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

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

Issue	Primary Theme/Committee	Article Deadline
Spring 2012	Commercial Litigation Committee	November 30, 2011
Summer 2012	Nonprofit Corporations Committee	March 31, 2012
Fall 2012	Uniform Commercial Code Committee	July 31, 2012
Spring 2013	Debtor/Creditors Rights Committee	November 30, 2012

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MISSION STATEMENT

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

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

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From the Desk of the Chairperson

By Robert T. Wilson

As I approach the last few months of my tenure as Chairperson of the Business Law Section, I can say unreservedly that this has been an outstanding year for us and that I leave the Section in excellent hands. One of the privileges of serving as Section Chair is the opportunity to become familiar with and help shape all of the many good activities in which our council members, committees, and other volunteers are involved. Over the past year, I have consistently observed ongoing and in some cases renewed vigor in the areas of our support for new and young lawyers, our publications, our efforts to enhance the legislative and regulatory environment for businesses in Michigan, our support for in-house counsel, and our sponsoring of venues for the finest business lawyers in Michigan to gather together in collegial settings.

In overseeing the breadth of the Section's activities, it becomes clear to the Chair that while some of our volunteers work more or less in public view, others work tirelessly behind the scenes to further our mission and ensure the continuity and vitality of our programs and leadership. Thanks are due to everyone who took time out of their busy practices to serve the Section in 2010-2011. It's not possible to identify each of you here by name, but I would like to specifically thank Section Vice-Chairperson Ed Lukas, Section Secretary Marguerite Donahue, and our Treasurer, Jeff Van Winkle, for their support and expertise. Each of you served the Section in multiple roles over the past year. It has been a pleasure to serve alongside such hard working and capable colleagues. Last but not least, the gratitude of the Section goes out (again) to our Section Administrator, Terri Shoop, for her outstanding support.

One of the initiatives I proposed upon my election as Chair was the review and revision of our Bylaws. While not a document likely to pique the interest of the world at large, our Bylaws are the core rules governing how we function, both on a daily basis and, if necessary, in times of conflict or crisis. In reviewing them with the goal of strengthening the Section, it became apparent that there were opportunities to modify and clarify certain aspects of our governance. I am happy to report that after several months of work, the Ad Hoc Committee on Section Bylaws finalized a revised draft of the Bylaws, which was distributed to the Section Council in May and approved for submission to the State Bar and ultimately for approval by the Section members in September. I would like to extend my gratitude to each of the Section members who served on the Ad Hoc Committee. Assuming the Bylaws are approved as revised, they will, among other things, help strengthen governance of the Section by changing the order of succession of the officers and clarifying the procedures for appointment of our committee chairs and directors. A copy of the revised draft will be published in a future edition of the BLS E-Newsletter.

The second initiative I proposed in my letter from last Fall's issue of the *Michigan Business Law Journal* was to challenge our Section members to, in some measure, consistent with our mission, "think outside the box" by considering what we as individual attorneys, members of law firms, and as an organization can do to help improve the climate for businesses in Michigan. At that time, I believe the economic prospects for our state were somewhat less favorable than they are now. Indeed, over the last nine months I have noted signs of growth, change, and recovery in various sectors and locations throughout Michigan. Yet we remain subject to the vagaries of a sputtering national economy with conditions here far more challenging than in most of the country. In response to my request, a number of attorneys have stepped up to the plate with ideas and are continuing to encourage a public dialog on the topic. I thank them for their ongoing efforts and hope that such a dialog will remain part of the Section's mission as our business clients and their attorneys grapple with what appears to be a permanently changed economy after the events of 2008. Certainly the economic challenges our clients face present us as attorneys with corresponding economic challenges and challenges as to how we practice law. Such challenges are of course not unique to Michigan or indeed to the practice of business law in particular, but are instead part of larger changes in our profession occurring both on a national and international level as technology and globalization affect how law is practiced and how lawyers compete with one another. Those interested in a detailed if sobering analysis of these forces may wish to read a recent article, "Paradigm Shift" by William D. Henderson and Rachel M. Zahorsky, published in the July 2011 issue of the *ABA Journal*. Food for thought.

I want to conclude by inviting each of you to attend our Business Law Section Annual meeting to be held on September 13 in Novi. One of the highlights of that meeting will be the presentation of the 2011 Stephen H. Schulman Outstanding Business Lawyer Award. It's my privilege to announce that this year's recipient is James R. Cambridge, of Kerr Russell & Weber PLC. Please join us to help celebrate a remarkable career in the practice of business law. I hope to see you there.

Thank you for the opportunity to serve the Section this past year.

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Did You Know? By G. Ann Baker

Department of Licensing and Regulatory Affairs

Executive Reorganization Order 2011-4 renamed the Department of Energy, Labor & Economic Growth to Department of Licensing and Regulatory Affairs (LARA) http://www.michigan.gov/documents/snyder/2011-4_346311_7.pdf, effective April 25, 2011. The ERO transferred the Bureau of Health Professions and Bureau of Health Systems from the Department of Community Health to LARA.

The Workforce Development Agency was created in the Michigan Strategic Fund by the ERO and the Bureau of Workforce Transformation transferred to the Workforce Development Agency. However, LARA retains authority and responsibilities regarding proprietary schools and postsecondary educational corporations and associations. Details about programs transferred from DELEG to other departments are available in the ERO.

The Michigan Administrative Hearing System was created as an autonomous agency within LARA. Administrative hearing functions were transferred from the State Office of Administrative Hearings and Rules (SOAHR) to the Michigan Administrative Hearing System.

Executive Reorganization Order 2011-5 created the Office of Regulatory Reinvention (ORR) in the Department of Licensing and Regulatory Affairs http://www.michigan.gov/documents/snyder/2011-5_346312_7.pdf. The primary goal of ORR is to work with the various departments and agencies of state government to amend or rescind unnecessary, obsolete, or overly restrictive rules and other regulatory burdens. The intention is to make regulations and doing business with the state more simple, fair, efficient, and transparent. ORR will take over all the administrative rulemaking functions previously housed in SOAHR.

Corporate Income Tax

Governor Snyder signed HB 4361 on May 26, 2011, and it became Public Act 38 of 2011.[1] PA 38 creates a new 6 percent corporate income tax, which takes effect January 1, 2012. The corporate income tax will apply to companies that file as "C" corporations for tax purposes. Flow-through entities, such as S corporations, partnerships, and limited liability companies taxed as partnerships, are not subject to the corporate income tax but will be required to collect withholding on the distributive shares of members' business income.

Public Act 39 of 2011, also signed by Governor Snyder on May 26, 2011, amends the Michigan Business Tax Act.[2] It eliminates the Michigan business tax for most taxpayers, effective January 1, 2012, by amending the definition of "taxpayer" and amends the Michigan Business Tax Act to provide for its repeal. Companies wishing to take advantage of previously issued certificated credits may choose to continue paying the tax until their credits are exhausted.

Medical Marihuana

The Michigan Medical Marihuana Act permits a patient with a serious or debilitating medical condition to register as a medical marihuana patient. It permits an individual who is at least twenty-one-years old and who has agreed to assist with a patient's medical use of marijuana, and who has never been convicted of a felony involving illegal drugs, to register as a primary caregiver. For each registered qualifying patient to which the caregiver is connected through the Michigan Department of Community Health registration process the caregiver may possess twelve marihuana plants kept in an enclosed, locked facility. Information regarding the Michigan Medical Marihuana Program is available on the Department of Community Health Web site at http://www.michigan.gov/mdch/0,1607,7-132-27417_51869---,00.html.

On August 30, 2010, the state attorney general issued Opinion No. 7250[3] regarding the authority of the Michigan Department of Community Health to enter into an agreement with a private or public contractor for the purpose of administering the Medical Marihuana Program. Interpreting the initiative in conjunction with the Public Health Code, the state attorney general concluded that the Department of Community Health "may enter into an agreement with an outside vendor to 'assist' the department in processing registry applications, DCH cannot delegate its discretionary authority to make a final determination with respect to the issuance of registry identification cards." However, discussing confidentiality requirements in section 6(h) of the Michigan Medical Marihuana Act and the DCH's promulgated rule, the opinion concludes that only DCH employees are permitted access to confidential information. The confidentiality requirements prevent DCH from entering into a contract with an outside vendor to process registry applications or renewals.

There is no place in the state to legally purchase medical marihuana. Recent court cases and news stories have pointed out a wide variety of issues that have arisen regarding medical marihuana. The Corporation Division routinely rejects articles of incorporation, articles of organization, and assumed names that indicate the entity is being formed for an unlawful purpose.

Justice P. J. O'Connell's concurring opinion in *People v Redden,* docket No. 295809, discusses in detail issues raised by the Michigan Medical Marihuana Act.[4] Dearborn District Judge Somer's opinion and order in *People of City of Dearborn v Brandon*[5] issued March 7, 2011, discusses conflicts between state and federal law and the supremacy clause and held that the Michigan Medical Marihuana Act is void. An action in 30th Circuit Court in Ingham County resulted from the Corporation Division's refusal to file articles of incorporation for Helping Hands Cannabis Center. The Honorable Rosemarie Aquilina's April 8, 2011, decision in *Bueche v Michigan Department of Labor and Economic Growth*[6] held that "it would be contrary to Michigan and federal law to permit the corporate sale, growth, or distribution of marijuana. Therefore, DELEG was correct in their refusal to issue Plaintiff the general papers of incorporation."

Homeowners Construction Lien Recovery Fund

Public Act 147 of 2010, effective August 23, 2010, amended the Construction Lien Act to eliminate the Homeowner Construction Lien Recovery Fund. It repealed provisions relating to the administration and funding of and disbursements from the Homeowners Construction Lien Recovery Fund. Laborers and suppliers were permitted to become members of the Fund by payment of an initial fee and payment of a renewal fee every three years. The revenue to the Fund lagged far below claims against the Fund. Companion legislation eliminated the requirement for electrical, plumbing, mechanical and residential builders, and maintenance and alteration contractors to pay into the Fund.

Fees owed to the Fund before its repeal are valid and not extinguished by the repeal. Consistent with MCL 8.4a, the Bureau of Commercial Services will continue to pursue licensing action and collect restitution from licensees for violations of MCL 339.2411(3) before being amended on August 23, 2010. Monies collected in the Fund account will be used to pay obligations of the fund that existed on August 23, 2010, pursuant to a valid appropriation.

Public Act 147 retains a mechanism for a homeowner to prevent a construction lien from attaching to a structure. Section 118a of the act, MCL 570.1118a, provides a claim of construction lien does not attach, to the extent payments have been made, if the owner or lessee files an affidavit with the court stating that the owner or lessee has paid the contractor for the improvement to the residential structure according to the contract and the amount of the payment. Copies of the contract, any change orders and any evidence of payment must be attached to the affidavit. Instead of seeking payment from the Homeowner Construction Lien Recovery Fund, subcontractors and suppliers who were not properly paid by the contractor or builder will have to file an action in circuit court against the nonpayer. A contractor or subcontractor may also be prosecuted under the building contract fund statute, MCL 570.151-570.153.

Benefit Corporations

SB 359 and SB 360 were introduced May 4, 2011. They provide for the formation of a profit corporation as a "benefit corporation." SB 359 amends the Business Corporation Act to add Chapter 9A to create the "benefit corporation" classification of profit corporations. The purpose of the classification is to facilitate the corporation being designated as socially responsible and modify directors' responsibilities. SB 360 amends existing sections of the Business Corporation Act to accommodate benefit corporations.

The purposes included in the articles of incorporation for a benefit corporation would be required to include "creating general public benefit" and may include one or more specific public benefits. "General public benefit" is defined in SB 359 as "a material positive impact on society and the environment, taken as a whole, as measured by a third-party standard, from the business and operations of a benefit corporation." Existing corporations would be permitted to amend their articles to become a benefit corporation.

The Corporate Laws Committee is reviewing the benefit corporation concept and any comments or input on benefit corporations may be sent to Justin Klimko at Butzel Long.

New Information Storage and Retrieval System

All documents filed by the Corporation Division since 1990 are stored as electronic images and the database is updated each time a document is filed. Documents filed through MICH-ELF and corporation annual reports or limited liability company annual statements filed online are available online immediately after filing.

Using electronic formats requires significant commitment to maintenance of the current system, and migration to future systems and system redesigns must ensure that the records remain accessible and usable. Work is continuing on the development of a new information storage and retrieval system for the Corporation Division.

The Corporation Division has been experiencing some difficulties with MICH-ELF and the order system. Extra resources have been assigned to identify and resolve the issues and to assist staff in reviewing documents. The best solution to ongoing issues with the current system is to migrate to a new system as soon as possible. Review is underway to determine what steps may be taken to expedite the implementation of a new system.

The new system will assure continued access to current records while permitting the future migration to new hardware and software. The new system will allow rapid retrieval of information while providing frequent backups and disaster recovery. In addition, the new system will allow expansion of online services.

NOTES

1. http://legislature.mi.gov/doc.aspx?2011-HB-4361.
2. http://legislature.mi.gov/doc.aspx?2011-HB-4362.
3. http://www.ag.state.mi.us/opinion/datafiles/2010s/op10327.htm.
4. Only the Westlaw citation is currently available. __NW2d__, 2010 WL 3611716, Mich App 2010 (Sept 14, 2010).
5. http://www.duimaze.com/files/MMMA_Dearborn_v_Brandon.pdf.
6. Doc. No. 09-453-NI, Apr 8, 2011.

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

By Paul L.B. McKenney

S Corporation Preservation Basics (Your Carrier Will Greatly Appreciate You Reading This)

On the surface, S corporations are relatively simple. However, experience indicates there are some deeper currents that you need to be aware of to properly advise your clients and to avoid professional liability. If an entity loses its invaluable S corporation tax status, then 1) it is taxed as a C corporation and with a double tax on distributed earnings, 2) losses do not flow through to the owners, 3) there is a five-year wait before an S corporation status can be reelected, and 4) then, there is another ten-year "built-in gain tax" recognition period on assets that were appreciated when the subsequent S election took effect.

Many practitioners blissfully assume that once an S corporation election is made and there are eligible shareholders, they are basically done. Reality compels us to review the main operational problem, the "one class of stock" rule enshrined in IRC 1361(b)(1)(D). There are some permitted exceptions such as having voting and non-voting stock, so long as the shares are identical in all other respects. The biggest tax trap in practice is the requirement that "all outstanding shares of stock of the corporation confer identical rights to distributions and liquidation proceeds." Treas. Reg. 1.1361-1(l)(1). How can this seemingly simple requirement be violated? Two simple examples illustrate the problem. First, Mary and Sam are 50/50 shareholders. Sam needs some money for a vacation home, child's marriage, etc. So, with Mary's approval, the corporation makes a distribution of $50X dollars to Sam, and nothing to Mary. It may accrue an obligation to pay Mary a similar amount. Let us further assume Mary, in fact, receives the $50X equalizer at a distant date. In the second example, another S corporation owned 50/50 by the same two individuals makes a distribution of $100X to Sam but only $50X to Mary because Mary does not need the money at that time. Both of these situations violate the requirement of distributions being an identical amount per share and at the same time. *See* Treas. Reg. 1.1361-1(l)(2)(i).

Another common example is an S corporation that approves dividends of $1X per share aggregating $100X, but because of cash flow issues only pays a total of $70X at the time. It pays the full $1X per share to some shareholders, and nothing to others. Estate planning wisdom dictates not swelling the wealth of parents who have a potentially large taxable estate. In the case of multi-generations owning S corporations, some even suggest only making shareholder distributions to the children and grandchildren, but not the high net worth parents. Whatever the motivation, the disparity in distributions per share clearly contravenes the one class of stock rule.

Assume you have an S corporation with a buy-sell agreement, and it provides one shareholder will be paid under one valuation formula, which approximates fair market value, but another would be paid at book value, which is a fraction of fair market value. That disparity in buy-sell purchase or redemption values can cause violation of the one class of stock rule. Remember that if the one class of stock rule is contravened, then the corporation losses its S corporation tax status with the deleterious impact noted above.

Recommended Action Steps

I strongly recommend that you do the following with your S corporation clients.

1. Make sure that all prior distributions comply with the one class of stock rules. Take prompt corrective action if there is a problem, and make sure all future distributions follow the regulatory regime.
2. Again, verify that you have only eligible shareholders. The biggest class of inadvertent ineligible shareholder arises when a shareholder dies and, under the trust, some S corporation stock goes into a post-death created trust providing a "sprinkling" of income (i.e., each year the trustee can distribute income in any proportion among a given class of beneficiaries, such as children or grandchildren). The sprinkling clause makes that trust an ineligible S corporation shareholder.
3. Review your governing instruments. It is recommended that in addition to having simply one class of common stock (or very carefully drafted voting and non-voting shares), the articles, by-laws, and shareholder agreements all conform to the various S corporation restrictions. It is also suggested that you consider protective language in the articles of incorporation and bylaws such as that reproduced below. Additional protections can be built in.

Our clients have billions of dollars of revenues in their S corporations. We need to ensure that their valuable S corporation tax status is protected.

ARTICLE __

No attempt to transfer either legal or beneficial ownership of any stock or of any interest in stock in the corporation shall be effective unless and until the Secretary of the corporation registers such change of legal or beneficial ownership or interest, as the case may be, in the corporate records. The Secretary shall not register any such change in legal or beneficial ownership of any shares or of any interest in shares of the corporation unless and until either 1) stockholders of at least 60% [*or another supermajority*] of the voting stock of the corporation (other than stock and interests in stock owned by the transferring stockholder) approve of such proposed transfer in writing, or 2) the proposed transferee furnishes an opinion letter of counsel, in form and substance reasonably satisfactory to counsel for this corporation, that a) the proposed transferee is an eligible shareholder of stock in an "S corporation", b) if such transfer were consummated, then such transfer would not disqualify the corporation as an "S corporation" under the Internal Revenue Code of 1986, or a corresponding provision of a future revenue law (the "Code"), and c) the transfer complies in all respects with all provisions of any then existing buy sell agreement or other agreement then restricting the sale or assignment (for adequate consideration or otherwise) of any interest in stock of the corporation. This Article __ shall only apply either if the corporation is, at the time of the proposed transfer of legal or beneficial ownership of its stock or an interest in its stock, an "S corporation" as defined in Code 1362(a)(1), or if an S corporation election for a tax year beginning within twelve (12) months of the proposed transfer date has been filed with the Internal Revenue Service. This Article can only be amended by the affirmative vote of Stockholders owning at least 60% [*or another supermajority*] of the voting stock of the corporation at a validly held meeting of the shareholders in accordance with the corporation's Bylaws, or by the written consent of shareholders owning at least 60% [*or another supermajority*] of the then voting stock of the corporation.

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By Michael S. Khoury

Personal Liability Developments Related to Contracts and E-mail

A recent discussion thread in the ABA Science and Technology Section Information Security Listserv prompted some thinking about the impact of technology developments on business transactions. As business lawyers, we all know that it is important to understand how legal developments affect our practices and the businesses of our clients. Consider the following cases, and then we will circle back to the technology angle.

Liability of Business Owners and Officers for Principals in Business Contracts

Two recent unpublished decisions from the Michigan Court of Appeals reinforced well-known principles about the situation in which the shareholders or officers of a business may be held personally liable for the obligations of the business entity. The general rule, of course, is that the shareholder or officer is not personally liable if the agreement was signed in a representative capacity, which is the reason we all insist on the capacity being specific and business titles being used.

In the case of *Employees Only, Inc, v Provenzano*,[1] a services agreement provided that the officers of the contracting party would be personally liable for amounts not paid under the agreement. The signature block in the agreement, however, only provided for the signature of a corporate officer in his representative capacity. The court commented that officers of the company who did not sign the agreement could not be held liable, but stated:

> Thus, a corporate officer who signs in a representative capacity but not an individual capacity will only be held personally liable where a factfinder determines that he so intended when he executed a contract providing for personal liability. If the factfinder determines the officer's sole intent was to sign in a representative capacity, there is no personal liability, consistent with the general rule.[2]

In the second decision, *Hour Media, LLC v Schubot*,[3] the agreement in question did not contain specific language that purported to hold the president of the company liable. However, the "Proposal" signed by the president simply indicated that it was "accepted by Brian Schubot" without any further clarification. As part of the finding that a genuine issue of material fact existed that precluded summary disposition, the court made the following findings in support of its decision to remand the case:

> Here, the proposal contained a heading indicating that it had been prepared "for Jules R. Schubot Jewellers/Gemologists." Brian Schubot's signature appears on the signature line at the bottom of the proposal, followed by a notation "accepted by Brian Schubot." These two facts alone signify a latent ambiguity as to the party entering into the contract—the heading because it was clearly not a proposal prepared for Brian Schubot, individually, and the notation because if Brian Schubot was signing in his individual capacity, there would be no need for him to also accept the proposal on his own behalf.[4]

The moral of the story is the same as it was in first year Contract Law.

Contracting in the Electronic Age

What does this have to do with business and technology? Consider that contracts may now be validly formed electronically. The enactment in 2000 of the Michigan Electronic Transactions Act[5] and the related federal E-Sign legislation[6] made electronically created contracts enforceable. While intended to apply to electronic commerce in general, the other consequence of the enactments is that contracts can be validly formed through any exchange that can be documented, such as electronic mail. While some of the reported cases sometimes are challenged by the application of the laws,[7] it is important to consider how our clients are communicating with suppliers, customers, and other business partners.

E-mail makes some aspects of business easier to conduct, but it also can add risks to the methods of doing business. Developments in the law have enabled the formation of legally enforceable agreements outside of the traditional expectations of the statute of frauds, and the actions of business personnel need to account for that. Just as we would counsel our clients to always show their representative capacity in physically signed agreements, they should indicate that capacity in other communications such as e-mail. The better practice here is to make clear that the sender of the e-mail is not intending to contract electronically, and to show the representative capacity of the sender.

NOTES

1. *Employees Only, Inc, v Provenzano*, No 296575, 2011 Mich App LEXIS 819 (May 3, 2011).
2. *Id.* at p. 6.
3. *Hour Media, LLC v Schubot*, No 296697, 2011 Mich App LEXIS 1030 (June 9, 2011).
4. *Id.* at p. 3.
5. 2000 PA 305 (codified at MCL 450.831 et seq.).
6. Pub L No 106-229, 114 Stat. 464 (2000) (codified at 15 USC 7001 *et seq.*).
7. See for example *Buckles Management, LLV v. InvestorDigs, LLC,* 728 F Supp 2d 1145 (D Colo 2010).

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Recent Amendments to the Michigan Limited Liability Company Act

By James R. Cambridge, James L. Carey and Daniel H. Minkus

Introduction

The Michigan legislature amended the Michigan Limited Liability Company Act (the "MLLCA")[1] effective December 16, 2010.[2] As with prior amendments to the MLLCA, these most recent amendments (collectively, the "Amendments") either clarify certain issues or add provisions to make the act more user-friendly.

The Amendments were substantially based on the recommendations of a committee of business and tax lawyers who are members of the Business Law Section of the State Bar of Michigan. Periodically, this committee reviews the MLLCA and the limited liability company law in other states to make sure that Michigan maintains one of the most current, and best, acts in the country. While many of the Amendments involve basic maintenance issues, some substantive changes were made to the MLLCA as well.

The most meaningful of the changes to the MLLCA include:

- Permitting corporations to convert into limited liability companies ("LLCs") and vice-versa.[3]
- Explicitly authorizing an LLC to provide broad indemnification to, and obtain insurance for, members, managers and other persons.[4]
- Refining processes to address interested party transactions to authorize the approval of such transactions.[5] These changes are based on processes that have been used by Michigan corporations for years.
- Clarifying how a person is admitted to an LLC as a member.[6]
- Clarifying that the rights of a judgment creditor of a member of an LLC are limited to receiving a charging order.[7]
- Providing a process for the dissolution of an LLC before it has commenced business.[8]

Conversion of Corporations and LLCs

A conversion is a very simple process of changing the form of the business entity. Before the Amendments, only general and limited partnerships could convert into an LLC, or an LLC could convert into a general or limited partnership. Although the Michigan Business Corporation Act (the "MBCA")[9] had been amended to provide for conversions,[10] until the Amendments, the MLLCA has not allowed conversions of corporations into LLCs and LLCs into corporations. To fully provide for conversions for entities other than partnerships, both statutes needed to include such a provision. The Amendments do that. Now, corporations can be converted into LLCs and LLCs can be converted into corporations.[11]

LLCs are thought by many lawyers to be a preferred choice of entity. A previously incorporated corporation now can simply convert into an LLC through a process of conversion as opposed to the more complicated merger process. This avoids the necessity of using the more complicated merger process to accomplish the same end result. However, it should be noted that while a conversion is a simple process, the act of converting a corporation into an LLC or vice-versa may have unintended consequences, including adverse tax consequences.

Indemnification and Insurance

Before the Amendments, the MLLCA's treatment of the issue of indemnification and insurance was less fulsome than with the Amendments. Some lawyers have questioned that the MLLCA did not authorize the broad indemnification and insurance of an LLC member, manager, or other person like the MBCA provides for directors and officers of a corporation. Section 408 of the former MLLCA provided for the indemnification of managers only (and not members and agents) and included only "indemnify" and "hold harmless" language. Until now, the

MLLCA did not include "defend" language, which many consider necessary for a proper indemnification provision. Thus, Section 408 was replaced in its entirety and the new indemnification provision was placed in new Section 216.[12] As the indemnification provisions have been explicitly broadened beyond managers, it was appropriate to move these provisions from Article 4 (dealing principally with manager matters) to Article 2 (dealing principally with the powers of the limited liability company).

Section 216 explicitly authorizes indemnification and insurance not only for managers, but also for "members and others." Further, the provision explicitly permits an LLC to defend the person as well.

Now it is clear that an LLC may indemnify, hold harmless, and defend a member, manager, or other person and also purchase errors and omissions insurance (D&O) on behalf of such a person (and not just a manager). This new provision is not intended to represent a change in the law on indemnification but only makes the language more exact and reflect the current state of the law.

Transactions With an Interested Person

The MBCA has long included provisions for addressing transactions with interested persons.[13] Section 409[14] is a new section that has been added to the MLLCA to deal specifically with the ways of addressing a transaction in which a manager has an interest. Pursuant to the Amendments, except as otherwise provided in an operating agreement, a transaction in which a manager or agent of an LLC is determined to have an interest will not necessarily be void or voidable, or give rise to damages because of the interest, if (a) the transaction is determined to be fair to the company, or (b) the material facts of the transaction and the person's interest in the transaction were disclosed, and the disinterested managers, or the disinterested members, approved or ratified the transaction.

This new section is based on Section 502(5) of the MLLCA and Section 545a of the MBCA, both of which were originally intended to remove the common law taint that would make an interested transaction void or voidable. The amendment clarifies and expands on the language originally contained in Section 502(5) of the MLLCA. Instead of actually changing Section 502(5), the new Section 409 was placed where most practitioners would expect it—in Article 4, which deals with managers.

How a Person Becomes a Member

The Amendments clarify the issue of when a person becomes a member under the MLLCA, as there has been some confusion about this issue under the MLLCA. Before the Amendments, Section 501 of the MLLCA indicated that a person could only become a member of an LLC in connection with the formation of the LLC if the person signed the initial operating agreement. However, since an LLC is not required to have an operating agreement, a question was raised as to how a person might then become a member in connection with the formation of an LLC.

Section 501[15] now provides that a person will be admitted as a member if the person signs an operating agreement or if the person's status as a member is reflected within the LLC's records. If a person is reflected in the books of the LLC as a member, that person will be considered a member. Also, a person may be admitted as a member in any other way the members agree in writing. Further, if the person is becoming a member of a surviving LLC as the result of a merger or conversion, the person will be admitted as a member as provided in the plan of merger or plan of conversion.

Rights of Creditors of Member

Creditors of members have been increasingly more aggressive in their attempts to reach the full membership interest of a debtor member of an LLC. These instances, which have been seen in other states (most notably in Florida),[16] have made many lawyers concerned about a member's creditors who might try to become a full member in the LLC itself. This is a particular concern for a single-member LLC. Judgment creditors have shown interest not only in attaching the economic rights of their debtors, but also in assuming the right to participate in management. Concerns have also been raised that a judgment creditor may attempt to sell the membership interest like any other kind of personal property of a debtor. In such a scenario, the LLC, and its other members, would be faced with the harsh reality that there would be a new member in the LLC—a member whom the other members have had no role in approving or accepting and, perhaps worse, a judgment creditor of a debtor member.

That result was not intended by the original Section 507. Membership in an LLC was

This new provision is not intended to represent a change in the law on indemnification but only makes the language more exact and reflect the current state of the law.

always intended to be only by voluntary consent of the members—either through unanimous approval or through some other agreed on mechanism provided in an operating agreement. As amended, Section 507[17] makes it clear that a judgment creditor is entitled to receive only the distributions of a debtor member. Section 507 also now goes on to say that the judgment creditor does not become a member of the LLC, but that a judgment creditor receives a lien on the debtor member's right to receive distributions. However, that lien cannot be foreclosed on and the membership interest cannot be sold as personal property. As amended, Section 507 provides the creditor with access to the economic rights of the debtor member, but does not impinge on the managerial rights of the debtor member or the other members. This section makes a charging order the exclusive remedy regarding a judgment debtor's LLC interests.

Notwithstanding the clear language of Michigan's amended Section 507, a member in a single-member LLC should be mindful of how far this provision may be interpreted. One could see how a Michigan court, in all fairness, could refuse to hold in a single-member case that the member's membership interest is beyond the reach of the member's judgment creditor despite the statutory language. Thus, single-members should be careful about placing too much reliance on Section 507. Members in a multi-member LLC should not have the same concern. A judgment creditor of a member in a multi-member LLC may only get a charging order and nothing more.

The Amendments provide for the dissolution of an LLC by a vote of a majority of its organizers prior to the time the LLC commences business.

Dissolution of an LLC Before It Commences Business

The Amendments provide for the dissolution of an LLC by a vote of a majority of its organizers prior to the time the LLC commences business. In such an instance, a certificate of dissolution must be filed with the state. This provision creates an additional way in which an LLC may be dissolved.

Technical Changes

The Amendments also made several technical changes to the MLLCA. Although many of the technical amendments were intended to clean up the prior statutory language, some of the technical changes are somewhat important:

- An "authorized agent" executing and filing a document with the department no longer needs a power of attorney to do so.[18] The department formerly known as the Michigan Department of Energy, Labor & Economic Growth ("DeLEG") has, as of April 24, 2011, been reorganized as the Michigan Department of Licensing and Regulatory Affairs ("LARA").
- In the case of a conversion by a business organization (corporation, general partnership, or limited partnership) into an LLC or an LLC into another business organization, an assumed name that was used previously by the old entity can now be used by the new entity.[19]
- The Amendments clarify that members and managers of the LLC may be entities rather than natural persons by eliminating the references to "he or she."[20]
- If an operating agreement does not address a member's right to receive a distribution before the withdrawal or the dissolution and winding up of the LLC, the unanimous approval of the members is now required for any distribution to that member.[21]
- A member or manager may now avoid liability for a wrongful or illegal distribution made by the LLC if the member or manager either (a) votes against the distribution or (b) files a written dissent with the LLC within a reasonable time after the member or manager has knowledge of the decision to make the wrongful or illegal distribution.[22]
- On the written request of a member, an LLC must now provide the member with local, state, and federal tax returns and any other tax related filings.[23]
- The term "willfully unfair and oppressive conduct" in minority member oppression cases now expressly includes the termination of employment or limitations on employment benefits to the extent that the actions disproportionately interfere with distributions or other member interests of the affected member.[24]
- If an LLC files restated articles of organization, the LLC must now clearly state in the filing that the arti-

cles are restated. The LLC must also now clearly state all of the former names of the LLC.[25]

Acknowledgments

Legislative work like this, which is so important to Michigan, could not be completed without the significant contributions of many individuals. We thank Senator Tupac Hunter (D-Detroit) for sponsoring the legislation, the Council of the Business Law Section of the Michigan State Bar for supporting the project, and Joseph Palamara and Karoub Associates for their assistance in getting the measure through the legislature. Most of all, we thank and acknowledge the work of the committee members who worked hard to shape and draft the Amendments: Ann Baker (LARA), Tania (Dee Dee) Fuller (Fuller Law), Tim Damschroder (Bodman LLP), Tony Ilardi Jr. (Dykema), and Chris Maeso (Dickinson Wright).

NOTES

1. MCL 450.4101 *et seq*.
2. 2010 PA 290 (SB 1455).
3. MCL 450.4709 & 450.4708.
4. MCL 450.4216.
5. MCL 450.4409
6. MCL 450.4501.
7. MCL 450.4507.
8. MCL 450.4801.
9. MCL 450.1101 *et seq*.
10. MCL 450.1746.
11. MCL 450.4708 & 450.4709.
12. MCL 450.4216.
13. MCL 450.1545a.
14. MCL 450.4409.
15. MCL 450.4501.
16. *See Olmstead v Federal Trade Comm'n*, 44 So 3d 76 (Fla 2010). In 2011, the Florida legislature amended its LLC act to remedy the Olmstead problem, but the amendments still appear to leave single-member LLCs at risk in some circumstances. The amendments to Florida's LLC Act provide that a charging order is the exclusive remedy against multi-member and single-member LLCs but also state that, regarding a single-member LLC, if a judgment creditor of a member or that member's assignee establishes to the satisfaction of a court that distributions under a charging order will not satisfy the judgment within a reasonable time, a charging order is not the sole and exclusive remedy. On such a showing, a Florida court may order a foreclosure sale of that interest in the single-member LLC. If a foreclosure sale is ordered under the Florida statute, the purchaser obtains the member's entire LLC interest (not just the rights of an assignee) and becomes a member of the LLC while the former member ceases to be a member of the LLC. See Fla Stat 608.433, amended by 2011 Fla Laws ch 77 (eff. May 31, 2011, but applies retroactively).
17. MCL 450.4507.
18. MCL 450.4103.
19. MCL 450.4206.
20. For example, *see* 450.4302, 450.4403, 450.4406, among others.
21. MCL 450.4304.
22. MCL 450.4308.
23. MCL 450.4503.
24. MCL 450.4515.
25. MCL 450.4604.

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The Michigan Exemption Initiative

By Thomas R. Morris*

The Bankruptcy Appellate Panel (BAP) for the Sixth Circuit, in *In re Schafer,*[1] ruled in February 2011 that Michigan's bankruptcy-specific property exemptions[2] are unconstitutional. The basis for the ruling is that the bankruptcy-specific exemptions enacted by the Michigan legislature in 2004 violate the "uniformity" requirement of the bankruptcy clause of Article 1 of the United States Constitution.[3]

This has caused the bankruptcy-specific exemptions to be unreliable for bankruptcy debtors and the attorneys who advise them. The ruling by the BAP is binding only in the specific case, and the bankruptcy judges of the Western District are divided on the question.[4] None of the bankruptcy judges of the Eastern District has ruled on the issue, although Judge McIvor, one of six bankruptcy judges for the Eastern District, was a member of the panel of the BAP in *Schafer*. *Schafer* is now on appeal to the Sixth Circuit Court of Appeals.[5] A ruling from the court of appeals would be binding on all Michigan bankruptcy courts. That would settle the matter unless and until the question is ruled on by the Supreme Court. In the meantime, any debtor selecting those exemptions must be prepared for a challenge by the trustee.

A subcommittee of the Debtor-Creditor Rights Committee of the Business Law Section of the State Bar is working on a legislative solution. The subcommittee's project is referred to as the Michigan Exemption Initiative ("Initiative"). The Initiative has drafted proposed legislation to re-unify and modernize Michigan's exemption statutes. The provisions enacted in the bankruptcy-specific statute would be made generally applicable. New provisions covering health and education savings accounts would be added. Other improvements and corrections to the statute would be made.

The Initiative continues the work of the Advisory Committee to the Civil Law and Judiciary Subcommittee of the House Civil and Judiciary Committee,[6] which was formed in 2001 at the request of the Michigan House of Representatives subcommittee for the purpose of reporting on and recommending changes to Michigan's exemption laws. At that time, the exemption laws had been for the most part unchanged since 1963.[7] The exceptions were the addition in 1984 of an exemption of "an IRA" and in 1989 of certain other retirement plans. Many non-IRA retirement plans, however, are protected by federal law.[8] And the exemption of "an IRA" has been held to exclude an exemption of more than one IRA.[9] Therefore, the one effective addition since 1963 to Michigan's exemptions was itself in need of revision.

The enactment in 2005 of the bankruptcy-specific exemptions was a diversion from the path intended by the advisory committee. The committee's recommendation had been changes to the "general" exemption statute, MCL 600.6023. The legislature did not alter that statute and instead channeled the recommended changes into the new "bankruptcy-specific" exemption statute. Because Michigan bankruptcy debtors can select either the "state" or the "federal" exemptions,[10] and because most[11] debtors (particularly those with no more than $21,625 in home equity) select the federal exemptions, the adoption of the bankruptcy-specific exemptions had only a marginal impact on bankruptcy practice in Michigan. Because the existing statute, which became the "general" or "non-bankruptcy" exemptions, remained unchanged, debt collection outside of bankruptcy was unaffected, except to the extent that the enhanced state bankruptcy exemptions may have increased filing rates.[12] The most significant change incorporated into the bankruptcy-specific exemptions was to increase the homestead exemption about ten-fold. The allowance for IRAs was also broadened to "all IRAs." The allowance for a motor vehicle was increased. Professionally-prescribed health aids and a computer were added.

Opposition to updating of the general exemption statute by the Michigan Creditors Bar Association and the Michigan Court Officer, Deputy Sheriff & Process Servers Association resulted in the compromise by the legislature. That compromise was to limit the application of the modernized exemptions to bankruptcy cases by creating the bankruptcy-specific statute. The opponents of the reform were willing to accept the compromise because the increases in exemptions would not apply to judgment debtors outside of bankruptcy and therefore would have less

**The opinions in this article are those of the author and do not necessarily reflect the position of the State Bar of Michigan Business Law Section or any other organization of which he may be a member.*

effect upon their members and the creditors they serve.

Even with the bankruptcy-specific statute having been held unconstitutional, the same groups oppose legislative reform of the exemptions. Debts, they argue, should be enforced, and an increase in exemptions would be contrary to that policy.

There are several arguments that realistic exemptions are necessary and beneficial. From a utilitarian viewpoint, the small benefit to a creditor of the seizure from a debtor of, for example, clothing or other relatively unmarketable property necessary for the debtor (and his or her dependents) to be functional and productive is outweighed by the detriment to the debtor. Similarly, from a societal standpoint, for a debtor to be rendered destitute by a judgment may place a burden on the state when it is then called upon to support the debtor. Fairness, a vague but fundamental element in the maintenance of a legal system, requires some level of exemptions. These arguments are not new. Michigan has had exemptions since its time as a territory, and exemptions have been mandated by the State Constitution since 1850.[13]

The 1963 State Constitution sets a minimum homestead exemption of $3,500 and a minimum personal-property exemption of $750.[14] Thus, it is beyond debate at a legislative level whether some level of exemptions is appropriate. The question, with respect to the homestead in particular, is whether the constitutional minimum is still sufficient. The current non-bankruptcy homestead is set at that minimum. The (invalidated) bankruptcy-specific homestead exemption is approximately $35,000.[15]

Homestead exemptions in other states range from none to unlimited values. The median amount is approximately $50,000.[16] Other important exemptions, such as household goods, a motor vehicle, and clothing, vary from state to state, but at $1,000 for a motor vehicle (and only if used in the debtor's trade) and $1,000 for household goods,[17] Michigan's non-bankruptcy exemptions are lower than many other states. Adjusted for inflation the homestead exemption is lower than at any time since statehood.[18] Other states have adopted exemptions for recent financial innovations such as health savings accounts and education savings accounts.[19] Michigan should consider whether to follow suit.

The opponents of exemption reform argue that because personal bankruptcy has become an accessible remedy for individual debtors, exemptions outside of bankruptcy are no longer important. When Michigan's first exemption laws were enacted before statehood in 1837, and when exemptions first became a subject of the state constitution, in 1850, personal bankruptcy relief was not available. The number of personal bankruptcies has risen greatly in recent decades.[20] The federal exemptions, which most debtors find advantageous, are available to Michigan residents.[21] Therefore, it can be argued, bankruptcy now provides greater refuge than was historically the case.

Bankruptcy, however, is not available to all debtors. A debtor who has received a discharge in bankruptcy is barred from receiving another discharge for up to eight years.[22] Nor is bankruptcy always a fitting remedy for a debtor. For a debtor with relatively few creditors, an out-of-court workout may be an option. The enactment of state exemptions at a level closer to those allowed by the federal bankruptcy exemptions would afford some debtors a better opportunity to restructure their finances without resorting to personal bankruptcy. And a law that favors bankruptcy filers sends a mixed message. According to the state of Michigan's student loan Web site: "Bankruptcy should be the absolute last resort for any borrower.…Borrowers are encouraged to try to resolve all credit issues outside of bankruptcy."[23]

Reasonable exemption laws are a factor in attracting entrepreneurs and in encouraging business formation. According to a study published by the National Bureau of Economic Research, states with high homestead exemptions have about one-third more entrepreneurs than states with low homestead exemptions.[24] The counter-argument is that a system that is more favorable to debtors is less favorable to creditors, who as a result may be less willing to extend credit. But credit appears to have been available in adequate quantities in high-exemption states such as Florida and Nevada, for example, to fuel a construction boom and subsequent bust.

In the event that the court of appeals reverses the BAP and upholds the bankruptcy-exemption statute, the constitutional crisis will be averted. But the question will remain whether Michigan's exemption laws are due for an update. The Michigan Exemption Initiative is continuing work on the project with the goal of assisting the legislature in reevaluting Michigan's exemption laws.

Reasonable exemption laws are a factor in attracting entrepreneurs and in encouraging business formation.

NOTES

1. *Richardson v Schafer (In re Schafer)* and *Tibble v Jones (In re Jones)*, Nos 10-8030 and 10-8031, 2011 Bankr LEXIS 564 (6th Cir BAP Feb 17, 2011).

2. MCL 600.5451.

3. Art. 1, §8, Cl. 4 provides Congress with the authority to establish "uniform Laws . . . on the subject of Bankruptcies throughout the United States."

4. Judge Dales rendered the opinions in *Schafer* and *Jones* upholding MCL 600.5451. Judges Gregg (in *In re Pontius*, 421 BR 814 (Bankr WD Mich 2009)) and Hughes (*In re Wallace*, 347 BR 626 (Bankr WD Mich 2006)) have both ruled the statute to be unconstitutional.

5. *In re Jones,* the companion case to *Schafer,* was settled and is not on appeal.

6. Steven L. Rayman, chair; Thomas B. Radom, vice chair; Judy B. Calton, reporter.

7. And the 1963 exemptions are little changed since 1846. *See* Morris, *The History and Future of Michigan Debtor Exemptions*, 30 Mich Bus L J 57 (summer 2010).

8. ERISA, 29 USC 1056(d)(1); *Patterson v Shumate*, 504 US 753 (1992).

9. *In re Katranji*, 93-CV-75304-DT (ED Mich 1994) (unpublished ruling); *In re Spradlin*, 231 BR 254 (Bankr ED Mich 1999).

10. *See* 11 USC 522(b).

11. Statistical substantiation was not found, but the prevalence of the federal exemptions has been observed by the author and by practitioners who were consulted.

12. Several published statistical studies address the relationship between the levels of exemptions and filing rates, but the author is not aware of any such study which addresses the effect of the Michigan bankruptcy-specific exemptions.

13. Const. 1850, Art. 16. *See also* Morris, *The History and Future of Michigan Debtor Exemptions*, *supra*.

14. Const. 1963, Art. X, §3.

15. MCL 600.5451(1)(n) provides an inflation-indexed homestead exemption of $30,000. The amount is $45,000 for a debtor who is disabled or over 65 or who has a dependent who is disabled or over 65. The inflation-adjusted figures published on April 15, 2011 are $35,300 and $52,925. *See* http://www.michigan.gov/documents/BankruptcyExemptions2005_141050_7.pdf.

16. *See* West Bankruptcy Exemption Manual for the amounts allowed in individual states.

17. MCL 600.6023(1)(b).

18. For example, the $1,500 statutory homestead exemption in 1915 was calculated to be equivalent to $27,252 in 2003. Report of the Advisory Committee to the Civil Law and Judiciary Subcommittee of the House Civil and Judiciary Committee, August 11, 2003.

19. *See, e.g.*, Rosen, B., *State Creditor Protections for 529 Plans*, Corporation for Enterprise Development (April, 2007), available at cfed.org.

20. In 2010, the number of bankruptcy cases filed, most of which were for individuals, was over 50,000 in the Eastern District and over 16,000 in the Western District. Those figures are below 2005 figures, when filings increased due to debtors desiring to file before the 2005 amendments to the Bankruptcy Code took effect.

21. Michigan is one of 15 states in which the federal exemptions are allowed.

22. 11 USC 727(a)(8) requires eight years between the filing dates of cases filed under chapter 7.

23. http://www.michigan.gov/mistudentaid/0,1607,7-128-38170_38184-129878--,00.html (accessed May 1, 2011).

24. Fan, W. and White, M., *Personal Bankruptcy and the Level of Entrepreneurial Activity* (NBER Working Paper No. 9340).

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Garnishments: The Growing Menace for Michigan Employers

By Martin C. Brook

Why should employers consider directing scarce and expensive legal resources to garnishment processing? The reason is that federal and state garnishment laws provide rights to creditors and protections for employees and only impose obligations, expenses, and risks upon employers. For instance, for a miniscule one-time $6.00 fee, employers must accurately deduct from the debtor's earnings and remit payments for 91 days and often correctly balance several competing obligations such as other garnishments, wage assignments, tax levies, support orders, and Chapter 11 bankruptcy payments. As the number of garnishments rise, maintaining accurate payroll week-to-week is time consuming and certainly costs more than $6.00 per garnishment to administer.

The major risk that an employer faces is that it can be held liable for the entire debt of its employee, as well as court costs and attorney fees, if it fails to complete and properly serve the garnishee disclosure within 14 days of service or fails to comply with other obligations. Further, in their aggressive pursuit of debt repayment, creditors often care little about whether they get paid by the debtor or by defaulting the debtor's employer; they just want to be repaid. As a result, many debt collectors, realizing they may never collect from the delinquent debtor, will view even the smallest garnishee error as a fortunate opportunity to collect on the debt from the garnishee.

It would be a mistake to assume that the financial risk posed by garnishment processing errors are mere annoyances. The following true example demonstrates how significant the potential financial risks can be and how utilizing traditional business-to-business practices to administer garnishments may lead to legal liability. Unknown to this employer, one of its employees had a business outside of work that took a turn for the worse and the employee had a $596,000 judgment entered against him. The creditor issued a periodic garnishment that mentioned both the employee and his company. Not realizing that garnishment timelines are strict and that garnishment processes are immutable, the employer did what most business people would do—they sent a nice letter to the creditor attorney explaining that they could not identify the principal defendant as an employee or as a vendor and enclosed the original writ. The payroll staff member did not keep a copy of the writ or a copy of his letter and considered the case closed. The collection attorney, having superior knowledge of garnishment law and procedure, ignored the letter and two weeks after the disclosure was due, returned to court and obtained a default judgment against the garnishee for the entire $596,000 debt. This true example demonstrates several points. First, common business world responses—such as a nice letter sent as soon as the person could get around to it—are not legally sufficient. Second, the represented plaintiff/creditor had a significant advantage over the unrepresented garnishee defendant. Third, mishandling even one single garnishment can have serious financial consequences.

Garnishment Law and Procedeure

Background

The garnishment writ is a statutorily created and judicially enforced debt collection process. It is increasingly being utilized by creditors to attach employee earnings and is thereby increasing the costs and risks faced by employers.[1]

Garnishments may appear to be an informal and routine business matter because the proceedings are mostly administered with pre-printed forms and Michigan employers can respond to writs of garnishment without being represented by an attorney.[2] However, the garnishment process is actually an accelerated legal proceeding involving a complaint, answer, discovery, motions and trial. In order to obtain a wage garnishment, a creditor must first obtain a judgment against a debtor ("principal action"). After the debt is reduced to a judgment in the principal action, the creditor may institute a garnishment action to collect the judgment. In the garnishment action, the plaintiff is the

judgment creditor from the principal action and the garnishee defendant is a third party who may possess property or money of the debtor/defendant from the principal action. In the employment context, the alleged employer of the principal defendant is named as the garnishee defendant. In normal litigation terms, the complaint is the judgment creditor's verified statement for a writ for garnishment and the answer to the complaint is the garnishee's disclosure. Receipt of a writ for garnishment (commonly referred to simply as a garnishment) is similar to an injunction attaching the principal defendant's (debtor's) money, property or earnings. If the garnishee does not timely and accurately comply with the writ for garnishment or other garnishment processes, the principal plaintiff (creditor) can obtain a default judgment against the garnishee for the full amount of the debt owned by the principal defendant. If there is a dispute as to whether the garnishee has property of the debtor, there are provisions for discovery, motions and for a trial to resolve questions of fact. While creditors are almost always represented by counsel in garnishment actions, garnishee defendants almost never seek counsel nor are they represented by counsel in the garnishment action.

It would be a mistake to assume that the financial risk posed by garnishment processing errors are mere annoyances.

Consumer Credit Protection Act

In 1968 Congress passed the Consumer Credit Protection Act ("CCPA"), which placed responsibilities and restrictions upon employers who receive and process creditor garnishments and support orders.[3] In doing so, Congress concluded that unrestricted garnishments disrupted the economy by encouraging predatory lending, hindering the proper functioning of the Bankruptcy Code and causing individuals to lose employment. Congress provided that the Wage and Hour Division ("WHD") of the U.S. Department of Labor would be responsible to enforce the garnishment restrictions contained in the CCPA.

The CCPA and the WHD Regulations[4] set forth the maximum amount that may be deducted from an employee's earnings in compliance with a garnishment or support order. In particular, an employee whose weekly disposable earnings are 30 times the federal minimum wage ("FMW") or less cannot have money deducted for a creditor garnishment. If an employee's weekly disposable earnings exceed 30 times the FMW, the amount subject to garnishment is the lesser of the amount above 30 times the FMW or 25 percent of disposable earnings. For a support order, the cap varies between 50 percent and 65 percent of disposable earnings depending upon whether the earner is also supporting another family. The CCPA requires aggregation of all attachments ordered through a legal process; therefore, if more than 25 percent of an employee's disposable earnings are already deducted for child support, no deduction can be made for a garnishment. In other words, an employee's voluntary wage assignment or deductions do not impact calculation of disposable earnings nor do they prevent the deduction because they are not aggregated toward the cap. In practice, the Michigan employer will receive a garnishment that only seeks to collect a certain total debt, it is up to the Michigan employer, for every subsequent paycheck for the duration of the garnishment, to correctly calculate and apply the CCPA limits.

The CCPA prohibits employers from discharging employees to avoid the costs incurred administering garnishments. Specifically, the CCPA provides that an employer cannot discharge an employee "by reason of the fact that the employee's earnings have been subject to garnishment for any one indebtedness."[5] The penalty for a willful violation of the prohibition of discharge for garnishment due to a single indebtedness is a fine of not more than $1,000 or not more than one year imprisonment or both. There is no private right of action under the CCPA for wrongful termination.[6]

The WHD enforces the prohibition on discharge for garnishment due to a single indebtedness. The WHD will investigate allegations and seek to informally resolve violations and may file suit in court to remedy a violation. A search of published decisions did not uncover a lawsuit filed by the WHD to enforce this prohibition. There is no statute of limitations contained in the CCPA and the WHD's enforcement position is that the claim is limited only by the doctrine of laches. Also, the WHD enforcement position is that the discharge need not be "because of" the garnishment; rather according to the WHD, a violation of the CCPA is established if the garnishment was "a factor" in the discharge.

Federal Administrative Wage Garnishments

The Debt Collection Improvement Act ("DCIA")[7] and the Higher Education Act ("HEA")[8] provide authority for federal

administrative agencies to issue wage garnishments. The priority for an administrative wage garnishment is the same as a creditor garnishment and the CCPA limits apply. If an employer does not promptly respond to the administrative garnishment, the agency will usually issue a second garnishment. If the employer still does not respond (and withhold), the agency may file suit in federal court to enforce the administrative garnishment and collect the amount that should have been withheld plus attorney fees, costs, and punitive damages.[9]

Michigan Attachment and Garnishment Law

A Michigan law providing for garnishment of periodic payments (i.e. wages) was first adopted in 1961 and has been amended several times between 1974 and 1996.[10] The statute sets forth the general requirements for garnishments, obligations of the parties and priority among garnishments. Of particular note is that Michigan law provides that creditors may not garnish money owed on account of labor performed until after a judgment is obtained against the principal defendant or employee.[11] Also, Michigan law provides that any person who knowingly and willfully falsely answers a writ for garnishment is liable to the plaintiff for the full amount due on the judgment plus interest.[12] However, this section does not allow for double recovery, so if the debtor has paid the judgment, there can be no award against the garnishee for a false disclosure, even if it was willfully and knowingly submitted.[13]

Michigan law also prohibits employers from disciplining or discharging employees for having one or more garnishment actions against him or her.[14] A garnishee defendant who violates this prohibition "shall be required to reinstate the principal defendant to employment and reimburse all compensation lost by the discipline or discharge." The section provides for a private right of action. A search of published and unpublished Michigan case law did not locate one decision regarding "garnishment discrimination." While not specifically mentioned in the state law, other adverse employment actions because of a garnishment could risk liability. For instance, declining to employ a person because of the existence of a garnishment should be avoided, unless a high degree of personal financial health is required for the position (for example, the position deals with money or manages company finances or another position of trust).[15]

Michigan Court Rules— Garnishment After Judgment

Michigan Court Rule ("MCR") 3.101 establishes most of the details of the garnishment process. The MCR sets forth the court procedures to obtain a post-judgment garnishment, responsibilities of the various parties and the process to adjudicate disputes.[16] What is readily apparent from the court rules is that the garnishment action is an accelerated legal proceeding. For instance, while a defendant to a lawsuit has 21 days to file an answer, the garnishee defendant has only 14 days to answer the writ for garnishment. Also, unless a dispute arises, the entire garnishment process lasts just over 105 days, whereas litigation often takes years to resolve.

Dealing with Default Judgments

The Michigan Court Rules specifically provide for entry of default judgment if the garnishee defendant fails to disclose or to do a required act within the time limit imposed.[17] Also, a garnishee defendant who fails to comply with a court order may be adjudged in contempt of court.[18] The court may impose costs on a garnishee defendant whose default or contempt results in an expense to other parties. Costs shall include reasonable attorney fees and shall not be less than $100.[19]

A defaulted party can attack a default judgment by seeking to have it set aside under MCR 2.603 or by seeking relief from judgment under MCR 2.612.[20] The deadline to file a motion to set aside a default judgment is 21 days whereas a motion for relief from judgment may be brought within a reasonable period of time. Therefore, if a default judgment is received, efforts to overturn the judgment should begin immediately.

Informal Responses to a Default Judgment

Many creditors will voluntarily set aside a default judgment. A request to voluntarily set aside a default judgment is likely to be successful when: (1) you still employ the debtor/principal defendant; (2) the writ is still in effect and has priority or a new garnishment can be obtained that will still have first priority; and (3) you can assure the creditor that you will promptly file a garnishee disclosure. If unsuccessful, many other creditors may be persuaded to set aside the default judgment

The Michigan Court Rules specifically provide for entry of default judgment if the garnishee defendant fails to disclose or to do a required act within the time limit imposed.

if you offer to pay reasonable attorney fees incurred in obtaining the default judgment. Keep in mind that discussions to settle a default judgment are most likely to succeed when the garnishee defendant still has time to file a motion to set aside the default judgment.

Formal Responses to a Default Judgment

In order to have the default judgment set aside the defaulted party must prove that it has good cause and a meritorious defense. A party may establish "good cause" to set aside default judgment by showing: (1) a substantial defect or irregularity in the proceeding upon which the default was based; (2) a reasonable excuse for failure to comply with the requirements that created the default; or (3) some other reason showing that manifest injustice would result if the default is not set aside. Establishing a meritorious defense can be a challenge if the debtor is employed and deductions would have begun had the garnishment been properly processed. Common meritorious defenses are that the garnishee defendant is misidentified or improperly served, the principal defendant is not an employee, or was not entitled to any periodic payments, the subject garnishment would not be paid because of higher priority orders, or if the debtor has satisfied the judgment.

[T]o have the default judgment set aside, the defaulted party must prove that it has good cause and a meritorious defense.

Also, a garnishee has a "reasonable" period of time to file a motion for relief from judgment. Most often, a motion in response to a default judgment should argue both to set it aside and for relief from judgment. A relief from judgment may be obtained if the judgment is void or has been satisfied or the prior judgment upon which it was based has been reversed or vacated.

Facts that may support setting aside or voiding a default judgment include:

- Garnishment was obtained before expiration of the automatic stay of enforcement after a judgment as required by MCR 2.614;
- Garnishment was not properly served as required by MCR 3.101(F) and 2.105;
- Garnishment does not accurately identify the employer by its legal name;
- Service of the garnishment was without all the required items or information contrary to MCR 3.101 (E);
- The default judgment was not obtained in strict accordance with MCR 2.603;
- The primary defendant has filed for bankruptcy (see following section); and,
- The primary defendant has paid the judgment or the judgment has been reversed or vacated.

Impact of Employee Bankruptcy on a Default Judgment

Filing bankruptcy stays any action to collect against the bankrupt entity. The relevant question is whether pursuing a garnishment default judgment against the bankrupt employee's employer violates the automatic stay. There are two key provisions in the Michigan Court Rules that provide insight into this question. First, pursuant to MCR 3.101(O)(2), the judgment against the garnishee discharges the garnishee from any demands by the principal defendant for wages withheld and paid to the primary plaintiff and the garnishee defendant may introduce the judgment as evidence that the full amount of wages earn were in fact paid.[21] Second, pursuant to MCR 3.101(O)(7), the payment of a judgment by the garnishee constitutes a satisfaction of a judgment to the same extent against the defendant.[22] Because satisfaction of any judgment against the garnishee constitutes satisfaction of a judgment to the same extent against the defendant, any effort to obtain a default judgment against a garnishee or to collect from the garnishee would violate the automatic stay. This is what the Bankruptcy Court for the Eastern District of Michigan held in *In re Feldman*, 303 BR 137 (Bankr ED Mich 2003). The Michigan Court of Appeals has very recently come to the same conclusion. *Vanderpool v Pineview Estates, LC*, 289 Mich App 119, __NW2d__ (2010). In *Vanderpool*, the court reversed entry of default judgment against a garnishee who did not timely file its disclosure because the principal defendant had filed for bankruptcy.

Other Responses to a Default Judgment

Of course, the best option is for the debtor/employee to pay the judgment against himself or herself. This would cause the default to evaporate since there is no underlying debt. MCR 2.612. If the default judgment is not resolved and the employer pays the amount of the judgment, the employer may have a basis to collect from the employee. This possibility is based on the fact that

payment on the default judgment has two important impacts: (1) the principal defendant's debt is considered paid, and (2) the garnishee no longer has an obligation to the employee for the money it paid. Thus, it may follow that the employee is in debt to the employer. One option to pursue collection from the employee may be to explain the situation to the employee and seek a voluntary wage deduction agreement that complies with the Wages and Fringe Benefits Act.[23] Another option to consider would be to seek a judgment against the employee and garnish his or her wages. Obtaining a judgment allows you to pursue repayment even if the employee quits. However, there are no cases specifically authorizing an employer to treat its payment of a garnishment default as an employee debt. Therefore, an employer seeking to pursue an employee to repay the default judgment should seek counsel and proceed with caution.

Conclusion

Proactive and routine evaluation of your company's garnishment processing procedures and compliance to prevent errors could thereby reduce the risk of incurring significant future expenses correcting errors after they happen. When evaluating garnishment compliance, the first consideration is whether the company will handle garnishments internally or outsource this task to their payroll vendor. Whether garnishments are handled internally or outsourced, the employer (who remains legally responsible even if garnishment processing is outsourced) should undertake the following steps: (1) Establish a garnishment handling process that is legal-approved; (2) Record and document every step and all activity regarding each writ; (3) Develop metrics to quantify the amount of garnishment activity, the risks faced by the employer and the effectiveness of the company's handling process; and (4) Monitor and routinely report garnishment processing metrics to senior management and revise the garnishment handling process as required.

NOTES

1. The Michigan Supreme Court does not keep a record of post-judgment enforcement activity. Therefore, it is not possible to accurately gauge the past or present level of garnishment activity. My own survey of District Courts in Oakland County revealed dramatic increases in certain Districts. Specifically, the volume of garnishments from 2000 to 2010 increased over 400% at the 47th District Court and over 250% at the 46th District Court.

2. Under Michigan law, filing a garnishee disclosure with a court is not practicing law. Certain other states have taken the position that filing a garnishee disclosure on behalf of a company is the practice of law. Georgia UPL Advisory Opinion No. 2010-1. It may seem advantageous that Michigan employers handle these without counsel, however, this creates the unusual situation where the plaintiff pursuing the debtor's income held by the employer is represented by counsel but the at-risk employer is not. Since garnishment rules are strict and there is risk for direct employer liability, the fact that garnishee disclosures are not considered practicing law may ultimately prove to be penny wise and pound foolish.

3. 15 USC 1601 *et seq.*

4. 20 CFR Part 870.

5. 29 USC 1674.

6. *Smith v Cotton Brothers Baking Co, Inc*, 609 F2d 738 (5th Cir 1980) and *LeVick v Skaggs Cos, Inc*, 701 F2d 777 (9th Cir 1983), but see *Ellis v Glover & Gardner Constr Co*, 562 F Supp 1054 (MD Tenn. 1983).

7. 31 USC 37200.

8. 20 USC 1095a. An employer may not discipline, terminate or refuse to hire a person because he or she is subject to a student loan garnishment. 20 USC 1095a(a)(8).

9. 20 USC 1095a(a)(6).

10. MCL 600.4012.

11. MCL 600.4011(5).

12. MCL 600.4051.

13. *John Richards Homes Bldg Co v Adell Broad Corp (In re John Richards Homes Bldg Co)*, 402 BR 780 (Bankr ED Mich 2009).

14. MCL 600.4015.

15. Further, using the existence of excessive garnishments as a factor in the hiring decision may have an adverse impact on a protected class in violation of Title VII.

16. The Michigan Court Rules impose several obligations upon the garnishee defendant and timelines that must be followed. First and foremost, upon service of the garnishment, the garnishee becomes liable for the portion of the principal defendant's earnings that are not protected by the CCPA, MCR 3.101(G), until the writ expires 91 days after service, MCR 3.101(B). After receipt of the writ, the garnishee has seven days to deliver a copy of the writ to the defendant. MCR 3.101(F). Within 14 days after service of the writ, the Garnishee must then mail to the court, the plaintiff and the principal defendant the completed and verified disclosure form. MCR 3.101(H). Withholding is to begin the next full pay period, MCR 3.101(I), and the withheld money is to be transmitted after 28 days from the date of service of the writ. MCR 3.101(J). Lastly, a final statement is due to the court, the plaintiff and the principal defendant within 14 days after the garnishment expires. MCR 3.101(J).

17. MCR 3.101(S)(1).

18. MCR 3.101(S)(2).

19. MCR 3.101(S)(3).

20. MCR 3.101(P).

21. MCR 3.101(O)(2).

22. MCR 3.101(O)(7).

23. The employee must consent in writing to each payroll deduction.

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*RICO and the Theft of Trade Secrets**

By Ashish S. Joshi

According to a recent study, there has been exponential growth in the theft of trade secrets.[1] Another study reveals that nearly 60 percent of employees who quit a job or are asked to leave are stealing company data.[2] Among those who took proprietary company data from their former employers, email was the most frequently stolen, followed by nonfinancial business information, customer contact lists, employee records, and financial information.[3] With this growth in the theft of trade secrets, it is no surprise that litigation in this area has increased as well. The Uniform Trade Secrets Act (UTSA) as adopted by various states is the most common tool used by litigators to combat the theft of trade secrets. The UTSA imposes civil liability for the misappropriation of trade secrets and creates a private cause of action for the victim. Remedies for misappropriation of trade secrets under the act include injunctions, damages such as exemplary damages, and, in cases of bad faith or willful and malicious misappropriation, reasonable attorney fees. Another seldom-used tool in a litigator's toolbox for theft of trade secrets litigation that is being utilized more and more is the Racketeer Influenced and Corrupt Organizations Act (RICO).

RICO was originally enacted to combat the infiltration of legitimate businesses by organized criminals.[4] By providing a broad federal structure for imposing criminal and civil liability on a wide range of conduct, RICO has succeeded in reaching illegal activity that is beyond the scope of other statutes. Though primarily designed as a weapon against organized crime, RICO's application has not been limited to the "archetypical, intimidating mobster."[5] RICO's provision for treble damages in civil cases has made its use more attractive and creative. The statute has been used against legitimate businesses that have committed "offenses" that can be wedged into RICO's racketeering definition, ranging from union tactics to the theft of trade secrets.[6] In regard to data thieves, RICO, with its capacity to provide for treble damages and attorney fees, provides a significant advantage over traditional remedies such as the UTSA or the federal Computer Fraud and Abuse Act (CFAA).[7]

RICO Elements

To recover in a civil RICO action, a plaintiff must prove that there is a violation of the RICO statute, 18 U.S.C. § 1962; that there is an injury to the plaintiff's business or property; and that the RICO violation was the proximate cause of the injury.[8] To establish a violation of the RICO statute, a plaintiff must in turn prove the conduct of an enterprise through a pattern of racketeering activity.[9] While defendants usually contest every element of a RICO claim, the battle usually focuses on proper pleading of the last two prongs: the "pattern" of "racketeering activity."

Racketeering Activity

RICO imposes criminal and civil liability upon those who engage in "racketeering activity," or, as the Supreme Court put it, "prohibited activities."[10] Racketeering activity is defined as "any act or threat involving" specific state-law crimes, any "act" indictable under various enumerated federal statutes, and certain federal offenses.[11] Prohibited activities that apply to the theft of trade secrets are mail fraud, wire fraud, and interstate transportation and receipt of stolen property with a value of $5,000 or more.[12] Each prohibited activity is defined in the RICO statute as including, as a necessary element, proof of either "a pattern of racketeering activity" or the "collection of an unlawful debt."[13] Of the term "pattern," the statute says that it "requires at least two acts of racketeering activity" within a 10-year period.[14]

Pattern

A "pattern of racketeering activity" is an occurrence of at least two acts of racketeering activity, known as predicate acts and enumerated in the statute, within a period of 10 years.[15] Demonstrating a "pattern of racketeering activity" also requires showing "that the racketeering acts are related and that they amount to or pose a threat of continued criminal activity."[16] "[A]llegations cannot

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constitute a RICO 'pattern' unless they satisfy both the 'relatedness' and 'continuity' tests."[17] However, both tests depend heavily on the specific facts of each case. The test of relatedness is satisfied if the acts at issue "have the same or similar purposes, results, participants, victims, or methods of commissions, or otherwise are interrelated by distinguishing characteristics and are not isolated events."[18] Relatedness among the predicate acts for theft of trade secrets can be shown if the object was to steal the trade secrets for the purpose of using the victim's data for use by a competitor.[19]

In addition to satisfying the relatedness requirement, a RICO plaintiff must also satisfy the continuity requirement. Continuity signifies either a closed period of repeated conduct, i.e., "a series of related predicates extending over a substantial period of time," or "past conduct that *by its nature* projects into the future with a threat of repetition."[20]

Typically, the theft of trade secrets does not remain concealed for a long time; it is generally discovered shortly after it occurs.

Typically, the theft of trade secrets does not remain concealed for a long time; it is generally discovered shortly after it occurs. Accordingly, establishing close-ended continuity—conduct extending over substantial period of time—may not be feasible in the majority of circumstances, and all a RICO plaintiff is left with is to prove open-ended continuity through "past criminal conduct that by its nature projects into the future with a threat of repetition."[21]

In this circumstance, a RICO action for theft of trade secrets can be premised on the ground that the *past* theft poses a *future* threat of continuing criminal activity wherein the defendants will continue to use the stolen trade secrets. An argument can be made that there is a threat of continued activity because the defendants are continuing to use plaintiff's trade secrets. In addition, one can argue that not only did the defendants steal the plaintiff's trade secrets, but also the defendants threaten to commit additional predicate acts through their utilization of the stolen trade secrets.[22]

Open-Ended Continuity: *Gould* and *General Motors*

In *Gould*,[23] the plaintiff alleged that, prior to leaving its employment, its former employee copied and removed proprietary information that included trade secrets involving the manufacture of copper foil. The employee thereafter sold these trade secrets to two different companies who then proceeded to create a joint venture to construct a copper foil plant. The plaintiff brought a RICO claim against the two companies that received the stolen trade secrets from its former employee. In finding that the plaintiff sufficiently alleged a RICO claim, the *Gould* court, relying on the U.S. Supreme Court's decision in *H.J. Inc. v. Northwestern Bell Telephone Co.*,[24] noted that there was a threat of continued activity because the defendants would be continuing to use the plaintiff's trade secrets:[25]

> …there are allegations of a threat of continued activity…This joint venture allegedly will be using Gould trade secrets and, as this joint venture is constructed and operated, there will be an alleged continuing misappropriation of trade secrets that will continue to harm Gould. This certainly qualifies as a threat of continued wrongdoing as defined by H.J., Inc.[26]

Similar rationale prevailed in *General Motors Corp*.[27] General Motors (GM) alleged that its former employees secretly communicated with Volkswagen AG (VW) to leave GM and join VW. The employees agreed to bring confidential business plans and trade secret information with them that included listings of GM components by worldwide suppliers, price, terms, conditions, strategic purchasing models, and delivery schedules. The employees left GM with "20 cartons of stolen documents"[28] and joined VW, where they were paid significantly higher salaries. GM sued its former employees and VW for RICO violations and other claims in a federal court in Michigan. GM alleged that the defendants' actions caused the company enormous damage. Given the fact that GM and VW were the two largest car sellers in Western Europe, VW's alleged use of GM's trade secrets enabled it to "reduce its costs substantially and to increase its market share."[29]

The court agreed with GM's assertion that the allegations of the theft of trade secrets and their *threatened use* by VW were sufficient to allege an open-ended continuity. The court rejected VW's argument that each successive use of a trade secret did not constitute a new predicate act of theft and therefore subsequent use did not serve to continue a RICO scheme:

> When the Supreme Court spoke of the threat of repetition, it was referring to the threat of repeated *victimization*… not merely the retention of the ill-gotten fruits of previous crimes….The

> thief who steals $100 and then spends it a dollar at a time has victimized the owner only once, at the time the theft occurs. But the thief who steals a trade secret victimizes the owner every time the trade secret is used because the owner suffers a new loss with each use of the secret…. Moreover, although the predicate acts constituting the original theft of trade secrets do not threaten to be repeated, a fair and warranted inference to be drawn from the complaint is that the predicate acts of wire fraud, witness tampering, travel to aid racketeering, and transportation of stolen goods threaten to be repeated as the Defendants make use of the stolen trade secrets.[30]

Theft vs. Use: Threat of Future Activity

Not all courts have agreed with the *Gould* and *General Motors* rulings that a threat of continued criminal activity can be inferred from a theft of trade secrets. A federal district court in the Middle District of Pennsylvania refused to follow the rationale laid down in the *Gould* and *General Motors* decisions.[31] The *Minitab* court cleaved the theft of trade secrets from its subsequent use and refused to see the subsequent use of the trade secret as sufficient to establish a continued threat of future activity:

> …[W]e believe that using trade secrets is quite different from the initial act of stealing them. In fact, we believe that the theft of trade secrets necessarily implies that they will be used. Therefore, under plaintiff's theory, every misappropriation of trade secrets could result in a RICO claim. This would surely expand the scope of the statute beyond what it was intended to reach.[32]

The principal flaw in *Minitab*, and certain of the cases upon which it relied, is that it improperly melds the separate acts of theft and subsequent use of the trade secrets into a single act.[33] The theft of an item and its subsequent use and/or possession have been universally recognized as distinct criminal acts, with the theft a precondition for use and/or possession. For example, the Economic Espionage Act makes theft and possession separate crimes. RICO predicate 2314 applies to the theft of data, while 2315 applies to the possession of the stolen data.[34]

While the theft of trade secrets may well be the gravamen of a RICO action, the subsequent use of stolen trade secrets poses a serious risk of repeated victimization. In *General Motors*, GM complained of a continuing threat of injury—that VW continued to use GM's trade secrets "to reduce [VW's] costs substantially and to increase its market share"[35] to GM's detriment. Not only was GM injured when its trade secrets were misappropriated, but also every subsequent use of those trade secrets further victimized GM, because it suffered a new loss with each use.

The *Minitab* court appears to have adopted the oft-cited logic that:

> When a thief steals $100, the law does not hold him to a new theft each time he spends one of those dollars. The same is true of the [trade secrets]…Its subsequent and varied uses…would not constitute new offenses but would go only to the issue of damages.[36]

The court clarified that "if plaintiff's complaint were to allege that defendants would continue to steal plaintiff's trade secrets, as opposed to use those which have already been stolen, then there may well be a threat of continuity."[37] In other words, the court simply saw use of stolen trade secrets as "the retention of the ill-gotten fruits of previous crime."[38] Unless a plaintiff alleged that a defendant would continue to steal the plaintiff's trade secrets, there would be no RICO liability for any subsequent use of stolen trade secrets. This overly simplistic reasoning does not do justice to the novel nature of trade secrets that derive "independent economic value, actual or potential, from not being generally known."[39] The value of a trade secret arises specifically from the fact that it is not generally known. The value is not just the worth of the information itself. By the same token, the benefits derived from a theft of trade secrets are primarily the benefits derived from its *use* and the cost avoided in independently developing such information.

A trade secret is confidential and protected information that is not only crucial to the success of its owner but also beneficial to a rival operating in the same market as its owner. In other words, unlike a thief who continues to spend dollars out of the total $100 that he stole, each successive use of a misappropriated trade secret not only benefits the person who stole it but also damages the aggrieved owner. Use of misappropriated trade secrets has real-world implications.

The principal flaw in *Minitab*, and certain of the cases upon which it relied, is that it improperly melds the separate acts of theft and subsequent use of the trade secrets into a single act.

The theft of trade secrets and other proprietary information that businesses develop after spending fortunes and devoting considerable resources to research and development is not similar to other garden-variety theft. The *General Motors* court hit the nail on the head when, distinguishing the retention of the ill-gotten fruits of a theft from the threat of repeated victimization, it held that "the thief who steals a trade secret victimizes the owner *every time* the trade secret is used because the owner suffers a *new loss* with each use of the secret."[40] The requirement of open-ended scheme was satisfied because VW threatened "to commit predicate acts through their *utilization* of the stolen trade secrets."[41] Every use of GM's trade secrets was a threat "of continued activity because [VW] would be continuing to use [GM's] trade secrets."[42]

[E]ach successive use of a misappropriated trade secret not only benefits the person who stole it but also damages the aggrieved owner.

Stolen trade secrets can be used to penetrate new markets, reduce a competitor's costs, increase a competitor's market share, and do a million different things that would have otherwise required a serious expenditure of resources if done in a legal and legitimate manner.[43] Every use of misappropriated trade secrets continues to harm the victim of the theft. Moreover, although the predicate acts constituting the original theft of trade secrets do not threaten to be repeated, other ancillary predicate acts such as wire fraud, witness tampering,[44] travel to aid racketeering, and transportation of stolen goods threaten to be repeated as the trade secrets are used.[45]

Further, the *Minitab* court's reasoning that "every misappropriation of trade secrets could result in a RICO claim" and therefore would "surely expand the scope of the statute beyond what it was intended to reach," is misplaced.[46] First, the Supreme Court has "repeatedly refused to adopt narrowing constructions of RICO to make it conform to a preconceived notion of what Congress intended to proscribe."[47] Second, the Supreme Court has also held that the fact that RICO may be applied to situations not expressly anticipated by Congress does not demonstrate ambiguity. "It demonstrates breadth."[48]

Also, courts have explained that damages for RICO claims for the theft of trade secrets can be measured by the victim's loss or by the wrongdoer's profits.[49] Further, lost profits are recoverable under RICO as well. This fits in with the reasoning of the *General Motors* court. "Open-ended" continuity occurs where the past conduct projects into the future *by its very nature* with a threat of repetition.[50] Because of the threat of the use of stolen trade secrets, open-ended continuity should be established in these cases.

Conclusion

Given the split in the federal courts, it is essential to check the appropriate circuit law before filing a RICO action predicated on the theft of trade secrets. The *Minitab* opinion and other cases from the Third Circuit essentially foreclose a RICO action unless a plaintiff alleges a closed-ended continuity of predicate acts that have occurred over a substantial period of time. If not, then a plaintiff will have to demonstrate open-ended continuity by alleging that the defendants would continue to steal the plaintiff's trade secrets unless restrained. *General Motors* and other cases from the Sixth Circuit, however, allow a plaintiff to demonstrate open-ended continuity by showing use of stolen trade secrets. A plaintiff need not demonstrate that defendants would continue to steal trade secrets—a tough, if not unrealistic, burden to carry.

Overall, it is crucial in a RICO complaint predicated on the theft of trade secrets to allege in as much factual detail as possible the circumstances demonstrating the theft of trade secrets, continued and/or threatened use of the stolen trade secrets and the resulting victimization, how the theft will lead to the commission of further criminal activity, and the future criminal activity—the predicate acts—as separate and distinct violations.

NOTES

1. David S. Almeling et al., *A Statistical Analysis of Trade Secret Litigation in Federal Courts*, 45 Gonz L Rev 291 (2010).
2. Brian Krebs, *Data Theft Common by Departing Employees*, Wash Post, Feb 26, 2009.
3. *Id.*
4. Melvin I. Urofsky, *RICO, The Oxford Companion To American Law* 706 (Kermit Hall et al eds, 2002).
5. *Sedima SPRL v Imrex Co Inc*, 473 US 479, 498 (1985).
6. Kris Maher, *Firms Use RICO to Fight Union Tactics*, Wall St. J., Dec. 10, 2007, available at http://online.wsj.com/article/SB119725268618018954.html?mod=googlenews_wsj.
7. Nick Akerman, *RICO and Data Thieves*, Nat'l L J 12 (June 9, 2008).
8. *Holmes v Sec Inv Prot Corp*, 503 US 258, 265-68 (1992).
9. *Sedima,* 473 U.S. at 496.
10. *HJ Inc v Nw Bell Tel Co*, 492 US 229, 232 (1989).
11. 18 USC § 1961(1) (1994).
12. 18 USC §§ 1341, 1343, 2314, 2315.

13. *Id*.

14. 18 USC § 1961(5) (1994).

15. *Sedima SPRL v Imrex Co*, 473 US 479, 496 n.14 (1985).

16. *HJ Inc v Nw Bell Tel Co*, 492 U.S. 229, 239 (1989).

17. *Kehr Packages, Inc v Fidelcor*, Inc, 926 F2d 1406, 1412 (3d Cir 1991).

18. *HJ Inc*, 492 US at 240.

19. *General Motors Corp v Ignacio Lopez de Arriortua*, 948 F Supp 670, 677-78 (ED Mich 1996).

20. *HJ Inc*, 492 US at 241 (emphasis added).

21. *United States v Browne*, 505 F3d 1229, 1259 (11th Cir 2007) (citing *HJ Inc*, 492 US at 241).

22. See, e.g., *General Motors Corp*, 948 F Supp at 678 (citing *Gould, Inc v Mitsui Mining & Smelting Co*, 750 F Supp 838 (ND Ohio 1990)).

23. *Gould*, 750 F Supp 838.

24. *HJ Inc*, 492 US 229.

25. *Gould*, 750 F Supp at 842.

26. *Id.*

27. 948 F Supp at 678–79.

28. *Id.* at 674.

29. *General Motors Corp, supra* at 675.

30. *Id.* at 678-679

31. *Binary Semantics Ltd v Minitab Inc*, No. 4:07-CV-1750, 2008 WL 763575, at *4 (MD Pa Mar 20, 2008).

32. *Id.*

33. Nick Akerman, *RICO and Data Thieves*, The National Law Journal, June 9, 2008.

34. *Id*.

35. *General Motors Corp, supra* at 675.

36. *Management Computer Services, Inc v Hawkins, Ash, Baptie & Co*, 883 F2d 48, 51 (7th Cir 1989).

37. *Binary Semantics Ltd, supra*.

38. *Gotham Print, Inc v American Speedy Printing Centers, Inc*, 863 F Supp 447, 460 (ED Mich 1994).

39. Uniform Trade Secrets Act, § 1.

40. *General Motors, supra*, at 679 (emphasis added).

41. *Id*. at 678 (ED Mich, 1996) (emphasis added).

42. *Id.*

43. *Id.* at 675.

44. Witness tampering under 18 USC § 1512 includes misleading conduct with intent to cause a person to withhold testimony or a document as well as alteration of documents. Thus, making false statements regarding whether someone has stolen trade secrets or conducting an internal "investigation" that is designed to mislead investigators or others in investigating a theft of trade secrets constitutes witness tampering. See *General Motors Corp v. Ignacio Lopez de Arriortua*, 948 F Supp 670, 678 (ED Mich, 1996).

45. *General Motors, supra*, at 678; also see *Gould, Inc v Mitsui Mining & Smelting Co*, 750 F Supp 838 (ND Ohio 1990).

46. *Binary Semantics Ltd, supra.*

47. *Bridge v Phoenix Bond & Indemnity Co*, 128 S Ct 2131, 2145 (2008).

48. *Boyle v United States*, 129 S Ct 2237, 2247 (2009) citing *Sedima SPRL v Imrex Co Inc*, 473 US 479, 498 (1985).

49. *General Environmental Science Corp v Horsfall*, 800 F Supp 1497, 1503 (ND Ohio 1992), *aff'd in part, vacated in part on different grounds*, 25 F3d 1048 (6th Cir 1994).

50. *HJ Inc*, *supra* at 242.

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Case Digests

Arbitration—Preemption of State Law Unconscionability Doctrine Regarding Class Relief

AT&T Mobility LLC v Concepcion, 131 S Ct 1740 (2011). A couple purchased the carrier's cellular service, which was advertised as including the provision of free phones. They were not charged for the phones, but they were charged $30.22 in sales tax based on the phones' retail value. The couple filed a complaint against the carrier in district court, which was later consolidated with a putative class action alleging, among other things, that the carrier had engaged in false advertising and fraud by charging sales tax on phones it advertised as free. The carrier moved to compel arbitration under the terms of its contract with the customers. They opposed the motion, contending that the arbitration agreement was unconscionable and unlawfully exculpatory under California law because it disallowed classwide procedures. The district court found that the arbitration provision was unconscionable because the carrier had not shown that bilateral arbitration adequately substituted for the deterrent effects of class actions. The Ninth Circuit affirmed, also finding the provision unconscionable under California law and holding that the state law doctrine was not preempted by the Federal Arbitration Act (FAA).

The U.S. Supreme Court reversed, stating that the overarching purpose of the FAA is to ensure the enforcement of arbitration agreements according to their terms to facilitate streamlined proceedings. Requiring the availability of classwide arbitration interferes with fundamental attributes of arbitration and would create a scheme inconsistent with the FAA. The majority opinion noted several difficulties with classwide arbitration—slower procedures, procedural formality, and risks to defendants—that make it "poorly suited to the higher stakes of class litigation." Although the dissent asserted that class proceedings are necessary to prosecute small-dollar claims that might otherwise slip through the legal system, the majority pointed out the district court's conclusion that the customers in this case would have been better off under their arbitration agreement with the carrier than they would have been as participants in a class action, which could take months, if not years, and which could merely yield an opportunity to submit a claim for recovery of a small percentage of a few dollars.

Securities—Liability of Mutual Fund Investment Adviser under Rule 10b-5

Janus Capital Group, Inc v First Derivative Traders, 180 L Ed 2d 166 (2011). The issue in this case was whether a mutual fund investment adviser may be held liable in a private action under Securities and Exchange Commission (SEC) Rule 10b-5 for false statements included in its client mutual funds' prospectuses. Rule 10b-5 prohibits "mak[ing] any untrue statement of a material fact" in connection with the purchase or sale of securities. 17 CFR 240.10b-5 (2010). Janus Capital Group, Inc. (JCG), is a publicly traded company that created the Janus family of mutual funds. These mutual funds are organized in a Massachusetts business trust, the Janus Investment Fund. Janus Investment Fund retained JCG's wholly owned subsidiary, Janus Capital Management LLC (JCM) to be its investment adviser and administrator. A class of plaintiffs who owned JCG stock filed a complaint asserting claims against JCG and JCM for violations of Rule 10b-5 and § 10(b) of the Securities Exchange Act of 1934, 15 USC 78j(b). The complaint alleged that JCG and JCM "caused mutual fund prospectuses to be issued for Janus mutual funds and made them available to the investing public, which created the misleading impression that [JCG and JCM] would implement measures to curb market timing in the Janus [mutual funds]." The complaint contended that JCG and JCM "materially misled the investing public" and that class members relied "upon the integrity of the market price of [JCG] securities and market information relating to [JCG and JCM]." The complaint also alleged that JCG should be held liable for the acts of JCM as a "controlling person" under 15 USC 78t(a). The district court dismissed the complaint for failure to state a claim, but the Fourth Circuit reversed, holding that plaintiffs had sufficiently alleged that JCG and JCM, by participating in the writing and dissemination of the prospectuses, made the misleading statements contained in those documents.

The U.S. Supreme Court reversed, finding that statements in the Janus Investment Fund prospectuses were made by Janus Investment Fund, not by JCM. Thus, plaintiffs did not state a claim against JCM under Rule 10b-5. For purposes of Rule 10b-5, the maker of a statement is the entity with ultimate authority over the statement, including its content and whether and how to communicate it. Without this control, an entity or person can merely suggest what to say, not "make" a statement in its own right, and one who prepares or publishes a statement on behalf of another is not its maker. Although plaintiffs asserted that an investment adviser should generally be understood to be the maker of statements by its client mutual fund, the court declined to disregard the corporate form in this instance. Plaintiffs persuasively argued that investment advisers exercise significant influence over their client funds, but it was undisputed that the corporate formalities were observed in this case. The court stated that any reapportionment of liability in the securities industry in light of the close relationship between investment advisers and mutual funds is Congress's responsibility and not the courts.

Limited Liability Companies—Piercing the Limited Liability Veil

Florence Cement Co v Vettriano, No 295090, 2011 Mich App LEXIS 804 (May 3, 2011). In July 2006, plaintiff cement company contracted with defendant LLC to perform concrete and asphalt work on defendant's development, which

ultimately was unsuccessful. In establishing the project, defendant obtained a cost estimate and determined that it would need to borrow money to finance the project. On or around September 2003, defendant obtained a bank loan for $700,000. The LLC's members provided unlimited personal guarantees that this loan would be repaid. The members also personally borrowed from the bank and then "loaned" that money to the LLC to invest in the project. There was no promissory note from the LLC to the members. A number of other loans were made by the LLC and the members relating to the project, and defendants were able to pay all of the contractors and subcontractors on the job except for plaintiff. In April 2008, plaintiff began an action against the LLC and its members, alleging, among other things, claims for alter ego, breach of contract, account stated, and fraud.

At trial, plaintiff argued that the LLC had made improper distributions to its members, while insolvent and plaintiff sought to have the LLC's limited liability veil pierced to require that all the distributions made by the LLC while it was insolvent be refunded so that the LLC's obligation to plaintiff could be satisfied. The trial court concluded that there was a distribution that caused the LLC's total assets to be greater than the sum of its total liabilities. The trial court entered a judgment of no cause of action against several parties and judgments in the amount of $19,000 against two of the LLC's members.

The rules regarding piercing the corporate veil are applicable in determining whether to pierce the veil of an LLC. For a court to order an entity's limited liability veil to be pierced, (1) the entity must be a mere instrumentality of another individual or entity, (2) the entity must have been used to commit a wrong or fraud, and (3) there must have been an unjust injury or loss to the plaintiff. Because defendants in this case treated their own liabilities as the LLC's liabilities and vice versa, intentionally undercapitalized the LLC, causing it to be continuously insolvent, including at the time it contracted with plaintiff, and because a member of the LLC falsified a sworn statement in the final loan draw request, plaintiff satisfied all the elements for piercing the limited liability veil of the LLC. In addition, two members of the LLC were jointly and severally liable under MCL 450.4308 for distributions taken while the LLC was insolvent. However, this provision does not provide relief to an LLC's creditor, so the judgment was modified to order the LLC's members to refund the unlawful distributions to the LLC so that it could satisfy its obligation to plaintiff.

Sale of Goods—Statute of Limitations

Fisher Sand & Gravel Co v Neal A Sweebe, Inc, No 297156, 2011 Mich App LEXIS 1019 (June 7, 2011). Plaintiff provided concrete supplies to defendant from October 1991 through October 2004. Plaintiff periodically invoiced defendant for the goods, and defendant periodically made payments toward the accrued balance. On May 9, 2005, defendant received a delivery of goods for which plaintiff issued an invoice for $152.98. On May 13, 2005, defendant made a payment of $152.98, which was the last time that defendant made any payment to plaintiff. Plaintiff filed an action on August 13, 2009, alleging breach of contract, account stated, and unjust enrichment, and that defendant owed a remaining balance of $92,968.57 (including $3,718.32 in finance charges) as of June 30, 2009. On October 29, 2009, plaintiff filed an amended complaint that added a claim entitled "amount owed on open account." Defendant moved for summary disposition on the ground that plaintiff's action was barred by the four-year limitations period in UCC 2-725, MCL 440.2725. Plaintiff contended that defendant's obligation to pay an open account was an obligation that was distinct from the underlying contract for the sale of goods and, accordingly, its action was instead governed by the general six-year limitations period applicable to contract actions, MCL 600.5807(8). The parties also disputed whether defendant's May 13, 2005, payment was a payment on the open account, or a payment for a distinct transaction that was not part of the open account.

The trial court agreed with defendant that because the parties' open account related to the sale of goods, plaintiff's action was governed by the UCC's four-year limitations period rather than the six-year limitations period applicable to contract actions generally and, accordingly, granted defendant's motion.

The court of appeals did not find any Michigan caselaw that specifically addressed whether payment on an open account that relates to the sale of goods is subject to the four-year limitations period in the UCC. The court noted that the official comment to UCC 2-725 was in favor of applying the four-year limitations period to promote uniformity and consistency and that other jurisdictions that have addressed this question have favored applying the UCC limitations period to an action based on an open account related to the sale of goods. Thus, the court of appeals ruled that the trial court did not err in concluding that this action was subject to the UCC's four-year limitations period. Because it was undisputed that plaintiff's action was filed more than four years after the date of defendant's last payment on the account, the trial court properly determined that defendant was entitled to summary disposition pursuant to MCR 2.116(C)(7).

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Council Meetings

DATE	TIME	LOCATION
September 13, 2011*	3:00 p.m.	Sheraton Detroit, Novi
December 3, 2011	10:00 a.m.	Butzel Long, Bloomfield Hills

*Annual Meeting