 (1975).

15. *Singer v Goff*, 334 Mich 163, 167, 54 NW 290 (1953); *Michigan Minerals Inc v Williams*, 306 Mich 515, 528, 11 NW2d 224 (1943)].

16. *Nusbaum v Shapero*, 249 Mich 252,263, 228 NW 785 (1930)("Anything that tends to destroy the security is 'waste'").

17. *Id*. at 265.

18. R. Clark, *A Treatise on the Law and Practice of Receivers* (3d ed 1959) Vol I, Sec 178 at 261-262 ("The general equity ground for the appointment of a receiver is, therefore, that the property in dispute is in danger of loss, destruction, deterioration, or other impairment of its value through the neglect, waste, misconduct or other acts or failure to act on the part of the defendant or others who are holding the property.").

19. *Union Street Railway v Saginaw*, 115 Mich 300, 73 NW 243 (1897).

20. *Ralph v Shiawassee Circuit Judge*, 100 Mich 164, 58 NW 837(1894).

21. *Union Guardian Trust Co v Rau*, 255 Mich 324, 238 NW 166 (1931).

22. MCL 600.2927(1) provides: "The parties to any mortgage, trust mortgage, or deed of trust of real property, or any extension thereof, may, by agreement therein contained to that effect, provide that the failure of the mortgagor or grantor, as the case may be, to pay any taxes assessed against such property or installments thereof, in the event said taxes are being paid under the provisions of Act No. 126 of the Public Acts of 1933, as amended, or any insurance premium upon policies covering any property located upon such premises constitutes waste."

23. MCL 600.2927(2) provides: "If such mortgagor or grantor in such instrument fails to pay such taxes or insurance premiums upon property subject to the terms of a mortgage, trust mortgage, or deed of trust containing such agreement the circuit court having jurisdiction of such property may, in its discretion upon complaint or motion filed by such mortgagee, grantee, assignee thereof or trustee under such instrument and upon such notice as the court may require, appoint a receiver of the property for the purpose of preventing such waste. Subject to the order of the court, the receiver may collect the rents and income from such property and shall exercise such control over such property as to such court may seem proper." The statute contains an exception for an owner-occupied dwelling house or farm, as well as a store or business property having an assessed valuation of $7,500 or less. MCL 2927(3).

24. MCL 600.2927(2).

25. MCL 554.231 provides: "Hereafter, in or in connection with any mortgage on commercial or industrial property other than an apartment building with less than 6 apartments or any family residence to secure notes, bonds or other fixed obligations, it shall be lawful to assign the rents, or any portion thereof, under any oral or written leases upon the mortgaged property to the mortgagee, as security in addition to the property

described in such mortgage. Such assignment of rents shall be binding upon such assignor only in the event of default in the terms and conditions of said mortgage, and shall operate against and be binding upon the occupiers of the premises from the date of filing by the mortgagee in the office of the register of deeds for the county in which the property is located of a notice of default in the terms and conditions of the mortgage and service of a copy of such notice upon the occupiers of the mortgaged premises."

26. *Smith v Mutual Benefit Life Ins Co,* 362 Mich 114, 124, 106 NW2d 515 (1960).

27. *In Re PPG Properties*, 55 BR 864, 869-870 (Bankr ED Mich 1985). While this analysis stands under Michigan law, such treatment of rents may be different in a bankruptcy setting. See *In Re Mount Pleasant Ltd Partnership*, 144 BR 727 (Bankr WD Mich 1992). Such analysis is not possible due to the space constraints of this article.

28. *In Re PPG Properties, supra*, n 27.

29. 362 Mich 114, 106 NW2d 515 (1960).

30. *Fisk v Fisk*, 333 Mich 513, 517, 53 NW2d 356 (1952).

31. *Id.* at 516; *Preston Nat'l Bank v Emerson*, 102 Mich 462, 468, 60 NW 981 (1894).

32. *Kimmerle v Dowagiac Mfg Co*, 105 Mich 40, 41, 63 NW 529 (1895). *See also* MCR 2.622 for rules pertaining to fees and expenses of receivers appointed in supplementary proceedings following entry of a judgment.

33. *Hughes v Dungy*, 339 Mich 348, 355, 63 NW2d 422 (1954).

34. *Horvath v Vasvary*, 246 Mich 231, 234, 224 NW365 (1929).

35. *In re Angell*, 131 Mich 345, 350, 91 NW 611 (1902).

36. 69 Mich 377, 37 NW 303 (1888).

37. *Id.* at 379.

38. 96 Mich 617, 55 NW982 (1893).

39. *Id* at 618.

40. 228 Mich App 357, 579 NW2d 99 (1998).

41. 258 Mich 176, 241 NW 868 (1932).

42. *Id.* at 183 and *In re Hudson*, 266 Mich 274, 253 NW 295 (1934).

43. *Venus Plaza, supra* n 40, 228 Mich App at 361, citing *Morley v Snow, Circuit Judge*, 117 Mich 246, 250, 75 NW 466 (1898).

44. *Cohen v Bologna*, 52 Mich App 149, 151, 216 NW2d 586 (1974).

45. *Id.* at 151-152; *Venus Plaza, supra* n 40, 228 Mich App at 359; *In re Chaffee, 262 Mich 291, 293, 247 NW 186 (1933). See also Burk v Muskegon Machine & Foundry Co,* 98 Mich 614, 616, 57 NW 804 (1894); *In re Guarantee Indemnity Co,* 256 Mich 671, 240 NW 78 (1932). *Manchure v Wayside Oil Corp,* 259 Mich 667, 668, 244 NW 224 (1932); *Citizens' Savings Bank v Ingham Circuit Judge*, 98 Mich 173, 177, 57 NW 121 (1893); *Petition for Appointment of a Receiver for Peoples State Bank*, 51 Mich App 421, 431-432, 215 NW2d 722 (1974).

46. *Cohen, supra* n 44, 52 Mich App at 151-152.

47. *Kenney v Ranney*, 96 Mich 617, 55 NW982 (1893).

48. Due to space constraints, this article has not addressed the important related context of appointment of receivers in construction cases. The Michigan Construction Lien Act, MCL 570.1122 et seq, prescribing special rules for such cases, should be consulted.

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Mergers and Acquisitions in India: A Primer

By Ashish S. Joshi

India is one of the fastest growing economies in the world. With the recent acquisitions of Land Rover and Jaguar brands by India's Tata Group from the Ford Motor Company, the message is clear—India sees herself as a global player in the race for economic power and supremacy. While Indian companies are scouring the horizons globally for strategic acquisitions, India also offers exciting deals in its domestic corporate sector. In the past decade, Michigan's automotive giants and other Michigan companies have steadily cultivated business and supply-chain relationships with Indian companies. India's dynamic business and regulatory environment, intellectual property rights protection and enforcement, and 300 million-plus middle class population with a rapidly increasing purchasing power makes investing or acquiring a business in India a strategic business decision for Michigan corporations.

This article attempts to provide a bird's-eye view of various requirements under India's prevailing company law, tax law, and accounting standards, focusing on mergers and amalgamations. India had more than 40 years of protected economy along with numerous dysfunctional and unproductive state-owned corporations. However, since the 1990s there have been landmark developments in India's corporate sector. First, the corporate sector was freed from the red-tape of the earlier "license raj." Second, there were attempts to privatize the state-owned industries. Third, the rules concerning foreign direct investment in several industries were relaxed, and cross-border cash flow was eased. All of these factors propelled India's mergers and acquisitions (M&A) activity into a frenzy.[1] In the past three years, India's M&A activity has truly been phenomenal. Even though the volume of M&A activity is small when compared to the global volume of M&A, Indian companies' appetite for global assets is growing, which has been demonstrated by a spate of audacious overseas acquisitions made by Indian companies and conglomerates such as the Tata Group[2], Ranbaxy, Videocon, Satyam, Mahindra & Mahindra, etc.[3]

Although this article focuses on mergers and acquisitions in India, it would be remiss to ignore Indian companies' buying spree on a global scale. India's opening of its doors to foreign investment and competition, low interest rates, pressures of globalization, and the advent of private-equity funds have spurred India's cash rich companies to go on a global buying spree[4]:

Period	Company	Acquirer	Deal Worth US$
2/2007	Novelis	Hindalco	6 billion
1/2007	Corus Group	Tata Steel	12.1 billion
1/2007	Ritz-Carlton	Boston Indian Hotels	170 million
9/2006	Jeco Holding AG	M&M	180 million
7/2006	Arcelor	Mittal Steel	30 billion
6/2006	Eight O'Clock Coffee	Tata Tea	220 million
6/2006	Sabah Forest	BILT	261 million
3/2006	Hansen	Suzlon Energy	565 million
3/2006	Terapia	Ranbaxy	324 million
2/2006	Betapharm	Dr. Reddy's	570 million
7/2005	Teleglobe	VSNL	239 million

Before we focus on India's legal framework for mergers and acquisitions, let us take a look at the definitions of the key terms in this area:

Key Definitions

Under Indian law: "Acquisition" is the purchase of a company or a part of it so that the acquired company is completely absorbed by the acquiring company and thereby no longer exists. "Amalgamation" means two or more companies are fused into one by merger (or) by taking over by another so that a third company is absorbed into one or blended with another, with the amalgamating company losing its identity. Merger, in which all participating companies go out of existence to form a new company, is referred to as amalgamation. "Merger" is essentially a fusion or

absorption of one company by another, with the latter retaining its own name and identity and acquiring all assets and liabilities of the former. The absorbed company ceases to exist as a separate company.[5]

Legal Framework

Sections 391 to 394 of India's Companies Act, 1956 ("the Act") deal with the right of companies to enter into a compromise or arrangement either (a) between itself and its creditors or any class of them or (b) between itself and its members or any class of them. The term "arrangement" is a term of wide import and contemplates not merely reorganization of share capital but also a modification of the rights of the shareholders. It includes reorganization of share capital by the consolidation of different classes of shares or division of shares into shares of different classes or by both methods.[6] Essentially, these provisions cover restructuring, merger, demerger, and hiving off of a unit by a company.[7]

Sections 391 to 394 of India's Companies Act…deal with the right of companies to enter into a compromise or arrangement either (a) between itself and its creditors or any class of them or (b) between itself and its members or any class of them.

Some of the nuances of section 391 should be noted:

- This section has to be read with the Companies (Court) Rules, 1959, which forms a complete procedural code for implementing mergers.
- Section 391 is a complete code by itself. Once a scheme of compromise and arrangement falls squarely within the four corners of the section, it can be sanctioned, even if it involves doing acts for which the procedure is specified in other sections of the Act. To illustrate, once a scheme satisfying the requirement of section 391 is sanctioned, there is no need to comply with other provisions of the Act, such as section 293 for sale, lease, etc. of the company's property.[8]
- The scope of this section is very wide. It also applies to a company that is in the winding up proceedings. An arrangement under this section can, therefore, also take the merging company out of winding up proceedings.[9]
- An amalgamation or merger cannot be used to bypass other statutes.[10]
- Schemes of compromise and arrangement can only transfer such rights, powers, duties, and property as are capable of being lawfully transferred by a party to the scheme, if no sections of the Companies Act existed. If any part of the scheme includes anything to which the parties cannot bind themselves, then that part of the scheme will be treated as a nullity.[11]
- Subsection 6 of section 391 enables a court to stay suits and proceedings against the company pending in the same court or elsewhere till such time as the proceeding for the sanction of the court, under section 391, is disposed. High courts in India are split over whether this sub-section allows courts to order a stay of any criminal proceedings against the company.[12]

The usual steps involved are[13]:

1. Inspection of the objects clause - The memorandum of association of both companies—the transferor company and the transferee company—should contain an enabling provision for the amalgamation to take place. If such clauses do not exist, necessary alteration of the object clause of the memorandum of association must be put through at the outset.[14]
2. Approval of the scheme by the board of directors - The board of directors of the transferor and the transferee companies have to approve the scheme of amalgamation, including the exchange ratio. To enable the board to make a decision, a draft of the scheme of amalgamation has to be prepared by the legal advisors, the valuation report is prepared by the financial advisors, and a merchant banker generally provides a fairness opinion certificate on the valuation report.
3. Notification of the stock exchange - Since the decision of the board on a proposed merger of the company is price-sensitive information, in cases of public companies, both the companies are, among other things, required under clause 36 of the listing agreements with the stock exchanges to communicate the price-sensitive information to the stock exchanges. This is done immediately after the board meeting deciding on the merger and/or according to approval of the merger scheme.
4. Application to the court for directions - The next step is to make an application under section 391(1) to the high court having jurisdiction over the company. Whether jointly

or individually, both companies, the transferor, and the transferee have to seek the court's sanction under sections 391-394.[15] The high court generally is the high court of the state in which an incorporated company has its registered office. The application should seek the court's permission for convening a meeting of creditors and/or members and is generally made through a judge's summons in Form 33 (supported by an affidavit in form 34 of rule 67 of the Companies (Court) Rules, 1959 ("the Court Rules")). A copy of the proposed scheme of amalgamation needs to be annexed to the affidavit. Documents accompanying the summons should be a true copy of the company's updated memorandum and articles of association. However, depending on the high court, it would be prudent to also submit a certified copy of the company's latest audited balance sheet and certified copy of the board resolution that authorizes making the application to the court.[16]

5. Forwarding a copy of the application made to the court to the concerned regional director of the department of company affairs.[17]

6. Obtaining the high court's directions for convening a shareholders' meeting - The hearing on the summons is usually attended by the representatives of the merging companies as well as their respective advocates (attorneys). Following this hearing, the high court gives directions under rule 69 of the Court Rules determining, among other things, (a) the class or classes of creditors and/or of members whose meeting or meetings have to be held for considering the proposed merger, (b) fixing the date, time, and place of the meeting, (c) appointing the chairman who will preside over the meeting, (d) fixing the quorum and the procedure to be followed at the meeting(s) including voting by proxy, (d) the notice of the meeting and the advertisement thereof, and (e) the time within which the chairman of the meeting is to report to the court the result of the meeting. In case a request has been made in the application for dispensing with holding of the creditors' meeting, the court may, after considering the grounds for dispensation, direct that separate requirements of the creditors' meeting be dispensed with.

7. Dispatching notice to shareholders and creditors - In order to convene the meeting of the shareholders and creditors, a notice of the mergers/acquisitions and an explanatory statement of the meeting, as approved by the court, should be dispatched by the transferor and the transferee companies under Section 393 of the Act to their respective shareholders and creditors together with the scheme of amalgamation at least twenty-one days prior to the date of the meeting. The notice is to be drawn up in form 36 of the Court Rules and a proxy form in form 37 to the Court Rules also needs to be sent. The documents are required to be mailed under certificate of posting.

8. Advertising the notice of the meeting - Rule 74 of the Court Rules stipulates that the notice of the meeting should be advertised in a format specified in form 38. The advertisement is to be issued by both the companies in an English-language daily together with a translation thereof published in the regional language of the place where the registered office of the company is situated. Under rule 76 of the Court Rules, the chairman appointed for the meeting shall file with the court—not less than seven days prior to the date of the meeting—an affidavit confirming that the notice has been dispatched to the shareholders/creditors and that the same has been published in the newspapers as required.

9. Holding the shareholders' and creditors' meeting – The shareholders'/ creditors' meeting should be held on the appointed date.[18] The amalgamation scheme should be approved by the members/creditors by a majority in number present

in person or by proxy. This majority must represent at least three-fourth in value of the shareholders/creditors present and voting.[19] The requisite majority must be computed on the basis of a poll.[20] Mere presence is not enough. Any member who, though present at the meeting, does not vote for or against, but remains neutral, is not to be taken into consideration.[21] Further, only those creditors whose names are shown on the company's books of account are entitled to vote.[22]

10. Submitting the chairman's report on the conduct of the meeting to the court - Pursuant to rule 78 of the Court Rules, the chairman of the shareholders'/creditors' meeting is required to submit to the court within the time fixed by the judge or, where no time has been fixed, within seven days after the date of the conclusion of the meeting, a report in form 39 of the Court Rules that, among other things, sets out the number of persons who attended and voted at the meeting personally or by proxy, their individual values, and the percentage of members who voted in favor of or against the scheme.

11. Filing of the resolution with the registrar of companies – Within thirty days from the date of passing the resolution, a copy of the resolution passed by the shareholders/creditors approving the scheme of amalgamation is required to be filed with the registrar of companies in form 23 appended to the Companies (Central Government's) General Rules and Forms, 1956.

12. Submitting of the petition to the court for sanction of the scheme - Under rule 79 of the Court Rules, within seven days from the date on which the chairman submits his or her report on the result of the meeting to the court, the transferor and the transferee companies are required to make a petition to the high court for confirmation of the scheme of amalgamation. The petition has to be drawn up in Form 40 of the Court Rules. Rule 80 of the Court Rules states that, based on the petition, the court will fix the date of hearing of the petition and direct that the notice of the hearing must be advertised in the same newspapers in which the notice of the meeting has been announced or in such other newspapers as the court may direct. This advertisement must be issued not less than ten days before the date fixed for the hearing. The notice affirms that should any member or creditor of the transferor company raise written objections to the proposed amalgamation, no objection may be raised to the member or creditor being heard on its objections by the court.

13. Issuing a notice to regional director, company law board, registrar of companies, and the official liquidator - On receipt of the petition, the court issues a notice of the petition to the concerned regional director of the company law board having jurisdiction over the transferor and the transferee companies, the respective registrar of companies, and also to the official liquidator of the company that is to be dissolved upon the merger.

14. Conducting hearings and issuing an order confirming the scheme - Proceedings begin with the court hearing the objections, if any, on the amalgamation scheme filed—in response to the advertisement mentioned above—with the concerned regional director of the company law board, the concerned registrar of companies and/or the court by any member, creditor, or any other person wishing to oppose the petition. Thereafter, the court may pass an order sanctioning the amalgamation scheme in form 41 of the Companies (Court) Rules. The court may also issue an order in form 42 directing that all properties, rights, and powers of the transferor company, to be specified in the schedule attached to the order, be transferred without any further act or deed to the transferee company, and all liabilities and duties of the transferor company be similarly transferred to the

transferee without any further act or deed.

15. Transferring the assets and liabilities to the transferee company - Passing of the order is pursuant to the scheme of amalgamation, which provides that from the appointed date and upon the scheme becoming effective, all assets and liabilities, including intellectual property rights,[23] licenses, etc. in relation to the transferor company, or to which the transferor company is a party, are transferred and are in full force and effect on, against, or in favor of the transferee company and may be enforced as fully and effectually as if, instead of the transferor company, the transferee company has been a party or beneficiary thereto without any further act or deed by the transferee company.

16. Filing the court's order with the registrar of companies by both companies - Under section 394(3) of the Act and Rule 81 of the Court Rules, the transferor and the transferee companies are required to file the court's order sanctioning the scheme of amalgamation with the registrar of companies under their respective jurisdictions. The filing is made in Form 21 appended to the Companies (Central Government's) General Rules and Forms, 1956. Under section 394(3) the time limit given for the filing is thirty days.[24] The amalgamation takes effect from the date on which the court's order is filed with the registrar of companies. Therefore, in the interest of synchronization with the effective date of the merger, it is advisable for both the transferor and the transferee companies to file the order with their concerned registrar of companies on the same date.

17. Issuing the shares to the shareholders of the transferor company - Pursuant to the sanctioned scheme of amalgamation, the shareholders of the transferor company are issued shares in the transferee company as per the exchange ratio or the swap ratio approved under the scheme. This is made by way of an allotment, following which the return of allotment in form 2 must be submitted to the registrar of companies by the transferee company within thirty days from the allotment date in accordance with section 75 of the Companies Act, 1956. Necessary entries in the register/index of members must also be made in compliance with sections 150 and 151 of the Companies Act, 1956.

18. Listing the new shares – After making the allotment, the transferee company, if applicable, must apply to the stock exchange where its securities are listed for listing the new shares allotted to the shareholders of the transferor company.

19. Attaching the court's order to the memorandum of association - Section 391(4) of the Act stipulates that a certified copy of the court's order sanctioning the scheme of amalgamation must be annexed to every copy of the memorandum of association issued by the transferee company, failing which penal clauses become applicable.

20. Preserving the books and papers of the transferor company – Under section 396A of the Companies Act, 1956, the books and papers of the amalgamated company are to be preserved and not to be disposed of without prior permission of the central government.

Although in a number of other countries an additional approval under applicable anti-trust laws may be required at this stage, this is still not necessary under the Indian law. Nevertheless, the stage has been set for a change with the introduction of the Competition Act, 2002. Once this act becomes fully operational, acquisitions and mergers will require the approval of the Competition Commission of India if the combined assets of the acquirer and the acquired enterprise in India cross the various thresholds envisioned under that law.

Effective date of scheme – A compromise or arrangement takes effect from the date when it is arrived at subject to the sanction of the court. If the court grants sanction, it takes effect, not from the date of the sanction, but from the date when it was arrived at. Sanction of the court to a compromise has "re-

lation back," and a scheme or arrangement agreed to by the creditors of a company becomes operative from the date of the meeting in which it is agreed to and not from the date on which the court's sanction is given.[25]

Tax Issues

Under the Indian Income-Tax Act of 1961, the transferor company is described as the amalgamating company, while the transferee company is called the amalgamated company. Section 72A of the Income-Tax Act of 1961 stipulates that the accumulated loss and the unabsorbed depreciation of the amalgamating company are deemed to be the loss or depreciation allowance of the amalgamated company for the previous year in which the amalgamation is effected and can be setoff or carried forward as per other provisions of the said Act. However, the right of setoff is subject to the following conditions:

(a) There has been an amalgamation of a company owning an "industrial undertaking," a ship or hotel with another company, or there has been an amalgamation of a banking company within the meaning of section 5 of the Banking Regulation Act, 1949 with a "specified bank" as defined therein;

(b) The amalgamating company has been in business—from which loss has occurred or depreciation has remained unabsorbed—for a minimum period of three years;

(c) The amalgamating company has held, continuously for a period of two years preceding the date of amalgamation, at least three-fourth's of the book value of its fixed assets;

(d) The amalgamated company holds, continuously for a minimum period of five years from the date of amalgamation, at least three-fourth's of the book value of the fixed assets acquired under the amalgamation scheme; and

(e) The amalgamated company continues the business of the amalgamating company for a minimum period of five years from the date of amalgamation and fulfills such other conditions as may be prescribed to ensure that the amalgamation is for a genuine business purpose.

On fulfillment of the conditions above, the unabsorbed business losses and the unabsorbed depreciation of the amalgamating company are deemed to be the loss or depreciation of the amalgamated company for the year of amalgamation. This leads to the possibility for a fresh term of eight years for setoffs or carry forwards.[26]

Further, upon the amalgamation taking effect, a few other deductions are available to the amalgamated company under the Income-Tax Act, 1961 to the extent these are available to and remain unabsorbed in the hands of the amalgamating company. Such as the following:

1. Capital/revenue expenditure on in-house scientific research and contributions to approved scientific research associations/approved national laboratory [Section 35]
2. Amortization of preliminary expenses [Section 35D]
3. Expenditure on an in-house research and development facility [Section 35(2AB)]
4. Amortization of expenses incurred exclusively for the amalgamation [Section 35DD]
5. Amortization of expenses on prospecting for certain minerals [Section 35E]
6. Amortization of telecom license fees incurred for acquiring the right to operate telecom services [Section 35ABB]
7. Expenditure on acquisition of patent right, copyright, and know-how. [Section 35AB]

Accounting Issues

Accounting Standard 14 (AS-14)[27] of the Institute of Chartered Accountants of India relates to accounting for amalgamations. The standard stipulates that amalgamation means an amalgamation pursuant to the provisions of the Companies Act, 1956 or any other statute as may be applicable to companies. The Accounting Standard distinguishes between two types of amalgamation,

A. An amalgamation in the nature of merger

B. An amalgamation in the nature of purchase/acquisition

An amalgamation would come within the fold of type A if all the following conditions are fulfilled:

(a) All the assets and liabilities of the transferor company become the assets and liabilities of the transferee

company upon the amalgamation.

(b) Shareholders holding not less than 90 percent of the face value of equity shares of the transferor company become equity shareholders of the transferee company on the amalgamation.

(c) The consideration for the amalgamation is discharged by the transferee company wholly by issue of equity shares in the transferee company except that cash may be paid only in respect of any fractional shares.

(d) The business of the transferor company, after amalgamation, is intended to be carried on by the transferee company.

(e) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

If any of the above conditions is not fulfilled, the amalgamation would be in the nature of purchase and hence be covered under type B, that is to say, purchase or acquisition.

The accounting treatment of the amalgamation depends on the nature of the amalgamation. In the case of a merger, the "pooling of interests method" is to be applied, and for an acquisition the "purchase method" is to be adopted. Under the pooling of interests method, the assets and liabilities of the merging companies are aggregated and recorded by the transferee company at their existing carrying amounts except to the extent necessary to ensure uniformity of accounting policy. Similarly, the reserves appearing in the balance sheet of the transferor company are carried into the balance sheet of the transferee company. The difference between the amount recorded as share capital issued consequent to the swap ratio and the amount of the share capital of the transferor company is adjusted in the reserves. Under the purchase method, the assets and liabilities of the transferor company are incorporated into the books of the transferee company either at their existing carrying amounts or at their fair values on the date of amalgamation. The excess of purchase consideration (whether consisting of shares, cash, or other assets) over the net book value of assets (i.e., minus liabilities) is treated as goodwill that has to be amortized on a systematic basis over a period not exceeding five years, unless a longer period can be justified as its useful life. In case of a shortfall, however, the difference is adjusted as a capital reserve.[28]

Conclusion

This article has presented an overall picture of the legal paradigm of India's M&A activity. This is an oversimplified and generalized view of India's laws and regulations concerning mergers and acquisitions. India has a labyrinth of laws and regulations that need to be carefully navigated as M&A activities are directly linked to international equity markets. The Indian government and its regulatory bodies are making attempts to simplify the laws and make the working of its regulatory agencies transparent. In the recent Companies Bill, it has been proposed to provide a single forum for approval of scheme of mergers and acquisitions in a time bound manner. This concept of "deemed approval" is a welcome move. In the Competition Act 2002, the commission must take a view within ninety working days, failing which the merger is deemed to have been approved based on the market place, i.e. the relevant geographic and product markets.

NOTES

1. See generally Bhatnagar, N., Mergers and Acquisitions – Will It Be Effective In Indian Context? *Chartered Secretary*, April 2007

2. *See* Tata and Ford Reach Deal For Land Rover, Jaguar, *The Wall Street Journal*, March 27, 2008 at B3.

3. See Bhatnagar, *supra*.

4. See generally Kumar, N., Corporate Strategy in Emerging Scenario – Mergers & Acquisitions, *Chartered Secretary*, April 2007.

5. *Id.*

6. *Hindustan Commercial Bank v. Hindustan General Electric Corporation*, 30 Comp Cases 367 (1960)

7. See Ramaiya, A. *Guide to the Companies Act* (16th edition, 2006), Volume 2, Commentary to Section 391, page 3205.

8. *Re HCL Infosystems Ltd.*, 46 SCL 365 (2003); 121 Com Case 861 (2004). However, it should be noted that a scheme under this section cannot be regarded as an alternative mode of liquidation. It is only an alternative to liquidation. The incidents of a scheme under section 391 are different both in principle and in consequences from those of winding up. *Himalaya Bank Ltd. V. J. Roshan Lal*, 31 Com Cases 333 (1961); AIR Punj 350 (1961).

9. *Re Vasant Investment Corporation Ltd.*, 52 Com Cases 139 (1982).

10. See for instance *General Radio & Appliances Co. Ltd. v. Khader*, 60 Com Cases 1013 (1986); AIR 1986 SC 1218. The transferor company in an amalgamation was the tenant of premises under an agreement which specifi-

cally prohibited subletting without the consent in writing of the landlord. Under the scheme of amalgamation, all the assets of the transferor company including the tenancy passed to the transferee company. The written consent of the landlord was not taken. The transaction was held to be a transfer of the tenancy without the sanction of the landlord and the transferee company was held to be liable to evicted from the premises.

11. *Re Skinner*, 29 Com Cases 247 (1959); 3 All ER 273 (1959)

12. *Re Uma Investment Private Ltd.*, 47 Com Cases 242 (1977); *Harish Raskapoor v. Jaferbhai Mohamedbhai Chhatpar*, 65 Com Cases 163 (1989)

13. See Ghosh, A., The Mechanics of Mergers and Acquisitions, *Chartered Secretary*, April 2007; Ramiya, supra, at page 3267 ("Secretarial Action Points")

14. Section 391 does not permit sanction to arrangements which are ultra vires the company. *See Ramiya, supra*, at page 3230.

15. Courts have refused its sanction where only one of the companies – the transferor or the transferee – had applied for it. See *Re Kirloskar Electric Co. Ltd.*, 40 SCL 745 (2002)

16. Although the Companies (Second Amendment) Act, 2002 has substituted the term "Tribunal" for the term "Court" in Section 391/other Sections under Chapter V of the Act, the change will only become operational from a date which is yet to be notified.

17. Section 394A of the Act.

18. Creditors meeting is not necessary where scheme is only between members and the creditors are not likely to be adversely affected. See *Re ICICI Ltd.*, 36 SCL 682 (2002); 119 Com Case 941 (scheme of merger between a parent and its subsidiary).

19. The Court has the power to go into all the incidental and ancillary questions in an effort to satisfy itself whether the scheme has the approval of the requisite majority. *See Miheer Mafatlal v. Mafatlal Industries Ltd.*, 4 Comp LJ 585 (1996). However, the Court will not substitute its judgment as to whether there is a scope for a better scheme. *Re Blue Star Ltd.*, 104 Com Cases 371 (2001).

20. *Dinesh Lakhani v. Parke Davis (India) Ltd.*, 47 SCL 80 (2003)

21. *Re Kirloskar Electric Co. Ltd.*, 116 Com Cases 413 (2003).

22. *Re Mahalaxmi Cotton Mills Ltd.*, 20 Com Cases 164 (1950).

23. The court in a proceeding under section 391 may not hold an inquiry into questions to entitlement to brand names, trade marks, etc. Such matters can be taken up either in a civil court or before any other appropriate forum. The sanctioning of a scheme would not in any way fetter the powers of the court or other forum to adjudicate upon the same. *Re Kirloskar Electric Co. Ltd.*, 43 SCL 186 (2003); 116 Com Cases 413 (2003).

24. This 30-day period was substituted for 14 days with effect from October 15, 1965. However, since the time-frame under Rule 81 still shows 14 days, many legal advisors in India believe that it would be advisable to complete the filing within 14 days.

25. See *Ramiya, supra* at page 3259.

26. An earlier condition that shareholders holding not less than 90% in value of the shares in the amalgamating company should become shareholders of the amalgamated company on the amalgamation is no longer a criterion for availing tax benefit under the current tax provision.

27. As formalized or amended by the Notification dated 7th December, 2006 of the Ministry of Company Affairs of the Government of India.

28. See generally, Notification dated 7th December, 2006 of the Ministry of Company Affairs of the Government of India – laying down Accounting Standards 1-29 pursuant to the provisions of Section 642 of the Act; also see Ghosh, *supra* note 11.

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Proving the "Honest Belief" Defense in Employment Litigation

By Bart M. Feinbaum

Introduction

Terminations and other adverse employment actions are inevitable occurrences at most companies. Litigation often follows that challenges these decisions. For employers, the ultimate goal is to dismiss these lawsuits by pre-trial motion, thereby eliminating the risk of trying the case before often unpredictable juries. The likelihood of prevailing on motion will depend largely on how credible the judge views the actions undertaken by the company.

Most typically, the garden-variety employment case involves a claim of alleged disparate treatment.[1] In such cases, a fundamental issue will be whether the plaintiff was the victim of intentional discrimination.[2] The answer to the elusive question of intent will depend on whether the employer acted with illegal motive as opposed to acting in a mistaken, foolish, trivial, or even mistaken manner.[3] Even then, the question will often turn to how mistaken or riddled with error an employment decision may be without causing suspicion that discrimination was the real reason for the action.

In addressing the question of liability, the United States Court of Appeals for the Sixth Circuit ("Sixth Circuit") allows an employer to prevail on summary judgment if it is able to demonstrate that it had an honest belief in its proffered legitimate, non-discriminatory reason, provided that such belief is reasonably based on particularized facts at its disposal at the time of the adverse employment action.[4] The purpose of this article is to provide practitioners with an overview of the honest-belief rule as adopted by the Sixth Circuit and to suggest steps that employers should consider prior to undertaking discipline to ensure a greater chance of fitting within this rule.[5]

Proving Intentional Discrimination

In most employment discrimination cases, the issue typically boils down to the employee challenging the decisional process reached by the employer in concluding that discipline is warranted for a policy or rule violation. Through the honest-belief rule, the employer asks the court to honor its business decision, in essence to credit its version of events, leading to the imposition of the discipline, over the employee's counter-version of the facts. Thus, before describing how the honest-belief rule operates, it is first necessary to understand how employment discrimination cases are proven.

A plaintiff can prove discrimination either directly or by circumstantial evidence.[6] Direct evidence is that evidence that, if believed, *requires* the conclusion that unlawful discrimination was at least a motivating factor in the employer's action.[7] In the context of alleged race discrimination, for example, the alleged statement made by a university president that "we already have two black vice presidents. I can't bring in a black provost" was considered direct evidence of race discrimination.[8] The statement, "I fired you because you are disabled" is considered to be direct evidence of disability discrimination.[9] Such comments require no inference to conclude that illegal considerations motivated, at least in part, the employment decision.

Of course, employers rarely act with such brutal honesty in dealing with their employees. Because direct evidence of discrimination is so uncommon, plaintiffs are able to prove discrimination circumstantially through the well-known framework established in the seminal case of *McDonnell Douglas v Green*.[10] In the absence of direct evidence, a plaintiff must first present a prima facie case of discrimination by showing that he or she (1) is a member of a protected class, (2) experienced an adverse employment action, (3) was qualified for the position, and (4) was replaced by a person outside of the protected class or was treated differently than similarly situated employees.[11] If the plaintiff is able to present a prima facie case, the burden then shifts to the defendant to articulate a legitimate, non-discriminatory business reason for the adverse employment action.[12]

If the defendant meets its obligation, the burden then shifts back to the plaintiff, who maintains the ultimate burden of proving

that the defendant's proffered reason is a pretext for discrimination.[13] As the United States Supreme Court has explained, however, "it is not enough … to *dis*believe the employer; the fact finder must *believe* the plaintiff's explanation of intentional discrimination."[14] Stated differently, a reason cannot be construed as a pretext *for discrimination* unless it is shown *both* that the reason was false *and* that discrimination was the real reason.[15] Under appropriate circumstances, however, the trier of fact can "reasonably infer from the falsity of the explanation that the employer is dissembling to cover up a discriminatory purpose."[16]

The decision to discipline an employee results in an exercise of discretion on the part of the employer. Naturally, companies are reluctant to have such decisions second guessed by a judge or jury. Nevertheless, an employer's business judgment is not an absolute defense to claim unlawful discrimination.[17] More specifically, a court may consider the reasonableness of an employer's decision to the extent that it assists in answering the question of whether the proffered reason for the employment action was the actual motivation or, rather, a cover-up for illegal discrimination.[18]

The decision to discipline an employee results in an exercise of discretion on the part of the employer.

In employment litigation the focus will be on whether an employer made a reasonably considered and informed decision before implementing its employment action or, instead, implemented a business judgment "so ridden with error that defendant could not honestly have relied upon it."[19] It is the employer's reasonableness, or lack thereof, that is the fundamental inquiry a court will assess in determining if the honest-belief rule should be applied to assist the employer in convincing the court that its actions were taken in the absence of discriminatory intent.

The Honest-Belief Defense to Pretext

The honest-belief rule is applied when examining the reasons offered by an employer for disciplining an employee. In support of its motion for summary judgment, an employer will argue that, even if its ultimate determination was wrong, it was based on an honest belief and not discrimination. The employee, on the other hand, will assert in opposing such motion that the employer's belief was unreasonable. As will be discussed, the honest-belief assessment serves as a defense to the plaintiff's claim of pretext. The court, in essence, evaluates the reasonableness of the proffered non-discriminatory basis for the adverse employment action. In doing so, an inference of pretext will not be warranted when an employer can demonstrate that it acted with an honest belief based on particularized facts at its disposal at the time of the employment decision.

The version of the honest-belief rule used in the Sixth Circuit was recognized in *Smith v Chrysler*.[20] In *Smith*, the plaintiff applied for and was hired as an electrician at one of the defendant's plants. Before applying for this position, the plaintiff had been diagnosed with a variant of narcolepsy, a sleeping disorder.[21] The plaintiff did not disclose his narcolepsy on a "Self-Administered Medical History" form completed at the time of his original application for employment or on an application in connection with a heavy-machinery driver's license that he later completed.[22] The plaintiff subsequently requested to move from the night shift to the day shift when his sleep problems resurfaced. An investigation commenced, and the defendant's plant superintendent terminated the plaintiff for lying on the forms.[23]

The plaintiff sued the defendant under the Americans with Disabilities Act (ADA)[24] and the Michigan Handicappers' Civil Rights Act.[25] The plaintiff appealed the grant of summary judgment in favor of the defendant. The district court determined that the company's good faith belief that the plaintiff lied on the forms shielded it from liability.[26] The defendant did not challenge the district court's holding that the plaintiff had established a prima facie case of disability discrimination. The plaintiff did not contest that lying on forms represented a legitimate, non-discriminatory reason for the termination. Rather the appeal focused on the legitimacy of this proffered reason.[27] The plaintiff's argument was that had the defendant undertaken a better and more thorough investigation, it would have learned that he did not have narcolepsy and did not suffer from unusual fatigue. Consequently, he did not lie on the forms.[28]

In response, the defendant argued that the court should adopt the so-called honest-belief rule as articulated by the Seventh Circuit Court.[29] Under this version of the honest-belief rule, an employee cannot establish pretext as long as the employer honestly believed the reasons offered for the termination, even if the employer's reasons were

ultimately found to be mistaken, foolish, trivial, or baseless. The rationale behind the Seventh Circuit's interpretation of the rule is that the critical issue in employment discrimination cases is discriminatory intent. Therefore, if an employer honestly, albeit mistakenly, believes that the reason it relies upon in implementing discipline is true, then the employer arguably lacks discriminatory intent.[30] Under the Seventh Circuit approach, the employer need only articulate an honest reason for taking an adverse action against an employee, even if that reason lacks any factual support.

The *Smith* court rejected the Seventh Circuit approach, finding it to be at odds with the purpose of the ADA, a statute requiring that actions taken against an individual with a disability be based on facts and not on "unfounded fear, prejudice, ignorance or mythologies."[31] Given this, the Sixth Circuit announced a modified honest-belief rule:

> [I]n order for an employer's proffered non-discriminatory basis for its employment action to be considered honestly held, the employer must be able to establish its reasonable reliance on the particularized facts that were before it at the time the decision was made. If the employer is unable to produce such evidence to support its employment action, then the `honest belief' rule does not apply.
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> ***
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> In deciding whether an employer reasonably relied on the particularized facts then before it, we do not require that the decisional process used by the employer be optimal or that it left no stone unturned. Rather, the key inquiry is whether the employer made a reasonably informed and considered decision before taking an adverse employment action. … Although courts should resist attempting to micro-manage the process used by employers in making their employment decisions, neither should they blindly assume that an employer's description of its reason is honest. When the employee is able to produce sufficient evidence to establish that the employer failed to make a reasonably informed and considered decision before taking its adverse employment action, thereby making its decisional process `unworthy of credence' then any reliance placed by the employer in such a process cannot be said to be honestly held.[32]

The court cautioned that the protection under this rule is not absolute. Even if an employer can make a showing of particularized facts that motivated its decision, the employee still has the opportunity to produce "proof to the contrary."[33]

Applying these principles, the court held that the defendant reasonably relied on particularized facts at hand when it determined that the plaintiff lied on his driver's license application during the course of its pre-discharge investigation. More specifically, the company consulted letters from the plaintiff's treating physician stating that the plaintiff was being treated for narcolepsy; it relied upon the medical opinion of the company doctor who spoke with the plaintiff's treating physician; and it examined the medical notes from the company doctor indicating that the plaintiff had admitted to suffering from narcolepsy. In view of these particularized facts gathered prior to the discharge decision, the burden of production shifted to the plaintiff to demonstrate that reliance on such facts was unreasonable. The plaintiff failed in this regard.[34] Thus, the honest-belief rule applied to defeat the plaintiff's claim of pretext as to the company's justification for terminating his employment for lying on the driver's license application.

On the other hand, the court determined that it was not appropriate to apply the honest-belief rule to support the defendant's belief that the plaintiff lied on his Self-Administered Medical History form, because the conclusion that the plaintiff lied on such a form was not based on any particularized facts revealed during its investigation. Rather, it was reached entirely on the personal and subjective non-medical opinion of the plant superintendent who believed, in a stereotypical way, that persons with narcolepsy also suffer from fatigue.[35]

In sum, *Smith* holds an employer's proffered, legitimate, non-discriminatory basis for its adverse employment action cannot be a pretext for disability discrimination provided that it is honestly held. In order for a reason to be honestly held, the employer must establish its reasonable reliance on the particularized facts before it at the time of the adverse employment action. Even then, the rule is not applied automatically as the employee has

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the final opportunity to produce proof to the contrary. As the court in *Smith* observed, "if the employer made an error too obvious to be unintentional, perhaps it had an unlawful motive for doing so."[36]

The Sixth Circuit has applied the honest-belief rule in cases involving other grounds of discrimination. In *Majewski v Automatic Data Processing, Inc*,[37] the plaintiff sued the defendant for, among other things, age discrimination under Ohio state law. The defendant maintained that it terminated the plaintiff due to his increasingly poor job performance.[38] In response, the plaintiff claimed that his work performance was satisfactory.[39] The court rejected this latter argument and noted that the plaintiff's "disagreement with [Defendant's] honest business judgment regarding his work does not create sufficient evidence of pretext in the face of the substantial evidence that [Defendant] had a reasonable basis to be dissatisfied."[40] Such evidence included the defendant documenting the plaintiff's performance problems, placing him on a performance improvement plan, verifying lapses in his performance, and investigating problems that he had with his supervisor, all undertaken prior to the decision to discharge.[41]

[W]here an employer can show that the honest belief in its proffered reason for implementing its adverse action against an employee is based on a reasonable reliance on particularized facts, the inference of pretext is not warranted.

In *Wright v Murray Guard, Inc*,[42] the defendant employed the plaintiff as a security guard. The defendant terminated the plaintiff based on sexual harassment allegations made against him, work performance problems, and his failure to follow procedures.[43] The plaintiff sued alleging discrimination based on sex and race in violation of Title VII of the Civil Rights Act of 1964 ("Title VII").[44] In affirming the grant of summary judgment against the plaintiff, the court applied the honest-belief rule in favor of the defendant. The facts demonstrated that the defendant reasonably relied on particularized facts available to it at the time of the discharge decision. These included the plaintiff's documented performance problems, an anonymous letter indicating that the plaintiff sexually harassed several women, incident reports supporting the alleged harassment, allegations made by a co-worker that the plaintiff touched her in a sexual manner, and that he pressured her to perform a sex act. In addition, the defendant conducted two separate investigations into the allegations of sexual misconduct.[45] While the plaintiff challenged the truthfulness of one of the witnesses who complained about him, the court noted that this was not the real issue. More specifically, the court indicated that the defendant did not need to prove that the plaintiff actually sexually harassed anyone to defeat his claims. Rather, the defendant only needed to show that it made its decision to terminate the plaintiff "based on an honestly held belief in a nondiscriminatory reason supported by particularized facts after a reasonably thorough investigation."[46]

The employer also prevailed in asserting the honest-belief defense in *Abdulnour v Campbell Soup Supply Co*,[47] a claim of national origin discrimination under Title VII. In *Abdulnour*, the defendant terminated the plaintiff for poor performance. At the time of the discharge, the defendant had received complaints that the plaintiff was not adequately performing his job. In addition, the defendant had received complaints from several employees indicating that the plaintiff was demeaning, was not at the work site at critical times, would not communicate with them, and was the "worst supervisor ever."[48] Given these particularized facts supporting the work performance problems, the plaintiff failed to meet his burden of producing evidence sufficient for a jury to conclude that the defendant did not have an honest belief that he was performing his job poorly.[49]

To summarize, where an employer can show that the honest belief in its proffered reason for implementing its adverse action against an employee is based on a reasonable reliance on particularized facts, the inference of pretext is not warranted.[50] In considering whether a reason is honestly held, the issue is not whether the employee, in fact, committed the work rule violation.[51] Moreover, as courts should "resist attempting to micro-manage the process used by employers in making their employment decision,"[52] an employee likely will not prevail in challenging an employer's business judgment by merely questioning the nature or sufficiency of an investigation undertaken by the employer, provided that such investigation is credible and generates "particularized facts" supporting the proffered reason for the adverse action. Rather, the key question will be whether the employer *legitimately perceived* that the employee violated a particular work rule based on a "reasonably informed and considered decision" taken before the adverse employment action.[53]

Practical Pointers for Establishing the Honest-Belief Defense

The elusive issue of proving discriminatory intent most often boils down to assessing the credibility and veracity of the actions undertaken by the employer. As the United States Supreme Court has observed, "proving the employer's reason is false becomes part of (and often considerably assists) the greater enterprise of proving the real reason was intentional discrimination."[54] The mere fact that "the employer's proffered reason is unpersuasive, or even obviously contrived, does not necessarily establish that the plaintiff's proffered reason of [discrimination] is correct. That remains a question for the fact finder to answer…"[55] This, of course, is where the employer most likely does not want to find itself—having the jury decide whether its actions were reasonable or not.

Cases in which the honest-belief rule is not applied in favor of an employer typically involve situations where employers were sloppy in its actions leading up to the implemented adverse employment actions. In general, these are cases where employers, oftentimes in haste, rush to judgment and skip steps in the overall process leading to the discipline. From these cases and others, the following are suggestions that will assist employers in taking advantage of the benefits of the honest-belief rule.

An Employer Must Know Its Own Policies

Because policies and procedures are created by companies, employers are expected to know the pertinent requirements set forth in these documents. For example, if the policy states that the company must conduct an investigation prior to disciplining an employee, then an investigation must occur unless the policy provides for an exception. If the policy indicates that the accused party must be interviewed prior to issuing discipline, then the employee must be interviewed. If the policy states that progressive discipline should be adhered to, then such steps should be followed unless the policy allows for the skipping of steps depending on the nature and seriousness of the infractions. The bottom-line is that a court is more likely to conclude that an employer's actions are unreasonable if it fails to follow its own written policies and guidelines on implementing discipline.

Conduct a Thorough Investigation Before Deciding on Discipline

A well-thought-out investigation will lead to a gathering of the "particularized facts" that will form the basis for the reasonableness of adverse action to be taken. Typically, investigations will be undertaken by employees of the company's human resources ("HR") department. Thus, it is important that HR personnel whose job it is to conduct investigations be adequately trained on employment laws and on how to investigate. The investigator should interview all relevant witnesses, obtain relevant documentation, retain copies of interview notes, and create a business-like investigative report because this information may be subject to disclosure during pre-trial discovery. The findings of the investigation should be shared with the decision maker before deciding on the level of disciplinary action. By reviewing such findings, the decision maker will have at his/her disposal the "particularized facts" determined through the investigation prior to implementing the adverse employment action.[56]

Do Not Ignore Statements That Could Lead to Finding of Innocence

In a zealous attempt to rid the company of a problem, some employers may purposefully ignore witnesses who might provide facts that could lead to exoneration of the charged employee. A company that operates in such a manner could face a claim that the investigation was merely a sham and, therefore, a pretext or cover-up for discrimination.[57] On the other hand, a jury may be more likely to find against a company, and perhaps even award punitive damages, if an employer ignores evidence that might have exonerated the individual of the charge.

In a zealous attempt to rid the company of a problem, some employers may purposefully ignore witnesses who might provide facts that could lead to exoneration of the charged employee.

The Charged Employee Should Be Interviewed As Part of the Investigative Process

It is good practice to allow the charged employee to air his/her version of events. Even for the at-will employee, the notion of due process involves fundamental fairness and is something that a trier of fact may assess in determining whether the employee based his decision on particularized facts. For instance, an interview may result in the employee admitting to the work rule violation. As noted previously, it is not the employee's subjective view of the situation that matters.[58] Rather, the question will be whether the employer had a reasonable

belief based on particularized facts that the employee violated the work rule. The interview of the employee may strengthen such belief. In addition, interviewing the accused may lead to other relevant evidence supporting the adverse employment action.[59]

Obtain and Maintain Documentation of Performance Problems

If an employee is terminated for work performance problems, the most powerful particularized facts supporting the discipline often will be the underlying cause of the problems themselves. Ideally, leadership will have documented these problems along the way. At the very least, HR should ensure through the investigative interview process that the decision maker is able to recount instances of poor performance through specific examples.[60]

If an employee is terminated for work performance problems, the most powerful particularized facts supporting the discipline often will be the underlying cause of the problems themselves.

The Termination Incident Should Not Be the Only Documentation of Problems

In some cases, employers will overlook opportunities to address performance problems. For example, the leader may possess a non-confrontational personality. Or the employee may have been passed on from one department to another, despite his/her past work deficiencies. Thus, the incident leading to the termination may be the only documentation supporting the work performance problems of the employee. To avoid this dilemma, employers should take a proactive approach in addressing these issues with the employee with the goal of improving performance. Such actions may include coaching and counseling, honest appraisals, performance improvement plans, and formal disciplinary action. These prior actions can serve as additional "particularized facts" that can be relied upon should it become necessary to eventually discharge the employee.[61]

Avoid Disparate Discipline

An employee may demonstrate pretext by producing "evidence that other employees, particularly employees not in the protected class, were not fired even though they engaged in substantially identical conduct to that which the employer contends motivated its discharge" decision.[62] Evidence that other employees not in the protected class were not discharged for similar conduct may call into question the reasonableness and honesty of the proffered reason for terminating the employee.[63] Thus, disparate treatment should be avoided.

Conclusion

As the Sixth Circuit recently observed:

> The honest-belief rule is, in effect, one last opportunity for the defendant to prevail on summary judgment. The defendant may rebut the plaintiff's evidence of pretext, by demonstrating that the defendant's actions, while perhaps `mistaken, foolish, trivial, or baseless,' were not taken with discriminatory intent. We give the defendant an opportunity to show that its intent was pure because `the focus of a discrimination suit is on the intent of the employer. If the employer honestly, albeit mistakenly, believes in the non-discriminatory reason it relied upon in making its employment decision, then the employer arguably lacks the necessary discriminatory intent.'[64]

Under the honest-belief rule, the burden is on the employer to point to specific facts that it had at the time the decision was made that would justify its belief in the proffered, legitimate, non-discriminatory reason for the adverse employment action. The business judgment of the employer in undertaking such action is not absolute. The key inquiry in applying the honest-belief defense will be whether the employer made a reasonably informed and considered decision prior to implementing the adverse action or, in the alternative, a business judgment so riddled with error that the employer could not have honestly relied upon it. If the plaintiff introduces evidence calling into question the veracity of the termination process, a jury likely will be the final arbiter of the dispute, a forum often less predictable and generous to employers. On the other hand, an employer that honestly bases an employment decision on particularized facts gathered prior to the disciplinary action will have a greater chance of prevailing on summary judgment.

NOTES

1. As the United States Supreme Court has observed, "`Disparate treatment' … is the most easily understood type of discrimination. The employer simply treats some people less favorably than others because of their race, color, religion, sex, or national origin." *Teamsters v United States*, 431 US 324, 335 n 15 (1977). Dis-

parate treatment also can involve other protected traits such as disability, age, height, weight, marital status, family status, and veteran status.

2. *Tisdale v Federal Express Corp*, 415 F3d 516, 529 (6th Cir 2005) quoting *Reeves v Sanderson Plumbing Prods Inc*, 530 US 133, 153 (2000).

3. *Clay v United Parcel Serv, Inc*, 501 F3d 695, 714-15 (6th Cir 2007).

4. *Id.*

5. Michigan courts have not formally recognized the honest belief rule. Thus, this article focuses primarily on how federal courts have applied and developed this defense. The suggestions offered through this article, however, are not meant to be limited to defending litigation brought in federal court but rather can be used as an overall risk prevention strategy for employment discrimination matters filed in both state and federal courts.

6. *DiCarlo v Potter*, 358 F3d 408, 414 (6th Cir 2004).

7. *White v Columbus Metropolitan Housing Authority*, 429 F3d 232, 238 (6th Cir 2005) (quoting *Jacklyn v Schering-Plough Healthcare Prods Sales Corp*, 176 F3d 921, 926 (6th Cir 1999).

8. *Johnson v Univ of Cincinnati*, 215 F3d 561, 577 n 7 (6th Cir 2000).

9. *Smith v Chrysler Corp*, 155 F3d 799, 805 (6th Cir 1998).

10. 411 US 792 (1973).

11. *Id.*, p. 802.

12. *Id.*

13. *Id.* at 804; *Texas Dep't of Cmty Affairs v Burdine*, 450 US 248, 253 (1981).

14. *St. Mary's Honor Center v Hicks*, 509 US 502, 519 (1993) (emphasis in original).

15. *Id.*, p. 515.

16. *Reeves v Sanderson Plumbing Products, Inc.*, 530 US 133, 147-148 (2000) (noting that it is not always necessary for a plaintiff to introduce independent evidence of discrimination to show pretext where there is sufficient evidence to reject the employer's explanation).

17. *EEOC v Yenkin-Majestic Paint Corp*, 112 F3d 831, 835 (6th Cir 1997).

18. *Wexler v White's Fine Furniture, Inc*, 317 F3d 564, 576 (6th Cir 2003). *See also Hartsel v Keys*, 87 F3d 795, 800 (6th Cir 1996) ("The distinction lies between a poor business decision and a reason manufactured to avoid liability. Thus, facts may exist from which a reasonable jury could conclude that the employer's 'business decision' was so lacking in merit as to call into question its genuineness.") citing *Dister v Continental Group, Inc*, 859 F2d 1108, 1116 (2d Cir 1988); *EEOC v Yenkin-Majestic Paint Corp*, 112 F3d 831, 835 (6th Cir 1997) ("A decision to terminate an employee based upon unlawful considerations does not become legitimate because it can be characterized as a business decision.").

19. *In re Lewis*, 845 F2d 624, 633 (6th Cir 1988).

20. 155 F3d 799 (6th Cir 1998).

21. *Id.*, p. 802.

22. *Id.*, pp. 802-803.

23. *Id.*, pp. 803-804.

24. 42 USC 12101, *et. seq.*

25. MCL 37.1101, *et. seq.* (now known as the Michigan Persons with Disabilities Civil Rights Act).

26. 155 F3d at 801.

27. *Id.*, p. 805.

28. *Id.*

29. *See* Michaels, Note, Legitimate Reasons For Firing: Must They Honestly Be Reasonable?, 71 *Fordham L. Rev.* 2643, 2657 (2003).

30. 155 F3d at 806 citing *Kariotis v Navistar Int'l Trans. Corp.*, 131 F3d 672, 676-677 (7th Cir 1997).

31. *Id.* citing 136 Cong. Rec. S 7422-03, 7437 (daily ed. June 6, 1990) (statement of Sen. Harkin).

32. 155 F3d at 807-808 (citations omitted).

33. *Id.*, p. 807 citing *Pesterfield v TVA*, 941 F3d 437, 443 (6th Cir 1991) (Rehabilitation Act).

34. 155 F3d at 808.

35. 155 F3d at 808-809. While the court found that the honest belief rule did not apply to support Defendant's belief that Plaintiff lied medical history form, the court nevertheless affirmed summary judgment as the Defendant did have a reasonable basis to believe that Plaintiff lied on the driver's license form. *Id.*, p. 809.

36. 155 F3d at 807 citing *Fischbach v District of Columbia Dept of Corrections*, 86 F3d 1180, 1183 (DC Cir 1996). One way to demonstrate pretext is to show that a company's "asserted business judgment was so ridden with error that defendant could not honestly have relied upon it." *Wexler v White's Fine Furniture, Inc*, 317 F3d 564, 576 (6th Cir 2003) citing *In re Lewis*, 845 F2d 624, 633 (6th Cir 1988).

37. 274 F3d 1106 (6th Cir 2001).

38. *Id.*, pp. 1110-1112.

39. *Id.*, p. 1116.

40. *Id.*

41. *Id.*, p. 1117.

42. 455 F3d 702 (6th Cir 1996)

43. *Id.*, pp. 705-706.

44. 42 USC 2000e *et seq*

45. 455 F3d at 708-709.

46. *Id.*, p. 709.

47. 502 F3d 496 (6th Cir 2007).

48. *Id.*, pp. 502-503.

49. *Id.*, p. 503.

50. *Smith*, *supra*, 155 F3d at 806-808.

51. *See Majewski*, supra, note 37, 274 F3d at 1117 ("[Plaintiff's] assertion that he did not delete the payroll wrap is insufficient to call into question [Defendant's] honest belief that he did."); *Campbell v Washington County Public Library*, 2007 US App LEXIS 17393, at 13 (6th Cir 2007) (Unpublished) ("[T]he issue before the court is not whether [employee] was insubordinate …; instead, the issue is whether the [employer] legitimately perceived [employee] as being insubordinate").

52. *Smith*, 155 F3d at 807.

53. *Id.*, p. 807.

54. *Hicks*, *supra*, 509 US at 517 (emphasis added).

55. *Id.*p. 524.

56. *See Archer v Mesaba Aviation Inc*, 2000 WL 376677 (6th Cir 2000) (Unpublished) (Defendant did not base its decision on "particularized facts" where witnesses did not actually observe alleged sex act committed by Plaintiff and the decision maker testified that he only "believed" that he reviewed the reports submitted by the witnesses).

57. *See Braithwaite v. the Timken Co*, 258 F3d 488, 495-496 (6th Cir 2001) (noting that based on witness statements there was no doubt that Defendant had a reasonable belief that Plaintiff shoved another employee, the basis for the discharge).

58. *See* note 52 *supra*.

59. *Id*, p. 497 (Plaintiff's evidence did not establish that Defendant did not make a "reasonably informed and considered decision" when, among other things, Defendant allowed Plaintiff several opportunities to present his version of the facts). *Contra*, *Rhea v Wal-Mart Stores, Inc*, 2007 WL 3408546 (ED Mich 2007) (Slip Copy) (Defendant did not make a reasonably informed decision before terminating him. Among other things, Defendant terminated Plaintiff the day after the alleged incident without speaking to him even though company policy is not to take employment actions before hearing the employee's "side of the story.").

60. *See Burks v Yellow Trans, Inc*, 2008 US App LEXIS 518, at 20 (6th Cir 2008) (Unpublished) (Defendant reasonably relied on particularized facts when Plaintiff's supervisors recounted in affidavits and depositions as to his specific instances of poor performance and attitude).

61. *Michael v Caterpillar Financial Services Corp*, 496 F3d 584, 598-600 (6th Cir 1997) (Employer's honest belief in employee's performance problems as reflected in company's investigation was buttressed by the fact that employee previously had been placed on a performance improvement plan).

62. *Manzer v Diamond Shamrock Chemicals Co*, 29 F3d 1078, 1084 (6th Cir 1994).

63. *Rhea v Wal-Mart Stores, Inc*, 2007 WL 3408546 (ED Mich 2007) (Slip Copy) (Defendant failed to make a reasonably informed and considered decision in terminating Plaintiff even though the employer's policy generally called for progressive discipline and a younger employee received a warning by the same managers for a comparable offense).

64. *Clay v United Parcel Service, Inc*, 501 F3d 695, 715 (6th Cir 2007).

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Case Digests

Arbitration Agreement—Modification of Statutory Review

In *Hall Street Assocs, LLC v Mattel, Inc*, _US_, 128 S Ct 1396 (2008), the parties entered into an arbitration agreement to decide an indemnification dispute between a landlord and tenant over environmental violations. The agreement provided that:

> [t]he United States District Court for the District of Oregon may enter judgment upon any award, either by confirming the award or by vacating, modifying or correcting the award. The Court shall vacate, modify or correct any award: (i) where the arbitrator's findings of facts are not supported by substantial evidence, or (ii) where the arbitrator's conclusions of law are erroneous.

The issue before the court was whether the parties may supplement the statutory grounds under the Federal Arbitration Act (FAA), 9 USC 1 et seq., for prompt vacatur and modification.

The Act provides mechanisms for enforcing arbitration awards: a judicial decree confirming an award, an order vacating it, or an order modifying or correcting it. 9 USC 9-11. An application for any of these orders gets expedited treatment as a motion, eliminating a separate contract action that would usually be necessary to enforce or modify an arbitral award in court. 9 USC 6. Under the terms of 9 USC 9, a court "must" confirm an arbitration award "unless" it is vacated, modified, or corrected "as prescribed" in 9 USC 10 and 11. 9 USC 10 lists grounds for vacating an award, while 9 USC 11 designates those for modifying or correcting one. Resolving a split between the federal circuit courts as to whether the statutory grounds to confirm, modify, or vacate an award are subject to contractual expansion, the court held that the statutory grounds are exclusive. In holding that §§ 10 and 11 provide the exclusive means for statutory review, the court did not purport to state that this excludes more searching review based on authority outside the FAA. For example, the parties may contemplate enforcement under state statutory or common law, where judicial review of different scope is possible; thus, this decision was limited to the scope of the expeditious judicial review under 9 USC 9, 10, and 11.

Employment Law—Retaliation Claim under 42 USC 1981

In *CBOCS West, Inc v Humphries*, _US_, 128 S Ct 1951 (2008), a former assistant manager of a restaurant alleged that he was dismissed because of racial bias and because he had complained to managers that a fellow assistant manager had dismissed another black employee for race-based reasons. The question before the United States Supreme Court was whether 42 USC 1981, a post-Civil War civil rights statute that protects the right to "make and enforce contracts," encompasses retaliation claims. Finding ample authority in a long line of related cases to support its view, the court ruled that 42 USC 1981 includes protection against retaliation.

Professional Service Corporation Act—Standing to Contest Validity of Entity's Formation

In *Miller v Allstate Ins Co*, Nos 134393, 134406, 2008 Mich LEXIS 1385 (July 2, 2008), an insurer alleged that a corporation that provided physical therapy services was unlawfully incorporated under the Michigan Business Corporation Act and that it was required to incorporate under the Professional Service Corporation Act (PSCA). The court of appeals had ruled that such a provider was required to incorporate under the PSCA but that the provider was entitled to payment because treatment was rendered by licensed physical therapists, and the corporate defect had nothing to do with that treatment. 275 Mich App 649, 739 NW2d 675 (2007).

The Michigan Supreme Court ruled that, under MCL 450.1221, only the attorney general may bring a challenge to an entity's corporate status. Thus, the insurer lacked standing to challenge the incorporation of the entity in this case, and the supreme court affirmed the court of appeals' decision on alternative grounds.

Contracts—Forum-Selection Provision

In *Robert A Hansen Family Trust v FGH Indus, LLC*, No 276372, 276452, 2008 Mich App LEXIS 1336 (2008), the action arose from a dispute over an investment that the plaintiff made in a business venture under an LLC operating agreement. A September 2003 operating agreement contained a Michigan choice-of-law provision and an Arizona forum-selection provision, while an amended December 2003 operating agreement had Delaware choice-of-law and forum-selection provisions. The defendants moved for summary disposition and sanctions, asserting that the December 2003 agreement was the operative agreement between the parties, and arguing further that, in either case, the court of a state other than Michigan—either Arizona or Delaware—was selected by the parties as the exclusive forum for the adjudication of all claims or disputes arising out of or relating to the operating agreement, thus requiring that the trial court dismiss the plaintiff's complaint. The plaintiff opposed the defendants' motion, asserting that the defendants waived their claim that Michigan was an improper forum for this action by failing to contest the court's personal jurisdiction over them in their first responsive pleading. The plaintiff also argued that the September operating agreement constituted the agreement between the parties and that the forum-selection clause was unenforceable under MCL 600.745(3). The plaintiff contested the defendants' request for sanctions on the basis that this action was properly filed in Michigan.

The trial court concluded that because neither agreement permitted a Michigan forum, the question of which agreement was operative was not material to the issue of whether the parties had an enforceable agreement to adjudicate their disputes exclusively in a forum other than

Michigan so as to require dismissal of the plaintiff's action. The trial court granted the defendants' summary disposition on all of the plaintiff's claims, on the basis that "they are not properly brought in Michigan." However, finding that the record before it suggested that the plaintiff "believed that it had an arguable case for jurisdiction of its claims in Michigan," the trial court denied the defendants' request for sanctions.

The court of appeals stated that enforcement of contractual forum-selection clauses is premised on the parties' freedom to contract and does not divest Michigan courts of personal jurisdiction over the parties. However, the parties' contractual agreement to forego Michigan as a forum for adjudication leaves Michigan courts incapable of granting relief on claims based on the contract. Regardless which of the two agreements was determined to be the operative agreement between the parties, neither provided for a Michigan forum for resolution of this case. The court of appeals also found no clear error in the trial court's conclusion that the plaintiff's filing of its complaint in Michigan was not patently frivolous because there was no evidence in the record to establish that the plaintiff filed its complaint in Michigan for improper purposes.

Contracts—No Privity Requirement for Rescission

In *Davis v Forest River, Inc*, 278 Mich App 76, 748 NW2d 887, *appeal granted*, 2008 Mich LEXIS 1191 (2008), the plaintiff purchased a new recreational vehicle (RV) but experienced numerous problems with the purchase. The plaintiff later concluded that the dealer should take the RV back and repay the purchase price. The plaintiff filed suit, alleging eight counts, including breach of express and implied warranties under the UCC and the Magnuson-Moss Warranty Act (MMWA). The jury found that the plaintiff was entitled to revoke acceptance of the RV in this case.

The court of appeals initially found that neither the state's lemon law nor the UCC was relevant to this case. Instead, the court stated that the critical issue was whether a purchaser who is not in contractual privity with a manufacturer may obtain the common-law remedy of rescission. The court found that privity has long been eliminated in Michigan as a prerequisite to purchasers' bringing suit against manufacturers, and the Legislature's adoption of the UCC did not abolish rescission except where the parties actually do have a contract with each other. The court stated that in this case, the plaintiff proceeded under theories of revocation of acceptance and rescission and was clearly entitled to the verdict of rescission awarded by the trier of fact. The supreme court granted leave to appeal, asking the parties to address the following issues: (1) whether the MMWA provides for a cause of action for breach of warranty and a remedy of rescission where the plaintiff and the defendant are not in privity of contract; (2) whether Michigan law provides a cause of action for breach of warranty and a remedy of rescission where the plaintiff and the defendant are not in privity of contract; (3) whether the economic loss doctrine and the UCC apply to the plaintiff consumer's claims for breach of warranty; (4) whether, if the UCC applies, revocation of acceptance, MCL 440.2608, is available in the absence of privity, and whether the revocation-of-acceptance provisions of the UCC supplanted any former common-law action for rescission; and (5) whether, if the plaintiff is confined to the UCC, either privity or third-party beneficiary status was required for an action for breach of warranty.

Third-Party Beneficiary—Repair Contract with Subcontractor

In *Vanerian v Charles L Pugh Co, Inc*, No 276568, 2008 Mich App LEXIS 1333 (July 1, 2008), the plaintiff's basement was damaged by flooding, and she hired a contractor to repair the basement floor. The contractor suggested that if the plaintiff already had a flooring contractor, she should use that person to make the repairs. The plaintiff had dealt previously with a subcontractor and contacted it to make the repairs. The contractor and flooring subcontractor later agreed to replace the plaintiff's floor, titling the plaintiff's name and residence as the name of the job. A later flood again damaged the floor, and plaintiff sued the contractor and subcontractor, alleging that she was the third-party beneficiary of their repair contract.

Viewing the contract objectively, the court of appeals stated that the subcontractor undertook a promise directly for the plaintiff's benefit, and the plaintiff was expressly referred to in the contract. Thus, the plaintiff was not an incidental beneficiary since the whole and singular purpose of the contract was to secure repairs to the flooring in the plaintiff's basement. The court distinguished earlier authority in arguably similar circumstances, relying in particular on the express reference to the plaintiff by name and the plain language of Michigan's third-party beneficiary statute, MCL 600.1405, which does not create any situational distinctions such as those involving contractors and subcontractors.

Index of Articles

(vol XVIII and succeeding issues)

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SECTION CALENDAR

Council Meetings

DATE	TIME	LOCATION
September 25, 2008*	4:00 p.m.	Sheraton Detroit, Novi
December 6, 2008	10:00 a.m.	Jaffe, Raitt, Heuer & Weiss, Southfield

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3RD ANNUAL FAMILY & CLOSELY HELD BUSINESS INSTITUTE

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