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

As part of our commitment to provide you with substantive information of importance to the business law practitioner, we are very proud of this issue of the Michigan Business Law Journal. In it you will find a host of extremely timely and well written articles and columns. We are grateful for the dedication of the authors, and for the continued top level work of Robert Wilson, our Section’s Director of Publications, and our partner in the publication, ICLE. This is indeed a Journal that our Section can be proud of.

Another of our commitments is to work to enhance the opportunity for as many people as possible to become active in the Business Law Section. This Journal includes a very good introduction to our Section written by Tim Damschroder (Chair-Elect), which I commend to each of you.

Lastly, please do not forget to mark your calendars for this year’s Mid-Year Meeting to be held at the Grand Traverse Resort on May 17-18. This year’s program promises to be among our best ever.

Respectfully,

Tracy T. Larsen
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DID YOU KNOW? by G. Ann Baker

Corporations Providing Professional Services

Corporate Practice of Medicine
Each year, the Corporation Division, Bureau of Commercial Services, mails preprinted bar-coded annual report forms to active corporations several weeks before the May 15 due date. This year notices included in the mailing remind corporations that profit corporations may only provide services in a learned profession if the corporation is formed under the Professional Service Corporation Act (PSCA).1 The Bureau also includes these notices because it appears that some corporations that were formed under the Business Corporation Act2 that should have been formed under the PSCA. Attorney General Opinion No. 6592 states that a corporation formed under the Business Corporation Act may not engage in activities that may only be performed by one of the learned professions.3

When the proposed name or assumed name of a profit corporation or limited liability company indicates or implies that the entity may engage in activities within one of the learned professions, the entity is required to select another name. Public Acts 273, 276, and 277 of 2001, providing more flexibility for names of entities owning nursing homes, were signed by Governor Engler on December 31, 2001 with immediate effect. Public Act 273 amends section 21712 of the Public Health Code to permit nursing homes to use health center, health care center, or rehabilitation center, or a term conveying a meaning substantially similar to those terms, so long as the name does not conflict with terms prohibited by section 21712. Public Act 276 and Public Act 277 amend the Business Corporation Act4 and the Michigan Limited Liability Company Act5 to permit profit corporations and limited liability companies licensed as nursing homes to use health center, health care center, or rehabilitation center in their names.

Professional Medical Pairings
Professions included within the Public Health Code6 may form a professional corporation to provide more than one service if all of the shareholders are licensed or legally authorized to render the same professional service.7 Public Act 139 of 1997 amended section 4(3) of the PSCA to specifically provide that “one or more physicians and surgeons licensed under the public health code . . . may organize a professional corporation under this act with 1 or more physicians and surgeons licensed under different provisions of the public health code.”8 The amendment permits logical pairings of podiatrists, medical doctors and osteopaths and adopts the position the agency had taken in Release 94-1a-C.9 The amendment does not, however, address pairings of other professionals who might wish to form a professional service corporation.

The Public Health Code, court cases and Attorney General’s Opinions may be helpful in evaluating pairings of other professionals. For example, construing provisions of the Insurance Code of 195610 the Attorney General stated, “clearly, chiropractors may only diagnose and treat spinal subluxations or misalignments. A chiropractor, unlike allopathic and osteopathic physicians, may not perform comprehensive medical examinations, perform surgery or dispense prescription drugs.” The Attorney General concluded, “because of differences in knowledge, skill, training, approach and professional responsibility, the services rendered are not the same.”11

Formation of Nonprofit Corporations by Cities
Generally, public bodies are not permitted to form private corporations unless specifically provided for by statute.12 In 1998 the Home Rule City Act13 was amended to allow a city to provide in its charter that the city, or one or more of its public corporations, could become a member or joint owner in an enterprise with a private nonprofit corporation that would “establish, operate, or maintain a medical facility for a public purpose.”14 Public Act 37 of 2001 further amended the Home Rule City Act to provide that the “legislative body of a city may by ordinance or resolution authorize the formation of a nonprofit corporation . . . for purposes that are valid public purposes for cities in this state.”15 Public Act 38 of 2001 amended the Open Meetings Act to include within the definition of “public body” a nonprofit corporation formed by a city under the new provision and any meeting of the corporation’s board within the definition of “meeting.”16

Statutes Regarding Professional Guardians
A nonbanking corporation is not permitted to act as a fiduciary in Michigan unless authorized to do so by statute.17 Public Act 463 of 2000, effective June 1, 2001, amended the Estates and Protected Individuals Code18 to provide for professional guardians and professional conservators and to permit a corporation to be a professional guardian or a professional conservator. Previously only nonprofit corporations were permitted to be appointed as guardians. New subsection (7) of section 5106 describes the limitations on the fiduciary’s authority “if the court appoints a for-profit, or nonprofit, nonbanking corporation organized under the laws of this state” and the applicability of section 1105(2)(e) of the banking code of 1999.19
Cyber Court Created

Michigan Cyber Court was enacted effective October 1, 2002, by 2001 PA 262. This legislation was the subject of an article in the last issue of the Michigan Business Law Journal.\(^{21}\)

NOTES

1. MCL 450.221-450.235.
2. MCL 450.1101-450.2099.
4. MCL 333.21712.
5. MCL 450.1213.
6. MCL 450.4204a.
7. MCL 333.1101-333.25211.
8. MCL 450.224(3).
9. MCL 450.224.
10. Release 94-1a-C provides that since doctors of medicine, osteopaths and podiatrists may be denoted as "physicians and surgeons," surgeons and physicians possessing any of those specific licenses "may be shareholders in a professional service corporation where the professional services are to be rendered by physicians and surgeons."
11. MCL 500.100-500.8302.
15. MCL 117.4n..
16. MCL 117.4o.
17. MCL 15.262.
18. MCL 487.11105.
19. MCL 700.1106 et seq.
20. MCL 700.5106.

G. Ann Baker is director of the Corporation Division of the Bureau of Commercial Services, Department of Consumer and Industry Services. As a member of the State Bar’s Business Law Section, she serves on the Section’s Council, as its secretary and its director of legislation.
Prodigious Tax
Triumph for Small Business

Introduction
The 2001 Tax Act, the largest tax cut in history, gave 99% of the benefit to individuals. Business was virtually shut out. Small business owners benefited indirectly because of the individual income tax relief. On December 10, 2001, the Administration gave small businesses a truly meaningful tax victory in the form of Notice 2001-76. The IRS graciously stated that it would issue a revenue procedure generally allowing businesses with less than $10M cash receipts to use the cash method of accounting. While the topic of cash versus accrual accounting methods may seem archaic, the tax implications typically represent large dollars. As the recent Enron scandal illustrates, differing accounting methods can produce enormous dollar swings. Commissioner Rosetti estimates that at least 500,000 small businesses can benefit under Notice 2001-76.

Cash Versus Accrual
A simple example illustrates the impact of cash versus accrual methods of accounting. A firm performs legal services in November 2001, bills in December, and receives payment in January 2002. Since the law practice is undoubtedly on a cash basis of accounting, and we are assuming a calendar year for tax purposes, the firm would not record the income until 2002 upon receipt of the fees. In 2001, the firm deducts salaries and a myriad of other expenses incurred in delivering the services. Special rules generally allow professional practices to employ the cash basis. By contrast, if the law firm was on the accrual basis, then it would have also accrued the income in 2001. That timing difference, built up over many years, even for a $5M annual sales business, typically represents 2 months or more of gross revenue. To include an extra 2, 3, or 4 months of gross revenue into income for one tax year would be catastrophic to a business.

Commissioner Rosetti estimates that at least 500,000 small businesses can benefit under Notice 2001-76.

An audit game between the Internal Revenue Service (IRS) and small taxpayers has been going on for decades. Internal Revenue Code (IRC) §471 grants the IRS tremendous discretion regarding a taxpayer’s method of accounting. If inventories are a material income producing factor, then the accrual method is mandatory. In Rev Proc 2000-22, modified in Rev Proc 2001-10, an exception was made for businesses with less than $1M in annual receipts.

Businesses that provide services and tangible products have perennial difficulties in the Tax Court. Two examples illustrate contentious areas: Are inventories material, thus requiring an accrual basis of accounting, use the cash receipts and disbursement method of accounting” subject to certain restrictions.

Qualifying Small Businesses
The first restriction is based on the annual sales of the taxpayer. The average gross receipts over the last three years must be less than $10M. If the company’s gross receipts for the last three years were $7M, $8M and $11M, the average is less than $10M, and that business would thus pass the receipts test. The second filter of qualifying small business taxpayer is based upon the taxpayer’s “principal business activity.” If a taxpayer’s principal business activity is mining, manufacturing, wholesale, retail, or certain information industries, then it cannot qualify. The key is the “principal” business activity. For example, if a plumbing contractor derives 60% of its revenue from installing plumbing fixtures in customers’ homes and businesses and 40% from retail sales through a store, it could qualify because its principal business activity is the service and not retail. Incidental service will not transform an otherwise disqualified taxpayer into one satisfying the Notice’s requirements. For example, if a taxpayer sells refrigerators but the sale includes delivery and installation, the taxpayer is deemed to be involved in a retail business despite providing delivery and installation services. There is also an exception for manufacturers if the manufacturing represents “the fabrication or modification of tangible personal property upon demand in accordance with customer design or specifications.” The end of §6 of the Notice contains 10 very helpful examples.

Mechanics
Notice 2001-76 permits an automatic change in accounting methods with most but not all of the requisite IRS Form 3115 being completed. The mechanics of changing accounting methods are set forth in §7. As a practical matter, an “automatic change” is extremely important as it does not require the lengthy time period, expense and uncertainty of a discre-
tionary change of accounting that the IRS must individually approve.

Overall, this is an extremely pro-taxpayer change. The pronouncement allows taxpayers whose returns are under examination, or under review in the Appeals Division, and who can otherwise qualify under the Notice, to elect the cash method of accounting. This will undoubtably bail out thousands of small businesses currently contesting the method-of-accounting issue with the IRS.

Effective Date

The Notice's stated effective date is for tax years ending on or after December 31, 2001. Thus, all of the C corporations, S corporations, and limited liability companies on a calendar year that otherwise qualify can benefit from the cash method for the 2001 year. There is also a very generous statement in §9: “the IRS will not challenge a taxpayer’s use of the cash method under §446, or a taxpayer’s failure to account for inventories under §471, for a trade or business in an earlier year if the taxpayer, for that year, was a qualifying small business taxpayer.”

Conclusion

Counsel should raise this issue with any small business client and with the accountant unless counsel is certain that they are on the cash basis already. There are tens of thousands of small businesses that are reporting income on the cash basis, and the accountant or tax counsel, if pressed, would concede that the taxpayer has significant exposure. Such enterprises in particular should ascertain whether or not they qualify under this new guidance. If not, they should consider what might need to be done to qualify.

The guidance consumes 11 pages of single-spaced type and contains many details that are beyond the scope of this article. Every practitioner with a client who may benefit from this pronouncement should carefully review Notice 2001-76.
What’s Hot in Technology Law

Information technology is a critical part of business, and electronic commerce affects the way many entities do business. Changes in the legal infrastructure have accommodated many of these technological changes, but others still provide challenges to the business lawyer.

This is the first in a series of columns that addresses this legal infrastructure. This article will be a summary of current developments. Future articles will provide in-depth analysis of current events.

Electronic Contracting

The “problem” of electronic contracting has existed since businesses started communicating electronically in the eighties. How does one effectively do deals in an environment where the closing means the physical execution of paper documents? The use of trading partner agreements to support electronic data interchange transactions was workable among significant trading partners that regularly had interactions. The use of the signed trading partner agreement established the “writing” often required under applicable law, such as the Uniform Commercial Code, but the use of trading partner agreements for widespread electronic transactions was certainly not conducive to the business model. In fact, most businesses began using “click” agreements long before the law supported the use of this mechanism.

Changes to the legal infrastructure that have laid the groundwork for electronic contracting began in the nineties. One of the first steps was to eliminate the concept of a writing; the UCC has, for several years, used the term record instead of writing in all revisions to the UCC. Record assumes that the embodiment (the “evidence”) may be electronic.

The next step was to facilitate an environment where electronic contracts could be made enforceable. That step came with the Uniform Electronic Transactions Act (UETA). One of the projects undertaken by the National Conference of Commissioners on Uniform State Laws (NCCUSL) and The American Law Institute resulted in the promulgation of UETA in 1999. The purpose of UETA was to provide a legal framework to permit electronic commerce to proceed on a substantially uniform legal basis nationwide. It has been enacted in at least 37 states, including Michigan. UETA was also pushed along when several states, starting with Utah in 1994, began enacting inconsistent legislation that enabled electronic contracting.

In early 2000, the federal government also acted, largely in response to urging by the high tech and financial services industries concerned by the amount of time before UETA could be truly adopted nationwide. On June 30, 2000, President Clinton signed the Electronic Signatures in Global and National Commerce Act (E-Sign). E-Sign was designed to reduce the uncertainty surrounding the use of electronic media in transactions and permits more businesses to realize the cost savings possible with electronic commerce. E-Sign closely parallels UETA, although there are some differences, and commentators have noted that there still are good reasons to pass UETA.

Some provisions in E-Sign that are not in UETA address consumer consent and federal preemption. Significant concepts of UETA omitted from E-Sign govern attribution of electronic signatures, the time when messages are deemed sent or received, mistakes in electronic contracting, admissibility of electronic records as evidence, electronic documents of title or promissory notes not secured by real property, and the manner in which paper processes will be converted to electronic by state governments. These are some of the core provisions of E-Sign:

- Neither a signature nor a writing may be denied legal effect solely because it is in electronic form.
- A contract may not be denied legal effect solely because an electronic signature or record was used in its formation.
- An electronic record may be denied legal effect, validity or enforceability if it is not in a form capable of being retained and accurately reproduced by all persons (if any) who are entitled to retain it.
- E-Sign specifies that it does not modify laws other than requirements that contracts or other records be written, signed or in non-electronic form, and it expressly provides that it does not affect requirements regarding the proximity with which warnings, notices or disclosures must be displayed.

Privacy

In a world where information about individuals and businesses has become easily accessible, the use of personal information has become a big business, and identity theft has become commonplace, issues of privacy have taken on enhanced importance.

In the United States, individual states have undertaken efforts under the Consumer Protection Act to prevent unfair and deceptive trade, and Michigan’s Attorney General has established task forces to protect individuals. At the federal level, however, the Federal Trade Commission has taken the lead. The FTC, under its general rule-making authority and enforcement power, can try to limit unfair practices. Government oversight and regulations have been very limited, however, and the current administration sees no reason to change. Specific legislation such as Gramm-Leach-Bliley and the Health Insurance Portability and Accountability Act (HIPAA) regulated individual aspects of customer privacy in the financial services and health care areas, but there has been no overall effort to regulate data privacy in the United States.

The opposite has taken place in Europe. The European Union issued a directive that is applicable to all EU member states. The EU Directive on Data Protection entered into effect in 1998 with the intention of restricting the collection, processing and dissemination of personal information collected from residents of EU Member States. Personal data may be collected, but only for legitimate purposes, and it cannot be used in a manner incompatible with the intended purpose. This purpose and the data processing required to fulfill the purpose will be considered legitimate if the consumer unambiguously consents to data collection, or if the data processing is necessary to the performance of the contract or the successful accomplishment of a task requested by the consumer.

In addition to restricting data collection, the Data Privacy Directive
also restricts transfer of data. Personal data may not be transferred from the EU to countries that the EU deems to have inadequate data protection laws. The United States is considered to be one such country offering inadequate protection, though some transmission is possible thanks to the Department of Commerce’s success in negotiating the Safe Harbor Principles approved by the EU in 2000 for companies that adopt the safe harbor.

US/EU Safe Harbor Agreement
The Safe Harbor Principles allow United States companies to receive data from the EU if the companies satisfy requirements intended to guarantee adequate data protection. If a United States company adopts the Safe Harbor, it must:
• notify consumers why personal information will be collected and used;
• give consumers the choice to opt out of permitting disclosure of personal information to third parties or use for incompatible purposes (for sensitive information, the consumer must be allowed to opt in to disclosure or use);
• give consumers both notice and choice before any information is disclosed to third parties;
• allow consumers access to personal information and the ability to correct mistakes with it;
• take reasonable security precautions to protect personal information from misuse or access;
• ensure data integrity and reliability for its intended use; and
• provide available and affordable mechanisms to enforce compliance, verify the company’s commitment, and remedy problems stemming from failure to comply with Safe Harbor principles.

Persistent failure to meet these seven requirements will cause a Safe Harbor certified United States company to lose its ability to receive data from the EU, at least from the perspective of the EU.

Companies can enjoy the Safe Harbor benefits by self-certifying annually to the Department of Commerce with a written statement that the company agrees to adhere to the Safe Harbor requirements. A statement to the same effect must be added to the company’s published privacy policy as well. United States sellers who wish to become self-certified can qualify for Safe Harbor status by either joining a self-regulatory privacy program that is EU compliant or by developing self-regulatory privacy policies that conform to EU standards. In general, enforcement of the Safe Harbor requirements will take place within the United States, using United States law, and will be carried out in the private sector.

Domain Name Disputes
The Anticybersquatting Consumer Protection Act (ACPA) at 15 USC 1125 created a cause of action against anyone who has “bad faith intent to profit” from another’s trademark, registries, traffic in, or uses a domain name that is identical, confusingly similar, or dilutive of that trademark. “Bad faith intent to profit” is determined by a number of nonexclusive factors listed in the ACPA, including:
• whether the defendant has trademark or other intellectual property rights in the domain name;
• the extent to which the domain name consists of the legal name or names by which the defendant is known;
• the defendant’s prior use, if any, of the domain name in connection with the bona fide offering of goods and services;
• the defendant’s bona fide noncommercial or fair use of the mark; and
• the defendant’s intent to divert consumers from the plaintiff’s web site in a manner that could harm the plaintiff’s mark, either for commercial gain or with intent to damage the mark by creating a likelihood of confusion.

A person using a domain name that meets the criteria can be found liable for damages under the ACPA. If a plaintiff is successful under the ACPA, then the plaintiff may obtain either actual damages or statutory damages ranging from $1,000 to $100,000. In some cases the plaintiff may also be entitled to attorneys’ fees and costs. Additionally, the court may order the transfer, forfeiture or cancellation of the infringing domain name.

The Internet Corporation for Assigned Names and Numbers (ICANN) created the Uniform Domain Name Dispute Resolution Policy (UDRP). All registrars of dot-com top-level domain names follow the rules of the UDRP. According to the UDRP, registrars may only cancel, suspend or transfer a contested domain name after the dispute has been resolved by agreement, court action or arbitration. Disputes alleged to arise from abusive registrations of domain names may be addressed by expedited administrative proceedings.

To begin the expedited administrative proceedings, a trademark owner submits a complaint to an approved dispute resolution service provider. The following conditions can support a UDRP complaint:
• The registrant’s domain name is identical or confusingly similar to a trademark or servicemark in which the complainant has rights.
• The registrant has no rights or legitimate interest with respect to the domain name.
• The registrant’s domain name has been registered and is being used in “bad faith.”

For purposes of showing registration and use in “bad faith,” the UDRP will consider, among other factors, whether the user of the domain name intended to attract, for commercial gain, users to its Web site by creating a likelihood of confusion with respect to the trademark. There is no cause of action for misuse of a trademarked logo under the UDRP. While actions taken solely under the UDRP should be less expensive and timely, the UDRP does not permit the trademark holder to obtain a monetary judgment.

Look to future issues for in-depth discussions of these and other technology law topics.

NOTES
2. MCL 450.831 et seq.
3. 15 USC 7001 et seq.
4. The consumer provisions in E-Sign vary this provision. Note that, in the practical world, Revised Article 3, MCL 450.1105 et seq., has contemplated a situation where electronic transactions of every kind may be the norm.
8. See Hudson and Huget, New Internet Domains Require Revisiting Domain Name Strategy, 21 MI Bus Law J, 48 (Fall 2001) for further discussion of this subject.

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An Introduction to the Business Law Section

Introduction
It is simple to become an active member of the Business Law Section of the State Bar of Michigan. The Section is funded and operated entirely by its members. As is true with many volunteer organizations, the time and effort put into the Section by its officers, council members, committee chairs and other active members directly correlates with the viability of the Section and its worth to all the Section’s members.

The Business Law Section was formed in 1965, and currently has over 3,500 members, making it the second largest elective section of the Michigan State Bar. It functions under the mission statement printed on the inside cover of this journal.

Section Leadership
The Section’s council governs general supervision and control of the affairs of the Section. One third of the council members are elected to serve a three-year term at each annual Section meeting (held in conjunction with the annual meeting of the State Bar of Michigan). The council also includes all past chairpersons of the Section. There are currently 14 elected council members (their names appear on page 2 of the Journal). The council meets several times a year and those meetings are open to all Section members. Persons are usually elected to the Section’s council after they have spent some time assisting with Section activities.

The Section’s executive committee consists of the Section’s chairperson, vice-chairperson, secretary and treasurer, and is elected by the Section’s council at the first yearly meeting of the council (held immediately following each annual Section meeting). Each officer position has a one-year term. Typically, to promote continuity among Section leadership, persons serve on the executive committee for four years, beginning as the treasurer, and moving on to the secretary, vice-chairperson, and then chairperson.

In addition to the council and the executive committee, the Business Law Section has committees and directorships (listed on pages 3 and 4 of the Journal). The primary functions of the Section are completed through committees. Accordingly, one of the best ways to become involved in the Business Law Section is to contact the chair or co-chair of a committee that covers one or more areas that interest you. The work and activities of the committees vary. In general, committees do one or more of the following: draft new legislation, assist the Michigan Legislature with legislation concerning business law issues, hold meetings and/or forums on topics of interest, organize and hold seminars, circulate information of interest to committee members, and the like. Committee chairs welcome your participation and ideas for future committee activities. Please contact a committee chair if you are interested in participating.

Current Activities

Mid-Year Meetings
The Section is currently involved in a wide variety of activities. As you may know, the Section’s biggest event of each year is the mid-year meeting held in Traverse City each May. This year, the meeting is scheduled for May 17-18, at the Grand Traverse Resort. Section members have received a meeting brochure from the Institute of Continuing Legal Education. The mid-year meeting provides lots of opportunities to meet other Section members and to discuss pertinent business law issues. There are plenty of opportunities for speakers and assistance with planning for future mid-year meetings.

Writing for the Journal
The Michigan Business Law Journal provides a great opportunity to publish articles. If you have had to research a business law issue recently, chances are other Section members would benefit from that research. If you have written a memorandum or brief on the topic, then consider converting that into an article for the Michigan Business Law Journal. Please contact Robert T. Wilson, the Publications Director, or Daniel D. Kopka, Senior Publications Attorney with the Institute of Continuing Legal Education, if you are interested in submitting an article for the Michigan Business Law Journal (for contact information, see inside cover page of the Journal).

Michigan Courts and Legislation
The Section has formed an Ad Hoc Committee to study whether the State of Michigan should have a business court. The Ad Hoc Committee is chaired by Diane L. Akers, chairperson of the Commercial Litigation Committee of the Business Law Section (contact information is on page 3 of this publication). Through a Section-wide e-mail sent by Ms. Akers, over 160 attorneys have expressed an interest in joining the Ad Hoc Committee. We look forward to the committee’s recommendations and results. Please contact Ms. Akers if you would like to participate.

Several committees are responsible for keeping track of current Michigan legislation, commenting on proposed legislation, and drafting general statutory amendments:


Please contact the appropriate committee chair if you would like to assist with any of these legislative activities, or if you have any recommendations for any legislative changes. These committees present a wonderful opportunity for members of the Business Law Section to impact the legislation that affects their business and their clients.

Scholarship Program
The council would like to establish a scholarship award program that would give annual awards to students attending Michigan’s law
schools for producing the best articles on business law topics. Please contact David Foltyn, the Section's treasurer, if you are interested in assisting in this effort (see contact information on page 2 of the Journal).

**Conclusion**
The Section has many other activities and projects which need the help of Section members. Please contact Timothy R. Damschroder, Section Development Director, if you have any ideas or comments on what the Section is, or should be, doing, or if you want to participate in any of the activities outlined in this article.

See you at the mid-year meeting.

Timothy Damschroder practices business and tax law at the Ann Arbor office of Bodman, Longley & Dahling LLP. He specializes in hi-tech companies from start up, to venture capital financing, to eventual sale or IPO. Mr. Damschroder is the current vice-chair of the Business Law Section.
Some Planning Ideas To Help Resolve Deadlocks In Closely Held Corporations

by Michael K. Molitor

Introduction
Small businesses with only a few shareholders make up the bulk of the typical business lawyer’s practice. While publicly held companies obviously generate a great deal of legal work, closely held companies greatly outnumber them.

When a company is owned equally by two shareholders or two groups of shareholders, there is always the possibility of conflict and deadlock. This article examines some of the issues that arise from that all-too-common phenomenon. Although conflict and deadlock between the shareholders of a closely held corporation cannot be entirely avoided, this article suggests some steps that company counsel can take to potentially avoid deadlock in the first place or to help provide for an orderly resolution if a deadlock does arise.1

What is Deadlock?
As used in this article, deadlock means the situation where two 50% shareholders (who will likely also be the directors) or groups of shareholders of a corporation are unable to agree on important decisions concerning the corporation’s business. Some have described deadlock as a corporate paralysis to such a degree that a corporation cannot function and faces imminent disaster as a result.2

How Does Deadlock Arise?
The ways in which shareholder conflict can result in deadlock are limited only by the personalities of those involved. In some cases, it might be a dispute between two equal shareholders and in others it might be a dispute between two families or groups. For example, siblings could fight for control of the business after inheriting it from their parents; incompatible owners could vie to determine the direction of the business; philosophical differences in management could disrupt an arrangement that was once harmonious; or one industrious shareholder could resent the fact that the other owner does not work as hard. The closely held business can truly be a soap opera.

What Are the Consequences of Deadlock?
The consequences of deadlock can be very serious. Despite the obvious effects on the company itself (such as the distraction of management, employee unease, declines in the quality of customer and supplier relationships, missed opportunities, etc.), deadlock can result in the attempted “freeze out” of one of the shareholders, the straining of family relationships and friendships and harmful emotional effects. While the potential harm of deadlock often will motivate the owners to find a mutually acceptable solution (even if they have to compromise), sometimes they still won’t be able to find common ground. Without prompt action, a company mired in deadlock can quickly run into deep trouble.

Unplanned Solutions to Deadlock
Informal Solutions
Deadlock, of course, can often be solved even if no advance planning has been done. For example, it might be resolved amicably by having one shareholder buy out the other shareholder or by having the corporation redeem one shareholder’s shares; by dividing the business; by selling the business to a third party; or, if the two shareholders are able to agree, by selecting an independent board of directors or an arbitrator. Also, one shareholder could decide to subordinate his views to the other shareholder and simply “live with it.” An unhappy shareholder could also end his daily involvement with the business but continue to own shares in the company, although he may receive little or no current return on his investment if he is no longer an employee. An “independent director”3 could be added to the board. Professional counselors, directors with personal relationships with both parties, and others could identify and define an emerging problem and suggest how to resolve it.

Dissolution under the Michigan Business Corporation Act
If no advance planning has been done, the Michigan Business Corporation Act
(MBCA)\(^4\) offers few options to the shareholders of a deadlocked corporation. In fact, seeking a voluntary or court-ordered dissolution of the company may be the only meaningful remedy.\(^5\)

Under Section 804 of the MBCA, a corporation can be dissolved by the board and the shareholders. The board must propose dissolution and, except in limited circumstances, recommend the dissolution to the shareholders. The shareholders must approve the dissolution by a majority vote, unless the corporation’s articles require a greater percentage. As a result, dissolution under Section 804 will require cooperation among the joint owners of the closely held corporation.

Where this cooperation is not present, a director or shareholder can also seek dissolution by court order. Section 823 of the MBCA permits a circuit court to dissolve a corporation upon proof of the following:

(a) The directors of the corporation, or its shareholders . . . are unable to agree by the requisite vote on material matters respecting management of the corporation’s affairs, or the shareholders of the corporation are so divided in voting power that they have failed to elect successors to any director whose term has expired or would have expired upon the election and qualification of his or her successor.

(b) As a result of a condition stated in subdivision (a), the corporation is unable to function effectively in the best interest of its creditors and shareholders.\(^6\)

Section 823 does not require that an action for dissolution be brought by the holders of some minimum percentage of the shares. Thus, Section 823 permits dissolution at the request of a single shareholder, based on the best interests of shareholders and creditors, even if the corporation is operating profitably.

**Judicial Solutions**

Before Section 823 was added to the MBCA effective January 1, 1973, Michigan courts had developed a common law right of dissolution for deadlocked shareholders. This common law right, which was developed through a series of cases,\(^7\) culminated in the 1957 case of Le Vant v Kowal,\(^8\) in which the Michigan Supreme Court found that courts have the equitable power to dissolve a corporation even in the absence of an abuse of trust, fraud or misappropriation of corporate funds. As the court noted, a careful review of the cases . . . reveal[s] that when the stockholders of a corporation become so engrossed in their personal enmities that they will not speak to each other, that they refuse to cooperate in the management of the business, and ignore the statutory requirements for doing business in the corporate form, such dissension rarely, if ever, stands alone. It is usually accompanied by circumstances of financial loss, corporate paralysis, mismanagement, and deterioration of property, all of which we have here.\(^9\)

The Michigan Supreme Court affirmed the lower court’s order to dissolve the corporation.

**Planning Ahead**

Given the limited remedies under the MBCA and the common law in Michigan for the deadlocked shareholder, as well as the disastrous results that can follow from deadlock, it becomes clear that advance planning holds the key to avoiding many serious problems. Leaving the deadlock solutions discussed above (if indeed some of them can be called solutions) to chance is not a wise idea for most closely held corporations. Instead, a well-crafted plan will help avoid conflicts that may lead to deadlock or resolve conflicts once they arise.

A number of approaches are possible, such as provisions in the corporation’s articles of incorporation or bylaws, or separate agreements among shareholders and the corporation. While it may not be a pleasant topic to think about (much like a prenuptial agreement), one should encourage closely held corporate clients to consider some of the options discussed below early in their existence.

**Some General Issues to Consider**

An agreement among shareholders can head off many of the issues potentially leading to deadlock by simply defining and resolving those issues before they become contentious. Even if the agreement does not dictate the specific outcome, it can provide a procedure to facilitate agreement between the shareholders or to resolve deadlock if the shareholders are unable to agree. For example, the agreement might specify or address the identity of or a procedure to determine the officers and/or directors of the corporation; compensation of employees; dividend policies; restrictions on the transfer of shares; procedures or requirements for issuing additional shares; procedures for the admission of additional shareholders; problems...
arising from death, disability, or termination of employment; and similar matters. Non-employee shareholders may want mandatory dividends based on corporate performance. With matters such as these agreed to in advance, deadlock becomes less likely.

The agreement should also specify what happens if deadlock does in fact occur. For example, it could specify procedures where one shareholder can offer to buy out the other shareholder's equity interest in the corporation, provide that the shareholders can dissolve the corporation if they cannot agree on a price, or provide that the shareholders can agree to look for a third party buyer.

When to Consider Deadlock Issues

It is easiest and simplest to deal with deadlock issues before they arise. At that time, however, the parties often are not anticipating problems and they may feel that to address problems is to ensure that they will occur. (Again, it's much like a prenuptial agreement.) While some clients will pay little attention to the organizational documents and agreements, counsel should seriously attempt to focus them on the issues at the beginning of the relationship. Otherwise, the issues might not be addressed until it's too late.

Vehicles for Addressing Deadlock Issues

The MBCA provides counsel with a fair number of alternatives for planning deadlock resolution mechanisms, including provisions in the corporation's articles of incorporation or bylaws, voting or other agreements, or the relatively new phenomenon of "Section 488 agreements."

Articles and Bylaws

The corporation's articles of incorporation are often a suitable place for setting forth agreements or arrangements between shareholders. The articles may contain any provision that is not inconsistent with the MBCA, including provisions for the "management of the business and the conduct of the affairs of the corporation or creating, defining, limiting, or regulating the powers of the corporation, its directors and shareholders, or a class of shareholders." The bylaws may also be a suitable place to set forth agreements among shareholders. The MBCA allows bylaws to contain any provisions "for the regulation and management of the affairs of the corporation not inconsistent with law or the articles of incorporation."

A provision in the articles of incorporation is somewhat more "permanent" than a bylaw provision because the articles may be amended only by a shareholder vote. In contrast, bylaws typically provide for amendment by either the board of directors or the shareholders, although the bylaws (or the articles) may provide that the bylaws, or any provision of the bylaws, may be amended only by the shareholders. Provisions in the articles of incorporation also become a matter of public record because the articles are filed with the state. This makes the restrictions or requirements readily available to all interested parties, but may disclose more information than the parties want. One option may be to address these matters in the bylaws so that they are not publicly available, but provide in the articles or bylaws that the bylaws may only be amended by the shareholders.

Voting Agreements and Voting Trusts

Section 461 of the MBCA specifically authorizes a voting agreement among two or more of a corporation's shareholders requiring that shares be "voted as provided in the agreement," as the shareholders may agree, or as determined under a procedure that the shareholders have agreed on. While the MBCA does not require that all of the shareholders of a corporation be parties to a voting agreement, it is often advisable to do so. A voting agreement is specifically enforceable.

Voting trusts under Sections 466 and 467 of the MBCA are another alternative. In a voting trust, one or more shareholders can delegate to a trustee the right to vote shares for a period of up to ten years (subject to renewal) by entering into a voting trust agreement, filing a copy of the agreement at the corporation's registered office and transferring shares to the trustee for purposes of the agreement. For various reasons, including the fact that a voting trust is limited to a ten-year duration unless the parties consent to extend it, voting trusts are not very popular.

Section 488 Agreements

Section 488 was added to the MBCA in 1997 and replaced the more limited former Section 463. Section 488 gives effect to an agreement between shareholders that complies with the requirements described below, even if the agreement is inconsistent with the MBCA in that it:

- eliminates the board of directors, or restricts the discretion or powers of the board;
- governs the authorization or making of distributions;
Other Agreements

Shareholders may enter into other agreements relating to their rights, either between themselves or with the corporation. One common example of this is a buy-sell agreement, which typically provides that a shareholder may not transfer his shares without giving the corporation and/or the other shareholders a right of first refusal to purchase the shares, and sets forth procedures for determining the purchase price and the other terms of the purchase. Buy-sell agreements also typically require the corporation or the other shareholders to repurchase a shareholder’s shares in certain situations, such as death or termination of employment. Unless these agreements meet the requirements of Section 488, they must be consistent with the MBCA to be enforceable.

Some Deadlock Resolution Suggestions

After determining the most appropriate vehicles, counsel should consider the following issues as part of the advance planning for the closely held corporate client.

Buy-Sell Provisions

An obvious solution to deadlock is a buyout of one shareholder by the other, or a redemption by the corporation of one shareholder’s shares. This approach will typically end disputes and restore peace where the shareholders must part ways. Also, the mere presence of a buyout mechanism frequently can motivate the parties to resolve their differences, even if the buyout ultimately does not happen. The overall goal in drafting these provisions is to determine when they may be invoked, who will buy the shares, who will sell them, and what a fair price will be.

The initial issue is to determine an appropriate “trigger” for buy-sell provisions. Counsel should consider a mandatory repurchase (either by the corporation or the other shareholder) where one shareholder is no longer working in the business, such as where he dies or incurs a disability or where he voluntarily leaves employment. Other conditions that would trigger a mandatory buyout provision could include deadlock, failure to elect directors for a given period of time, or an inability to agree on material matters. However, these conditions frequently create additional issues. Are the shareholders in fact deadlocked? If they are, is the deadlock having materially adverse effects on the business? On the other hand, not including conditions may make it too easy to trigger a buyout, allowing one party the opportunity to control the timing of a buyout to his strategic advantage. Only careful and thoughtful drafting, after con-

The MBCA provides counsel with a fair number of alternatives for planning deadlock resolution mechanisms, including provisions in the corporation’s articles of incorporation or bylaws, voting or other agreements, or the relatively new phenomenon of “Section 488 agreements.”
There are several types of buyout arrangements to consider, including put options, redeemable stock, or rights to trigger a mutual buyout procedure. A put option gives one shareholder the right to require the corporation (or the other shareholder) to repurchase all of his shares at any time, or in certain circumstances. The exercise of a put option could have a major financial impact on the corporation if it must pay cash to redeem the shares. It may also be restricted or prohibited by Section 345 of the MBCA, depending on the corporation’s financial condition.

“Redeemable” stock may be repurchased by the corporation in whole or in part with a “call,” depending on the terms of the stock. Again, counsel must consider triggering events, timing requirements, and other restrictions. Redeemable stock may solve some deadlock issues, but it may create other problems. Generally, a buy-sell agreement is preferable, because redemption by the corporation (unless automatically triggered by the terms of shares or a related agreement), typically requires action by the corporation, which may not be possible because of deadlock.

A put option and the use of redeemable stock are usually unilateral approaches. Practically, a more interactive buy-sell arrangement often will be easier for the shareholders to agree on and will lead to more satisfactory results. One common approach to a buyout is for one shareholder to state a dollar amount and terms for a purchase. The other shareholder then can elect whether to buy or sell at that price and on those terms. Another common approach is to allow each shareholder to submit a bid, and the highest bidder becomes the buyer. The bidding process can be simplified if the buy-sell arrangement includes all of the terms other than price. The parties may wish to include deferred payment terms (e.g., a promissory note), so as to lessen the advantage that one party’s superior financial resources will give him in the process. A few other suggestions include allowing each party adequate access to corporate operational and financial information, giving one or both parties a right to dissolve the company after the bidding process and giving one or both parties the opportunity to market the company to outside purchasers.

Planned Dissolution Rights

As previously discussed, if one 50% shareholder wants to dissolve the corporation, he must normally seek a court order under Section 823 of the MBCA. One solution to this problem is to allow any shareholder or a shareholder holding a specified percentage of the stock the right to dissolve the corporation in specified situations or upon specified conditions, which can be done pursuant to a Section 488 agreement. A Section 488 agreement may require “dissolution of the corporation at the request of 1 or more of the shareholders or upon the occurrence of a specified event or contingency.” (Of course, what such events or contingencies may be is left to counsel’s imagination.) This is an extreme approach, but might be used as a last resort. Dissolution pursuant to a Section 488 agreement is effected by executing and filing a certificate of dissolution stating that the corporation is dissolved pursuant to a Section 488 agreement.

Additional Directors

Additional directors can play many roles, largely depending on their relationship to the parties and when they join the board. In the best scenario, they arrive before the shareholders’ relations have become too strained and they encourage favorable relationships and bring good advice and perspective to the board and management, all of which helps avoid future deadlock. On the other hand, an additional director or directors may be brought in only to break deadlock long enough so that the business can be sold to a third party or one shareholder can buy out the other. In that case, the environment may be hostile and the additional director may be more of an interim manager than a “traditional” director. A statutory independent director may also be useful in these circumstances.

An additional director will often be brought in when a potentially difficult situation is developing, as the parties recognize the need for greater strength on the board if the business is to prosper. In these situations, each party may select one or more individuals who represent his views but who also bring additional strengths to the board. If the parties strongly desire to head off problems, the new directors may then be allowed to select another director or directors whose independence and skills may assist the parties in reaching a compromise and positively redirect efforts.

The parties can also attempt to improve a bad situation by adding a director who is more a peacemaker than a traditional director. If both parties can agree, they could
jointly select such an individual. Obviously, however, if the matter has reached a point of deadlock, there is little reason to consider this approach.

Arbitration

If dissolution or having one shareholder leave the business are not acceptable remedies, arbitration may provide a way of resolving disputes by engaging neutral third parties to review disputes and render a binding decision resolving disagreements that the shareholders cannot resolve on their own. However, arbitration will not be an effective way to make decisions concerning the corporation's day-to-day business.

In the typical arbitration agreement, the two shareholders agree that, if they cannot agree on some issue, they will submit the disagreement for arbitration and the arbitrators' decision will be binding on all parties. Each shareholder would further agree to vote his shares or resolve the issue as the arbitrators decided. While arbitration is usually quicker and cheaper and results in greater privacy than litigation, it can often result in "splitting the baby" or, in other words, decisions in which neither party really wins or loses (and thus neither party is really satisfied with the outcome).

The first issue that needs to be determined is the scope of the arbitration agreement, i.e., the universe of arbitrable subjects. These may include major issues, such as the removal of officers or directors, salary rates, the valuation of shares where one shareholder is buying out the other, or the dissolution of the corporation. At the other end of the spectrum, the agreement could provide that any dispute is subject to arbitration, although this could result in a very cumbersome and unworkable relationship between the parties. Other arbitration issues that should be considered include triggering events (i.e., what level of disagreement must occur before an issue can go to arbitration), "cooling off" periods before arbitration may begin, the place of the arbitration, who will bear the costs, procedural and evidentiary rules, the means of selecting the arbitrators (one common method is to allow each party to select an arbitrator and then have the two chosen arbitrators designate a third), whether the arbitrators must have certain levels of experience in the company's business or be practicing lawyers, limitations on the arbitrators' authority, and the types of relief that can be granted. It is also advisable to specifically provide that the parties waive their right to pursue judicial dissolution under Section 823 of the MBCA.

The arbitration agreement should be signed by all of the shareholders and, because the arbitrators' decisions will often affect the corporation itself, it is wise to include the corporation as a party to the agreement. Counsel should also consider adding the shareholders' spouses or other family members, especially if they serve as directors or officers of the corporation or may become shareholders through future stock transfers.

While arbitration agreements were not specifically enforceable at common law, Section 5001(2) of the Michigan Revised Judicature Act provides that arbitration agreements are enforceable. However, counsel should be mindful that courts in other states have sometimes refused to enforce arbitration agreements in the close corporation context.

Conclusion

Deadlock is obviously a situation that should be avoided if possible. If it cannot be avoided, then careful advance planning may help lessen its impact and provide for an orderly resolution. The MBCA provides counsel with several vehicles with which to plan for deadlock resolution in addition to the other options outlined in this article.

NOTE

1. This article is based in part on an earlier article written by two of the author's colleagues: Hugh H. Makens and Bruce C. Young, War and Pieces: The Impact of Deadlock in the Michigan Closely Held Corporation, 42 Wayne L. Rev. 1683 (1996).

Due to space limitations, this article focuses only on Michigan business corporations. It does not discuss other business vehicles, such as limited liability companies and corporations formed in other states, such as Delaware.

Section 489 of the MBCA (MCLA 450.1489) provides that a shareholder may bring an action to establish that the "acts of the directors or those in control of the corporation are illegal, fraudulent, or wilfully unfair and oppressive to the corporation or the shareholder" and provides the court with several available remedies. The Michigan Court of Appeals recently ruled that Section 489 creates a separate cause of action that is subject to the residual six-year statute of limitations. Estes v Idea Engineering & Fabricating Inc, No 211845, 2002 Mich App LEXIS 304 (March 5, 2002).

2. Harry J. Haysworth, Special Problems of Closely Held Corporations, Drafting Organizational and Structural Documents for Closely Held Corporations, C688 ALI-ABA 1, at 50 (1991). Deadlock can arise from the conflicting but well-meaning views of two owners. Deadlock does not necessarily include or follow from "oppression" of one shareholder by the other. It can, and frequently does, however, lead to oppression.

3. See Section 505(3) of the MBCA, which is found at MCL 450.1505(3). See generally Schulman et al., Michigan Corporation Law & Practice § 5.3 (2002 Supp).

4. MCL 450.1101 - 450.2090.

5. A shareholder could also attempt to remove a direc-
or from office. Under Section 511 of the MBCA, directors can be removed, with or without cause, by a majority of the shares entitled to vote. (A greater percentage can be specified for removal without cause.) Thus, in the typical 50-50 deadlock situation, this section will not be of much help. Under Section 514 of the MBCA, the holders of a least 10% of the outstanding shares of a corporation can bring a court action to remove a director and the court can remove a director if it finds that he “engaged in fraudulent, illegal or dishonest conduct, or gross abuse of authority or discretion . . . and removal is in the best interest of the corporation.” This section will obviously not be of any use if the deadlock results from an honest disagreement over how the business should be run.

6. MCL 450.1823.
9. Id. at 342 - 343.
10. See Section 345 of the MBCA (MCL 450.1345) for limitations on a corporation’s ability to declare dividends and other distributions.
11. MCL 450.1209. However, Section 488 of the MBCA (MCL 450.1488) allows the articles to contain provisions that are inconsistent in specified manners with the MBCA if the requirements of that section are met.
12. MCL 450.1209(1)(a).
13. MCL 450.1231. Section 488 would also allow provisions that are inconsistent with the MBCA to appear in the bylaws. See supra note 11.
14. MCL 450.1611.
15. MCL 450.1231. As a practical matter, where there are two 50% shareholders who are both directors, articles and bylaws provisions can be thought of as equally “permanent.”
16. MCL 450.1488(1).
17. MCL 450.1488(2).
18. Also, Section 472 of the MBCA provides that restrictions on the transfer of shares of the corporation may be set forth in the articles, the bylaws, or an agreement between any number of shareholders or an agreement between the corporation and its shareholders.
19. An irrevocable proxy under Section 422 of the MBCA may also be a possibility.
21. Id. at § 18.05.
22. Many corporations will maintain life insurance on one or more shareholders, the proceeds of which may be used to defray the costs of repurchasing the shareholder’s shares upon his death.
23. See supra note 3. This concept is apparently unique to the MBCA. An independent director may be appointed for a variety of purposes.
25. Id.
26. Id. § 9.11 at 9-49. For an extended discussion of arbitration provisions in the closely held corporation context, see §§ 9.09 through 9.17 of O’Neal’s Close Corporations.
27. MCL 600.5001(2). The statute provides in part that a “provision in a written contract to settle by arbitration under this chapter, a controversy thereafter arising between the parties to the contract, with relation thereto, and in which it is agreed that a judgment of any circuit court may be rendered upon the award made pursuant to such agreement, shall be valid, enforceable and irrevocable, save upon such grounds as exist at law or in equity for the rescission or revocation of any contract.”
28. Some of the more common reasons for these decisions are that (1) using arbitration to make policy decisions impermissibly infringes upon the board’s statutory right to manage the business and affairs of the corporation; (2) the delegation of decision-making power to arbitrators is an unlawful separation of ownership of stock from the power to vote it; and (3) the exclusive method for resolving shareholder or director disputes in a close corporation is the dissolution-upon-deadlock procedure set forth in the applicable corporation statute. For an excellent discussion of these issues, see O’Neal & Thompson, supra note 24, §§ 9.17 and 9.17A. Also, note that the federal arbitration statute may apply to validate arbitration agreements in the close corporation context, despite the contents of local law, if the corporation’s business reaches interstate commerce. Generally speaking, this statute enforces arbitration agreements found in contracts that involve interstate or foreign commerce. See G. Richard Shell, A review and Corporate Governance, 67 N C L Rev 517, 525-34 (1989).

Introduction

Michigan-based companies typically choose either Michigan or Delaware for their state of incorporation. Delaware is the most popular jurisdiction for out-of-state businesses. In the 1996 article “Michigan or Delaware Incorporation,” I describe the background of the corporate statutes and considerations involved in deciding between the states. The present article supplements the 1996 article by describing recent developments that are relevant to the decision. Although there are many differences in structure and detail between the Michigan and Delaware statutes, both are flexible in recognizing business needs and, in some areas, the Michigan Business Corporation Act (MBCA) borrowed provisions from the Delaware General Corporation Law. Important Michigan and Delaware provisions also come from the Model Business Corporation Act (the Model Act).

In most cases, Michigan is the better choice. The conclusion of the previous article stated:

For the largest businesses headquartered in Michigan, the overwhelming choice for state of incorporation has been Delaware. This choice is understandable because of restrictions under the old law, the insignificance of the additional annual cost to such corporations, the assurance that the Delaware Legislature will be responsive to business needs in amendments to the statute, the sophisticated courts, and the familiarity of corporate advisors with Delaware law. For closely held Michigan businesses, it is almost always preferable to incorporate in Michigan to avoid the additional costs and litigation exposure of incorporating elsewhere. For medium-sized public corporations, the choice is less clear and the legal differences are not very significant. Overall, cost savings and the flexibility of the Michigan statute, anti-takeover provisions, broader indemnification, and avoidance of Delaware jurisdiction over the corporation and its directors in litigation indicate that Michigan should be favorably considered as a state of incorporation by the management of Michigan-based businesses.

These comments remain correct today. For most Michigan-based corporations, there have been no significant changes in the statutory or case law that make Delaware the better choice. On the other hand, for the largest public corporations, there still is little reason to leave Delaware.

Delaware’s Preeminence

The national preference for Delaware as a state of incorporation is clear, particularly for the largest corporations. A majority of the Fortune 500 companies are incorporated in Delaware and only a few are incorporated in Michigan. As of December 31, 1995, of the 219 corporations headquartered in Michigan reporting under the Securities Exchange Act of 1934, 80 were incorporated in Delaware and 123 in Michigan. Many of the Michigan corporations were local banks and bank holding companies. There has been no significant change in the totals since 1995.

Reasons for Delaware’s preeminence can be summarized by three major characteristics. The state possesses:

1. a flexible corporation statute with frequent amendments to keep it current with business needs and an efficient administration of the statute,
2. a sophisticated and responsive judicial system for resolving corporate disputes with a developed body of corporate case law, and
3. a familiarity and satisfaction of lawyers and managers with Delaware incorporation over many years.

These aspects make Delaware the presumptive choice for national businesses.

Despite these benefits, there are disadvantages in Delaware incorporation. First, since domestic and foreign corporations must pay Michigan franchise fees, the costs imposed by Delaware are an extra burden on Michigan-based corporations. In addition to the initial fee paid upon incorporation in Delaware, there is an annual franchise tax...
based on the authorized capital stock that has a maximum of $150,000 per year. Michigan corporations ordinarily avoid Delaware taxes for Michigan-based businesses.

Second, incorporation in Delaware creates greater risk of litigation in Delaware. As stated in 1996:

An overriding disadvantage of the Delaware court system for businesses having no other contacts with Delaware is the amenability of Delaware corporations and their directors to suit in Delaware. . . . A more subtle disadvantage to the Delaware court system is the greater likelihood that shareholder litigation will be instituted against a Delaware corporation than against a Michigan corporation. The Delaware bar is sophisticated and active in bringing shareholder litigation; the Michigan bar has only a few lawyers who regularly appear on the plaintiff's side of shareholder litigation. . . . Although there is no empirical evidence to support the conclusion, it is probable that experienced plaintiffs' lawyers in Wilmington or New York would be more likely to institute a shareholder class or derivative action in Delaware against a Delaware corporation, or its directors, than to bring a suit in Michigan against a Michigan corporation or its directors.7

Furthermore, some lawyers feel that there is an additional Michigan advantage: Michigan judges might be more likely to give a "hometown" decision to Michigan-based corporations.

Close Corporations

Delaware does not have any special provisions for close corporations outside of its little used elective close corporation Subchapter XIV.8 In 1997, the MBCA added Section 488 that allows great flexibility in unanimous shareholder agreements. This provision, based on section 7.32 of the Model Act, permits variation of corporate norms and allows shareholders to organize their relationship without the constraints of ordinary corporate rules. In addition to meeting the needs of small businesses, Section 488 is also helpful in corporate joint ventures and parent-subsidiary relationships where the standard corporate model is too restrictive.

MBCA Section 489,10 covering shareholder oppression, remains a valuable tool for protection of minority shareholders in close corporations. Delaware courts have rejected general remedies for unfair conduct but will enforce fiduciary principles to give some relief for wrongful acts of directors and controlling shareholders. MBCA Section 489 provides a more specific discretionary judicial remedy.

Delaware still may be preferred for subsidiaries of Delaware corporations because of the administrative convenience of referring only to a single state law, for corporate joint ventures where the parties are more comfortable with Delaware law, and for businesses where financing sources are fearful of possible Michigan peculiarities and desire the familiar Delaware format.

The increasing popularity of limited liability companies presents an alternative form of organization for closely held businesses. Here again, the practitioner is presented with a choice of state of organization and some of the same considerations apply.

Capital Structure and Reorganizations

There is a major formal difference between the capital structure permitted in Michigan and the Delaware provisions. Michigan has abolished the obsolete concepts of par value and stated capital and the mysteries of determining "surplus." Delaware continues to have the archaic provisions causing occasional complications in corporate planning for dividends and share repurchases.

For corporations seeking immediate use of innovations in corporate finance, Delaware is more likely to have a current provision. The Delaware General Corporation Law is amended almost every year based on recommendations of a committee of Delaware lawyers. In Michigan, the recent amendment pattern appears as a group of amendments to the MBCA every four years (1989, 1993, 1997 and 2001).

The 2001 amendments to the MBCA added flexibility and attempted to remove some uncertainties in the reorganization provisions. Amendments to section 75311 provided a safe harbor based on the Model Act for determining when the sale of corporate assets required shareholder approval. Delaware law is unclear in determining what is "substantially all of the assets" under the sale of assets provision. An amendment to section 703a12 limited the class voting right in mergers, bringing Michigan closer to Delaware section 251(c)13 that does not require class voting on mergers. Like Delaware, the MBCA now permits directors to avoid a merger recommendation
in special circumstances.

**Directors**

The Delaware courts have a steady flow of cases dealing with the duties of directors. In a recent article, the former chancellor and two vice chancellors of the Delaware Court of Chancery pointed out the confusing complexity of the Delaware Supreme Court cases dealing with directors’ duties in the takeover area. In the area of director duties, the supposed advantages of predictability of Delaware law and judicial efficiency are not present. The decisions are fact intensive and statements by the Delaware Supreme Court involve elaborate schemes of burden shifting that are difficult to interpret and apply by the Chancery Court. In November 2001, the Delaware Supreme Court for the second time remanded Emerald Partners v Berlin, filed in March 1998, and, in a confusing opinion, ordered an entire fairness review despite an exculpatory charter provision under section 102(b)(7) of the Delaware statute that removed the liability of the only remaining defendant directors. The Michigan exculpatory and indemnification provisions make the MBCA more attractive for directors than Delaware law.

In contrast to Delaware, there are only a few published cases in Michigan each year dealing with corporate issues. In Camden v Kaufman, the Michigan Court of Appeals reached a conclusion that helps directors and controlling persons sustain transactions with the corporation. Camden held that disinterested director approval of an interested director transaction under section 545a, even in a going private transaction, bars a suit for alleged breach of fiduciary duty by the interested director in connection with the transaction. This extreme position contrasts with the complicated Delaware treatment of interested director transactions under section 144 of the Delaware General Corporation Law. It appears that in Delaware, disinterested director approval may only shift the burden of proof relating to the fairness of the transaction. Similarly, in Krieger v Gast, a federal district court determined that, under Michigan law, a Delaware “entire fairness” review was not available to minority shareholders in a cash out merger. Based on these cases, Michigan affords more protection to interested director transactions than can be found in Delaware.

**Takeovers**

The MBCA has two chapters attempting to regulate takeovers. Chapter 7A, as initially adopted in 1984, was a “fair price” statute directed at two-tier tender offers. In 1989, Chapter 7A was amended to add a restriction on business combinations for five years without a supermajority vote, thereby effectively converting the original “fair price” statute into a more protective business combination law. Chapter 7B is a control share act that was added to the MBCA in 1988. There is no comparable provision in Delaware.

Delaware section 203, adopted in 1988, was intended to strike a balance between a free securities market and the need to limit abusive takeover tactics. The exclusions in the statute, notably the exclusion for business combinations with a holder of 85% of the voting stock, make section 203 much less a deterrent than chapter 7A. There have been no significant amendments to the anti-takeover statutory provisions in the past five years in either state.

Shareholder rights, or “poison pill plans,” are the main protective devices against hostile tender offers in Delaware. The Michigan 2001 statutory amendments removed lingering doubts as to the effectiveness of a poison pill plan in Michigan. It is now clear under section 342a of the MBCA that Michigan corporations, like Delaware corporations, can adopt poison pill option plans. The 2001 amendments did not address the problems of continuing director and other poison pill innovations or the fiduciary duties of directors in maintaining plans. In this area, Michigan courts are likely to follow Delaware courts in striking down extreme defensive provisions, especially those limiting shareholder voting rights.

**Miscellaneous Provisions**

Amendments to the MBCA in 1997 and 2001 adopted several provisions that had been added in Delaware. The Michigan rules governing conduct of shareholder meetings and written consents and electronic and other communications follow the Delaware provisions. There are other provisions that are primarily of interest to corporations with publicly traded securities, such as those dealing with the formation of holding companies, where Michigan has not yet followed the Delaware lead.

**Conclusion**

Michigan has not sought to attract out-of-state business incorporations. Delaware has a preeminent position in attracting incorpo-
rations and its frequent statutory amend-
ments are designed to meet the needs of
large publicly-traded corporations incorpo-
rated in that state. Michigan courts cannot
match the expertise and efficiency of the
Delaware Court of Chancery and Supreme
Court. Michigan, however, has a modern
corporation statute with some advantages in
certainty, clarity, and flexibility over the
Delaware statute. The conclusion remains
the same: for closely held Michigan busi-
nesses, Michigan incorporation usually is
the best corporate choice. For most publicly
traded corporations, Michigan incorpora-
tion should be as advantageous as Delaware
incorporation and less expensive. For those
Michigan-based corporations that rank
among the largest in the nation, notably the
major automobile manufacturers, Delaware
incorporation will remain the most attrac-
tive because of the complex financing and
major shareholder litigation issues that af-
fect those corporations.

NOTES
1. Moscow, Michigan or Delaware Incorporation, 42 Wayne
2. MCL 450.1101-.2099.
4. A recent comparison of the Model Act and
Delaware law can be found in Dooley and Goldman,
Some Comparisons between the Model Business Corporation Act
and the Delaware General Corporation Law, 56 Bus Law 737
6. Id. at 1900.
To Invest or Not to Invest? The Benefits and Risks of Equity Arrangements Between Law Firms and Their Clients

by Darrell W. Pierce and Liza B. Larky

Introduction
The concept of law firms investing in their clients is not a new one. In fact, law firms in Silicon Valley started taking equity in their clients a quarter of a century ago and there have been many isolated instances of lawyers taking equity for many years before the Silicon Valley trend began. With the dot-com boom in the late nineties, many other law firms across the country began to see the financial potential in making investments in their clients. Similarly, clients started to realize the upside of allowing their law firms to take equity in their companies. While there may be less incentive in today’s market for law firms to take stock in their start-up clients (if they, indeed, have any), the market will eventually turn and the choice to invest will present itself again.

Before a law firm hastily jumps into an investment in a client, it needs to weigh the benefits against the risks. The benefits of equity arrangements between a law firm and its client can be quite tempting. There is the potential of huge economic awards. It is possible that investments will lead to profitable long-term client/lawyer relationships. Additionally, law firms may be able to retain and attract valuable associates and partners by offering potential proceeds from firm investments. Yet, law firms must also be aware of the inherent risks associated with investing in their clients. Not only may an investment be a poor financial decision, a law firm may risk facing the appearance of impropriety. From a client’s prospective, there are the benefits of a committed relationship and the preservation of valuable cash reserves. These need to be balanced against the risk that the relationship may not work as well as it should and the ultimate economic cost of repaying the law firm’s investment.

This article does not attempt to provide detailed advice in making investment decisions. Rather, it provides a brief summary of the common ways to invest in clients, the various benefits and the potential risks of equity arrangements between law firms and their clients, and suggestions to help law firms avoid liability.

Methods of Investment
One author suggests three types of models for investment in a client: straight investment model, deferred billing model and stock-as-fees model. Each of the methods carries its own benefits and risks, which are touched upon throughout this article. It is ultimately up to each law firm to decide which equity arrangement, if any, is appropriate for its business.

In the straight investment model, a law firm acts like any other investor and purchases stock in its client. The law firm does not make any special fee arrangements with the client. The client agrees to pay regular hourly rates. By behaving like a normal investor, rather than exchanging legal services for stock, there is a potential for financial loss, but certain ethical risks associated with the investment are mitigated. However, as discussed below, there is always some element of ethical risk associated with any investment in a client, as a lawyer is obligated to maintain a capacity for independent legal judgment.

Under the deferred billing model, a law firm defers its billing for the client. In other words, in a deferred billing arrangement, a law firm takes the risk that its investment of services rendered in the client will eventually lead to profit, and therefore, the law firm will be repaid (perhaps with a premium) down the road. This model, while not an equity investment per se, has some of the risk-reward attributes of an equity investment. It is very similar to the typical contingency fee arrangement in litigation, and like contingent fees, may pose a significant financial risk for a law firm because the law firm may not be paid at all for its services. On the other hand, a law firm is likely to negotiate a premium to be paid if the client is financially successful. While this is
financially beneficial for the law firm, the premium must be “reasonable” under the rules of professional conduct. To a client, the deferred billing model has the potential to provide more benefits than the straight investment model. Not only does the client not have to pay legal fees up front, but it has the assurance that the law firm will take substantial interest in striving for the client’s success.

The final model, stock-as-fees, is an arrangement by which a law firm receives stock from a client in lieu of cash compensation. While this billing arrangement would highly benefit a client, most law firms do not follow this investment model and will not accept only stock in exchange for legal services.³ Not only does this model pose an economic risk for a law firm, it also poses a severe ethical risk. Not only will the firm be less independent, raising the specter of an allegation of improper motive in the rendering of legal services, but the law firm’s interests as an investor (for example, its desire to have a means to cash out) may conflict with management or majority stockholder objectives. Instead, a law firm may choose other forms of equity billing. For example, a law firm may agree to accept equity in the client in exchange for legal services, but also to charge the client a discounted hourly rate. This alternative to the basic stock-as-fees model tends to enhance the benefits of investment for the law firm and mitigate the risks.

Benefits of Investment for the Law Firm

Financial

Financial reward is the most obvious benefit of investing in a client. If a law firm has the opportunity to invest in a start-up client when the valuation of the client is low, the potential of profiting from the investment is very high.⁴ The price of stock during the initial stages of a company is much lower than the offering price of an initial public offering.⁵

To feel comfortable in investing in a client, a law firm must look beyond the “get rich quick” frame of mind that drove most investors to invest during the Internet frenzy. It is simply not going to happen. In fact, a law firm may significantly sacrifice costs, expenses and legal fees at the beginning of a business relationship with a client. However, if the client is successful, the investment will pay off and the firm will have retained a client that may well bring more business to the law firm in the future. As one commentator stated, “despite the risk of having to write off fees for start-ups that never get funded, Silicon Valley lawyers see long-term profits from the potential of continued service to the company once it grows into a powerhouse.”⁶ A good return on a law firm’s investment in one client can make up for amounts lost through investments in clients that did not succeed.

Long-Term Relationship

In order to grasp the full scope of the benefits available to a law firm when investing in its clients, a law firm needs to look beyond direct financial reward. An investment in a client is not necessarily a one-time economic benefit. A law firm should look at an investment in a start-up client as the commencement of a profitable long-term relationship. Since law firms thrive on long-term client relationships, equity arrangements should benefit law firms by promoting client loyalty.⁷ For one thing, if a law firm believes that a client who is unable to afford legal services at the onset of the lawyer/client relationship will ultimately be successful, the law firm’s willingness to invest in the client will provide financial, reputational and emotional support to the client. Additionally, the risk a law firm takes in its client (not only in accepting equity in the client, but by also providing business counseling and legal services), may create a sense of partnership that will keep the client loyal to the law firm in the future.

Retention of Associates and Partners

Associate discontent is not at all foreign to most law firms. Long hours, unfulfilling work and inability to “share in the wealth” are common complaints among associates. Partners are sometimes attracted to seek the financial rewards available in the business world. However, law firms that take equity in their clients can increase the retention rate of their associates and partners by distributing the proceeds of such investments to them.⁸ In fact, one of the reasons why many Silicon Valley law firms began setting up investments in their clients was to give partners who did not have start-up clients a chance to share in the returns with those partners who represented such clients.⁹

A law firm that does not offer its associates and partners investment opportunities risks losing its lawyers to other law firms that do have equity arrangements with their clients or to the law firm’s own clients once such clients are able to generate enough business to create a need for in-house counsel.¹⁰ It is important for law firms to recognize why attorneys move to in-house counsel.
positions at emerging companies. First of all, attorneys want to be involved in the creation and growth of a company. The perceived satisfaction of growing with a new company may be greater than that associated with billing required hours at a law firm. Similarly, attorneys may prefer that their compensation be tied to their company’s success, rather than to their billable hours at a law firm. Unlike law firms, high-growth companies offer their employees incentive stock options that can be quite profitable.

However, by obtaining stock or options in a single company, employees assume a significant risk associated with a non-diversified investment. If a law firm participates in equity arrangements with a number of clients, its portfolio will be more diversified than one emerging company’s investment potential. Therefore, associates and partners may be convinced that they have a better chance of earning more money from stock at the law firm than they would at an in-house position. Additionally, the law firm can attract new associates with its diversified investment opportunities.

**Benefits Of Investment for the Client**

**Financial**

All start-up clients need sound legal advice and continuous legal services. At the same time, however, most emerging companies cannot afford such services. Thus, if a law firm takes equity in its client, the client can substantially benefit from reduced legal fees. By providing stock in exchange for legal services or discounted legal fees, a start-up company will gain valuable legal assistance without using valuable cash resources.

Moreover, a law firm that has an equity billing arrangement with a client is likely to spend more time doing legal work and assisting the client than it would in a regular hourly rate arrangement. When a law firm bills hourly, the client has the tendency to put a limit on the amount of hours the law firm spends on its matters because of the expense. In an equity billing arrangement, however, a client need not worry about the length of time its law firm devotes to it because it will only pay the firm when cash is available (“deferred billing model”) or at a discount rate.

Unlike most investors, a law firm will not require its client “to make a formal pitch” or presentation to the law firm. This saves the client time and money because the client has the opportunity to make those pitches and presentations to other investors such as venture capitalists and angel investors. Moreover, if the law firm takes equity in the client in the same investment transactions as other investors, the client’s only additional cost is to produce investment documents since the terms of the investment have already been determined. Obviously, the degree of benefit to the client will depend on the relative value of the law firm’s investment to the (possibly minimal) incremental costs saved in not having to raise the additional capital to pay a cash fee to the law firm.

**Reputation /Business Services**

A client that provides stock in exchange for legal services also has the benefit of the law firm’s reputation in the community. An emerging company will have a much easier time raising capital if it has the recommendation of a prestigious law firm. Additionally, the law firm’s reputation will enhance the client’s credibility with the company’s future clientele. If the firm does not offer the option of an investment in lieu of cash fees, the client may have to seek the services of a less prestigious firm to conserve precious cash resources.

Finally, a law firm that has an ownership interest in a client has more of an incentive to provide additional business services to the client than to clients in which the firm does not take equity. For example, a law firm may “advise[e] the client on business matters, promot[e] certain transactions over others, mak[e] the company as attractive as possible to potential investors and introduc[e] clients to venture capitalists.” Most venture capitalists and angel investors will not review business plans of companies that are not recommended by other professionals for the simple reason that they do not have enough time to review all of the business plans that come before them. Therefore, law firms provide an important “in” at venture capitalists and angel investors for emerging companies. Law firms will be conservative in promoting clients to avoid securities law liability, but law firms do provide networking resources to clients and a firm’s investment is likely to increase the clients’ visibility at the firm.

A law firm that has a financial stake in a client has an incentive to be proactive in looking out for the client’s interests and opportunities, including future financing opportunities. Law firms do not intend to ignore any client, but an equity investment may serve to strengthen and promote the
importance of the firm's relationship to its "equity" client. The investment also tends to create and emphasize the long-term relationship between the client and the firm (as opposed to the "I'll call you when I need you" client). Like the law firm, the client has to look at the equity relationship between the client and law firm as long-term. Not only may a law firm help procure additional financing, it will probably consider additional investments of its own during such later rounds of financing.

**Risks Of Investment for the Law Firm**

**Financial**

While financial reward may be the most apparent benefit of investing in a client, economic loss may be the most significant risk. Every investor should know that there is no such thing as a "sure thing" when it comes to making investments. Law firms understand, probably better than most investors, the economic risks that are involved with investing in their clients and many law firms choose not to take that risk. To put it bluntly, "start-ups have a high rate of failure... only one in every ten start-ups ever reaches profitability." One commentator explains that "losers outnumber the winners by as much as 20 to 1. And that doesn't take into account the companies that make it to the public market but fail a few months down the road.”

The fact that a company's stock may not achieve liquidity poses a serious risk for a law firm. If a law firm is going to evaluate a client's prospect of successfully completing a liquidity event, it must carefully analyze the client's business model and continuously monitor the company in order to evaluate the merits of providing ongoing services that are tied to some form of equity investment. The firm may also feel compelled to continue to provide services under traditional billing arrangements when the client lacks creditworthiness; the firm's withdrawal of services may increase the likelihood that the company will fail, causing the firm's original investment to be lost.

While a liquidity event is vital to a significant return on investment for a law firm that invests in its clients, many law firms will nevertheless feel that they must retain stock of the clients after the liquidity event. Not only does a law firm want a long-term profit from a successful client, but it also wants to retain a future relationship with such a client. If it sells the stock immediately upon a liquidity event, the law firm may lose the trust and loyalty (not to mention future legal business) it developed with the client over the initial stages of the client's growth.

If a law firm decides to use any form of equity billing as described above, the law firm must take into consideration the prospect of losing out-of-pocket expenses and legal fees. To a small law firm, this may be too big a risk to take. Larger firms may be able to sustain the losses.

**Ethics**

Aside from the economic risk associated with investing in their clients, law firms need to be concerned about the professional risk of making equity arrangements with their clients. A law firm certainly does not want to earn the reputation of a firm whose actions are dictated by its investment strategy and motivated by greed and opportunity. A law firm needs to keep its interests as a stockholder separate from its role as legal counsel. Once a law firm decides to take equity in a client, it must always be conscious not to shape any subsequent legal services it provides to the client by the law firm's own incentives. The bottom line holds that a law firm must always remember to put its client's best interests before its own.

The ABA Model Rules of Professional Conduct (the "Model Rules") do not prevent law firms from investing in their clients. However, in order to avoid ethical violations regarding conflicts of interest and compensation when investing in their clients, law firms must adhere to the following Model Rules: Rule 1.8(a) governs business transactions between lawyer and client; Rule 1.5 requires that legal fees be reasonable; Rule 1.7(b) concerns conflicts between client's interests and lawyer's personal equity interests; and Rule 2.1 governs a lawyer's advisory role to his/her client.

Rule 1.8(a), Conflict of Interest: Prohibited Transactions, states:

A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless: (1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client in a manner which can be reasonably understood by the client; (2) the client is given a reasonable opportunity to seek the advice of independent counsel in the transaction; and (3) the client
The benefits and risks of equity arrangements between law firms and their clients

In order to avoid the appearance of impropriety, a law firm must make a tremendous effort to ensure that an investment in a client is “fair and reasonable” and disclosed to the client in writing. Since the terms and conditions of the investment must be “reasonably understood by the client,” a law firm may have to be especially careful in its disclosure to less sophisticated clients. Moreover, in order to avoid liability under the Model Rules, a law firm should encourage its client to consult outside legal counsel. Finally, and perhaps most importantly, a law firm should obtain written consent from a client before it invests.

Rule 1.5, Fees, does not prohibit any type of equity billing. In fact, the rule does not even address the issue of equity billing. Rule 1.5 simply states that a “lawyer’s fee shall be reasonable.” In a recent formal opinion regarding equity billing, the ABA noted that determining the reasonableness of equity billing involves making a difficult assessment of the market value of the stock at the time the billing arrangement is agreed upon. Since the value of the stock may not be ascertainable at such time, “the percentage of stock agreed upon should reflect the value, as perceived by the client and the lawyer at the time of the transaction, that the legal services will contribute to the potential success of the enterprise.” Nonetheless, law firms take the risk that, later, the fee determined at the time of the transaction will seem unreasonably high for the legal services rendered. To be fair to the client, most firms do not negotiate price and accept terms obtained by other investors, and limit the percentage of ownership in a client.

Rule 1.7(b), Conflict of Interest: General Rule, applies in situations where a law firm has already invested in a client. Pursuant to Rule 1.7(b), if a law firm believes that its own interests will “materially” limit its representation of a client, it must (1) determine that the quality of its representation will not be affected; (2) disclose all relevant facts to the client; and (3) obtain the client’s consent. It is conceivable that, in certain situations, a law firm that has an equity arrangement with a client will have personal interests in mind rather than its client’s interests. For example, the risk of violating Rule 1.7(b) may arise if a law firm counsels a client to act in a certain way because the law firm believes that other action by the client would hurt the stock’s prospects. Similarly, a violation of Rule 2.1 might occur in the same scenario. Rule 2.1, Advisor, requires a law firm to “exercise independent professional judgment and render candid advice.” A law firm that invests in its clients must be cognizant of not rendering more cautious or riskier advice than is necessary because of its investment in the client. If nothing else, the Rules 1.7(b) and 2.1 remind law firms who invest in their clients to always put the clients’ interests ahead of their own economic interests.

Another application of the foregoing rules should be considered. In general, we have assumed that the firm is making a “plain vanilla” investment, such as common stock, in a client. If the investment contains negotiated terms such as anti-dilution provisions, registration rights, transfer restrictions, voting rights limitations or rights relating to a disposition, and if the law firm is representing the client in connection with the negotiation of those rights, a more acute conflict arises. This is true even if the firm co-invests with third party investors. How can the law firm exercise independent judgment when it has a stake in the success of the negotiating investors? The Association of the Bar of the City of New York has concluded that, even though equity investments can be made under appropriate circumstances, in a situation where “the client expects the lawyer to exercise independent professional judgment for the protection of the client, . . . there may be non-consensable conflicts of interest which preclude such an arrangement.”

Fiduciary Duties

If a client has a relatively small number of investors or if a firm obtains a significant investment in a client, situations may arise where a firm has a fiduciary duty to other equity holders. This may arise from being part of a majority group or in the context of a particular decision to be made. In such a situation, the firm’s role as counsel can create trying circumstances. For example, when the firm is part of the majority in a transaction with a minority stockholder, what can the firm do if, in the context of privileged communication, it discovers a fraud?

Intra-Firm Relationships

A final disadvantage for law firms that offer investments to employees is the possible adverse effect on relationships within the firm. Mandatory investment plans can be divisive if unsuccessful. And “opt in” plans can create feelings of disparate treatment where some have more means to invest. In either case, disagreements over investment activity can arise. This has caused certain firms to
undertake investments through an entity that is not the firm. The firm is paid cash for legal services while attorneys at the firm are offered the opportunity to invest through the investment entity. In this way, each attorney can determine his or her own comfort level with investment, while the firm earns its traditional fees for legal services. This protects attorneys who do not wish to invest, while preserving the economic benefits of investment for the client. While the firm cannot eliminate the ethical and potential conflict issues that have been discussed, there is some degree of insulation offered by such an arrangement, particularly if investment decisions are made for the investing entity by a group that does not control the firm and if a significant number of firm attorneys choose not to invest and have significant influence on firm decision-making.

### Risks of Investment for the Client

The risks for clients that provide equity to their law firms are generally thought to be minimal compared to the benefits. After all, the client may have the benefit of valuable legal services that are paid for, if at all, only if and to the extent the client is economically successful. But there are some potential risks for the client to consider. First, there is a potential conflict of interest between the client and its law firm. In an investment transaction, a client may not know if the law firm's loyalties lie with the client or with the client's investors. A client may also wonder if the law firm is more concerned about its short-term return on investment or the client's long-term best interests. Anytime a client feels that the bond of trust between the client and its law firm is broken, the legal relationship is not very effective. Second, the client may feel pressure to allow its law firm to invest when it does not want the investment. Once law firms realized the financial potential in taking stock in their clients, it was not uncommon for law firms, rather than their clients, to initiate the lawyer/client equity arrangements.

### Avoiding Liability

Ultimately, law firms will decide whether or not to invest in their clients by weighing the benefits against the risks. In addition to their desire to profit, law firms naturally seek to avoid liability. According to the law firm insurer, Attorneys' Liability Assurance Society (ALAS), claims based on law firm investments in their clients are "a severity problem, not a frequency problem." That is, investing in clients in and of itself does not cause many claims against law firms, but it tends to be an aggravating factor in severe claims.

ALAS dubs the two most frequent claims "aiding and abetting" and "punch-pulling." An "aiding and abetting" claim may arise against a law firm when it represents a client that is alleged to have committed fraudulent or wrongful conduct in a business transaction. In this type of case, a law firm's most common defense is lack of scienter. However, such a defense is less likely to succeed the closer the business relationship is between the law firm and the client. A law firm that has invested in such a client cannot easily demonstrate that it did not know about the alleged wrongful conduct. Scienter is a state of mind that is proved by inference from objective facts. The existence of an investment will cause some to infer a culpable state of mind: there is an obvious incentive to help the client look good in the securities disclosure process.

A "punch-pulling" claim usually arises when a law firm has invested in one client (A) and then later represents another client (B) in a business transaction with A. According to ALAS, "the allegation is simply that the lawyer involved pulled his punches in representing B - he favored A in the transaction, at least in part because of the lawyer's financial stake in A." This type of claim clearly involves a conflict under Rule 1.7(b).

Based on studies of losses incurred by its members, ALAS has suggested a few guidelines for law firms to follow when deciding whether or not to invest in their clients: (1) a committee of the management of the law firm should approve all lawyer-client business transactions; (2) the proponent of the transaction should have the burden of establishing that the transaction is appropriate; and (3) if the committee permits the transaction, the form of Rule 1.8(a) disclosure and consent letters should be approved by a member of the firm's ethics committee.

Some firms supplement such guidelines...
with additional policies of their own. Wilson Sonsini Goodrich & Rosati, a Palo Alto, California law firm, has been extremely successful investing in its clients for the past twenty-five years. It follows a strict set of guidelines in making its investments. According to one source, Wilson Sonsini distributed approximately $200 million from client equity stakes in 2000. They follow this set of guidelines when deciding whether or not to take stock in their clients:

- Do not take stock as fees (i.e. do not use the “stock-as-fees model”).
- Invest cash through a separate partnership, not through the law firm itself.
- Do not permit lawyers in the firm to make individual investments in clients.
- “Rigidly comply” with all ethics rules.
- Develop policies for compliance with securities laws.
- Make many small investments rather than try to make a killing through one big investment.
- Set up an investment committee to control all investment decisions.
- Encourage the client to consult independent counsel on an investment transaction.
- Create a system to identify conflicts that may be created by investments.
- Check your firm’s insurance policy: it may include percentage limits on investments.
- Develop an insider trading policy.
- Do not buy stock when initially offered and then sell it the next day after the first-day run-up.

Other methods to control risks include the following:

- Ensure that committee members who do not perform legal services for the client support investment committee decisions.
- Ensure that each investment is not so large that a total loss would be materially adverse to any participating attorney or the firm as a whole.
- Try to tie future decisions as investors to decisions made by non-firm investors (e.g., tie sales of equity for the benefit of the firm to sales by professional venture capital investors – this is particularly effective when the firm’s primary client is the investor with its relationship to the corporate client arising out of the investor’s control of the client).
- Peer review legal work in transactions that directly involve investors in the client and other transactions that pose a potential conflict between attorney and investment roles.

Having a firm policy that is well thought out and consistently observed can allow a law firm to reap the rewards of client-lawyer equity relationships while avoiding potential liabilities.

**Conclusion**

There are many different models of investing in clients. These investments can be very beneficial to law firms and their clients, even though potential risks and conflicts should be evaluated seriously by both the firm and its client. Internal firm guidelines are strongly recommended to ensure that professional responsibilities are fulfilled, investments are financially appropriate and law firm objectives are achieved. The pace of change in today’s business world suggests that, while the “dot-com” business model has been rightfully questioned, there will be significant opportunities for young companies to achieve rapid growth. The economy will improve and the intellectual capital that supplies creative ideas for viable businesses to emerge has not dissipated. Law firms will soon again ask themselves “to invest or not to invest?”

**NOTES**

5. Id. at 578.
8. Boncompagni at 1.
9. Id.
10. McAlpine at 581 and 582.
12. Id.
14. Id.
15. Id.
16. McAlpine at 574.
17. Puri at 109.
18. Id. at 113 (citing Andrew B. Katz & William F. Savarino, Representing a Technology Start-Up, NY LJ, Nov. 9, 1998, at T2).
20. Puri at 113 and 114.
21. Rule 1.5 contains a list of factors that determine the reasonableness of the fee.
22. ABA Committee on Ethics & Professional Responsibility, Formal Opinion 00-418 (July 7, 2000).
23. Id.
26. Id.
27. Id.
28. McAlpine at 583.
30. Id. at 2 and 3.
31. Id. at 3.
32. Id.
35. Swanson at 785.

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Introduction
We work in a challenging time for many industries. In-house or general counsel are likely confronted with some unique legal questions. For example, the business group might ask counsel: “How are our customers able to unilaterally demand pricing reductions and even give-backs when we have a written contract or purchase order?” They may ask the next logical question: “Can we do the same to our suppliers?” Furthermore, suppliers may refuse to ship components unless the company pays cash or its equivalent on delivery because they’ve heard the company is having financial problems. Finally, the bank could be asking for overdue periodic financial reports, reports that would demonstrate to the bank that the company is out of formula and in breach of the financial covenants of the credit agreement, having negotiated them 6 months ago. This article explores such dilemmas and suggests several preventative measures and coping strategies.

Knowing there is a problem
Knowing that the company is in financial distress is the first step toward saving the company: do the necessary research. Counsel to the corporation should be reviewing the periodic financial statements. The financial statements, including the balance sheet for the most recent period ending, and more importantly, the statement of cash flows, are critical indicators of the company’s well being.

Pursuant to the Michigan Business Corporation Act (MCBA), no distributions may be made if after giving them effect, “the corporation would not be able to pay its debts as the debts become due in the usual course of business, or the corporation’s total assets would be less than the sum of its total liabilities plus . . . preferential rights.” These are commonly referred to as the solvency and balance sheet tests, respectively. Corporate counsel must educate the board of directors that they, as well as the shareholders receiving such distributions, may be held personally liable to the corporation and/or its creditors for any amounts distributed in violation of Section 345(3) of the MBCA.

For example, the United Auto Workers Union, on behalf of its constituency, sued the shareholders of an insolvent supplier seeking recoupment of distributions that allegedly violated Section 345(3). At a minimum, counsel must be aware of the financial condition as evidenced by the periodic financial statements.

In addition to the financials, what are other signs that a corporate client may be in financial distress? The income statement of the company may reveal serious operational problems, which in turn exacerbate the financial problems. More specifically, if the labor and freight costs represent an increasing percentage of the cost of goods sold, the company may have entered into a dangerous spiral.

There are at least two causal relationships that can throw a healthy company into an operational-financial spiral. First, if the company has exhausted its cash resources with excess capital expenditures, with program launch costs exceeding budget, or with the occurrence of an unexpected liability, the company’s inability to pay parts suppliers may result in hostage situations: a supplier stops a vital shipment because the company is beyond the payment terms of the purchase order and the supplier refuses to ship until the company’s account is current. Thereafter, this supplier may even demand cash on delivery payment terms that result in further cash constraints on the ailing company. Second, the company may be experiencing quality problems that result in return of goods from the customer (and eventually if uncorrected a resourcing of the part or component). In either case, the company is forced to increase labor costs in the form of overtime wages to workers for additional shifts once hostage parts are delivered, or to correct the quality problems (which may also include the cost of outside containment companies referred by the customer). Both situations will also inevitably increase freight costs as expedited shippers will be required to transport completed parts to the end customer because the time scheduled for “just in time production” has
If members of management are not capable or willing to do the job necessary to save the company, it may be counsel's duty to seek board approval to enlist such assistance and/or the removal of certain members of management.

Thus, the operational-financial spiral is evident: a lack of cash leads to hostage situations and/or quality problems lead to containment and replacement situations and both lead to increased labor and freight costs; this results in a greater cash loss and lower margins, which eventually lead to an upside down balance sheet as liabilities gradually exceed assets. The company is most likely in violation of permissible debt to equity ratios, net worth requirements, and other financial covenants. Eventually word will spread that the company is experiencing financial distress and hostage situations will become more and more prevalent.

Get help
This war to save the company is not one counsel or current management can fight alone. Counsel and management both need help and the sooner they obtain it, the better the odds are. A seasoned creditor’s rights/bankruptcy attorney should be consulted at the earliest signs of financial distress: such an attorney will have the knowledge not only of the applicable law, but also of the tactical maneuvers that may be required. Legal decisions and the execution thereof will need to be swift and decisive in dealing with banks, customers, suppliers, creditors, laborers and management. Counsel may have to convince members of management to do or refrain from doing certain things that are critical to the survival of the company.

The counsel to the company represents the legal entity "as distinct from its directors, officers, employees, members, shareholders, or other constituents." If in the course of representation, counsel becomes aware that an officer, director or other person associated with the corporation is engaged in action, intends to act, or refuses to act in a manner related to the representation; and such action or inaction is likely to result in substantial injury to the organization, he or she is required to proceed as is reasonably necessary in the best interests of the company. If members of management are not capable or willing to do the job necessary to save the company, it may be counsel’s duty to seek board approval to enlist such assistance and/or the removal of certain members of management. In fact, it may be necessary to induct one or more new officers to replace those unable or incapable of executing a recovery or reorganization plan; the bank, the creditors, and other officers may refuse to cooperate absent such action.

Management’s help may come in the form of newly hired experienced officers, or in the form of turn-around consultants. There are several national, regional and local firms comprised of former financial and operational professionals that serve to advise and guide management to a successful restructuring or reorganization of the company. As with the legal advisors, it is important to find competent and experienced turn-around consultants at the earliest signs that current management may need help. In fact, the company may have little choice in the matter. Banks keep a short list of approved consultants and may require the company to hire one such firm as a condition for continuing or forbearing on an existing credit facility. Please note that the fees for such consultants can be extremely high. However, if they have been brought in early enough to actually have time to help, and their efforts are monitored through a reporting process, they can be very effective, despite the cost.

Finally, make sure that there are competent labor and employee benefits attorneys involved. Employment issues involving labor concessions such as benefits and head count reductions will most likely be necessary.

Stop the bleeding
Once counsel has determined that the company is in distress, and has the advice of other specialized legal, financial and operational professionals, counsel must create and execute a plan to stop the bleeding, to pull out of the spiral and to gain the health necessary for the company’s survival and prosperity. Pursuant to the plan, one or more of the following actions may be required:

1. Meet separately with each of the following constituencies of the company to solicit their perceptions and relay (when ready) the company’s plan for a turnaround: the bank, key suppliers, management’s key employees, representatives of labor, and where necessary, the press.

2. Institute a cost reduction plan as soon as possible. This may include white and blue collar head count reduction, suspension of overtime where possible, suspension of expedited freight when possible, retention of quality control consultants, and institution of lean manufacturing processes.

3. Seek customer accommodations such as revisions to purchase orders to
allow customer purchases of inventory for production; accelerated payment terms by customers; customer influence on sub-suppliers to continue timely shipments or encourage consignment situations; and, in extreme cases, customer participation in bank credit facilities on a last-in, first-out basis.

4. Seek forbearance from the company's lender and suspension of principal payments for a specified period.

5. Retain key employees by instituting a key employee retention bonus plan, which provides in part that employees that stay with the company during a specified period or event shall receive a severance package if later terminated, or in the alternative, a bonus after such period.

6. Sell off unnecessary assets or engage in sale-lease back transactions with capital assets and real estate where possible to increase cash flow.

7. Engage an investment-banking firm to sell off a division or the entire company where necessary.

8. Seek outside equity partners including the various special situation funds that operate in the troubled company arena.

To file or not to file

Although filing for protection under the bankruptcy code would most likely wipe out shareholder equity and result in a change in control in the company management, it may become the only reasonable alternative to ultimately save the client. The question for the truly financially distressed company may actually be, “when to file?”

This is where the wisdom of the bankruptcy attorney will play a critical role, as well as counsel’s ability to know that he or she is right and to convince management to act accordingly. Other than waiting too long to bring in outside equity partners, one of the biggest mistakes corporate counsel can make is to wait too long to pull the trigger on the bankruptcy decision. The longer the company puts off the inevitable, the less of a chance it has to successfully reorganize and recover from the distress.

In preparing for and navigating through the bankruptcy process, the necessity of legal, financial and operational professionals to aid corporate counsel and management of the company will become apparent. The amount of time necessary to prepare the initial plan of reorganization and other documentation necessary to complete the filing is enormous. The chief financial officer of the company and corporate counsel will be engaged in an all-consuming process to maintain debtor-in-possession status for the company. The presence of the additional professionals on the battlefield will enable the chief financial officer, the corporate counsel and the other officers of the company to continue to run the business, and more importantly, to implement the recovery plan.

NOTES
1. MCL 450.1101 et seq.
2. MCL 450.1345(3).
3. MRPC 1.13(a).
4. MRPC 1.13(b).

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Restructuring Public Debt Securities: A Few Traps for the Unwary

by Patrick Daugherty

Introduction
Imagine spending months negotiating a comprehensive work-out of claims against a troubled company only to have the definitive agreement rejected by a judge because, in the judge’s opinion, you had negotiated with the wrong people.

That’s precisely what happened to the Southland Corporation, whose plan of reorganization was rejected by a bankruptcy judge because the company had solicited consents from the “record owners” of its public debt securities rather than the “beneficial owners.”

The genesis of this mistake is understandable. Corporate debt indentures invariably vest voting power in the record owners of the outstanding debt securities. If that were not enough to steer counsel away from the beneficial owners, the bankruptcy rules also direct the parties to solicit the record owners. One might hope that corporate counsel would be forgiven for recommending what the contract and the black letter law both said to do. But the bankruptcy judge ruled this course of action “error,” holding that the bankruptcy rule worked a substantive change in the law and concluding: “If the record holder of a debt is not the owner of a claim, or a true creditor, he may not vote validly to accept or reject, unless he is an authorized agent of the creditor . . . .”

The inability of management and its advisors to confirm a bankruptcy plan proved fatal. Today the Southland Corporation is defunct, as is its regular outside law firm.

The primacy of beneficial debtholders in bankruptcy is a trap for the unwary. Sadly, publication of the Southland Corp. opinion has not kept everyone out of that trap. As the longest period of economic expansion in history fades into memory, a fresh generation of public companies and corporate counsel is starting to encounter the law and expectations of public debt finance at the intersection of federal securities practice and federal bankruptcy law. In this article I illuminate a few of the hazards.

Radical Transformation of Fiduciary Duties
It is black-letter law that corporate directors and officers of a clearly solvent corporation owe fiduciary duties of care and loyalty to the corporation and, by extension, to its shareholders. These duties are not to be compromised in the service of some other, assertedly greater, good. In the venerable words of Justice Cardozo:

A trustee is held to something stricter than the morals of the market place. Not honesty alone but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty.

Thus, as long as the corporation is clearly solvent, the interests of creditors are subordinate to those of shareholders. Debtholders are not the beneficiaries of fiduciary duties owed by the issuer or its management. Instead, their rights and expectations are limited to the covenants included in the debt instruments; namely, the indenture and the notes, bonds or debentures evidencing the public debt.

These standards of corporate governance are, however, radically transformed when the corporation becomes insolvent; it is also well-settled law that directors then owe fiduciary duties to creditors. This is most clearly, but not only, the case when the corporation enters bankruptcy proceedings. Because one cannot serve two masters, shareholders are subordinate to debtholders when the issuer is insolvent. The directors must redirect their focus from the interests of shareholders to the interests of debtholders.

Since this reformulation of basic fiduciary duty is contrary to the ordinary conduct of a board of directors, it is a trap for unwary directors and counsel. Those who continue business as usual while the company defaults on its public debt are putting themselves and the company in harm’s way.

The transformation of the duty of loyalty raises a host of practical questions. This is surely the foremost: When does an issuer become insolvent?

There are two basic “tests” for solvency
under bankruptcy and applicable nonbankruptcy law. One is a balance-sheet test: Do total assets exceed total liabilities? (Does the company have a positive net worth?) When applying this test, some consideration is given to "contingencies"; that is to say, contingent liabilities, as well as contingent assets. These are items that do not warrant accrual on a balance sheet under generally accepted accounting principles, yet do merit consideration when computing value for "solvency" purposes. The input of independent accountants, valuation experts and other financial advisors is valuable in close cases.

The other test for solvency focuses on cash flow: Is the company able to pay its debts generally as they mature? The answer is often obvious, as when unpaid creditors are known to be dunning (or suing) the company for payment. Questioning the chief financial officer should yield probative information in other cases because a company with sound financial management will budget its cash flow expectations for at least a fiscal year in advance. Hearing or seeing these projections will enable the directors to assess the relative strength or weakness of cash flow in the current period and in the longer run, too.

Accountants can help lawyers and directors apply these tests, but they cannot reliably address the more subjective nuances of a particular situation nor will they take responsibility for the ultimate question, which is a "legal" one. These are among the issues that require seasoned legal and business judgment: What is the legal significance of acquisition goodwill and other "intangible" assets to this company and the possibility of accounting write-downs or write-offs due to impairment? Do "mezzanine" securities in the company's capital structure help or harm the balance sheet and liquidity? What are the likelihood and importance of "long-term insolvency" raised by mass tort litigation (in its early stages) or doubts about the ability of the company to repay "bullet" debt maturities as they come due years hence? Depending on the answers to such questions, a company that looks solvent might actually be, or be about to become, insolvent, changing everything from the board's perspective.

Still more consternation has been created by the claim that corporate directors owe care and loyalty to creditors not only when the company is clearly insolvent, but indeed somewhat earlier, when the company enters an undefined "zone of insolvency." The authority usually cited to support this claim is Credit Lyonnais Bank Nederlend, NV v Pathe Communications Corp, in which the Delaware Court of Chancery famously remarked, "at least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the resid[ual] risk bearers [i.e., the stockholders], but owes its duty to the corporate enterprise." In Credit Lyonnais a creditor-appointed executive committee disapproved asset sales proposed by a controlling shareholder by reason of their judgment that the prices were too low and would impair the corporation's ability to function. Considering a challenge to that action, Chancellor Allen ruled that the directors "had an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity." It followed that the directors did not necessarily breach their fiduciary duties when they declined to approve transactions in the financial best interest of the controlling shareholder: "in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act."

Contrary to the exaggerated claims of partisans, Credit Lyonnais did not hold that the beneficiaries of directors' fiduciary duties shift from the shareholders to the creditors in the vicinity of insolvency. It was the "corporate enterprise" that warranted fiduciary protection; "the community of interest that sustained the corporation." The Chancellor did hold that, in the vicinity of insolvency, creditors' interests merit consideration along with the interests of other stakeholders. Other courts have stated the claims of creditors more strongly. My former colleague Steve Schwarcz asserts, building on the cases, that directors should give less weight to the interests of shareholders and more weight to the interests of creditors as the likelihood of residual value for shareholders declines.

The vicinity-of-insolvency theory makes wise board counseling both urgent and extremely difficult when a company begins to falter. This is especially so in the case of a highly leveraged company with public debt outstanding. If it is hard to know when a company is insolvent, then it is harder still
to see when that same company has entered the vicinity of insolvency, especially in the absence of judicial guidance. And if it is hard enough to divine what course of action would be in the best interest of the shareholders, or even the creditors, then how much harder it truly is to know what would best serve "the community of interest."

Prudent directors will consult corporate counsel and other experts as they consider how to fulfill their fiduciary duties in the context of corporate plans, proposals and opportunities if and whenever the company's financial condition and cash flows begin to show signs of serious deterioration. The directors should consider thoughtfully the needs of all "constituencies" and the minutes of their meetings should reflect the process. Inclusion and caution should be watchwords for board decisions.

The Allure of Chapter 11 for Troubled Public Debt Issuers
If the company's ability to repay its public debt when due starts to look doubtful, then the company's management and financial advisors will likely begin to consider the wisdom and practicality of restructuring that debt and other claims against the company. No two restructuring transactions are identical. Typically, however, they involve the cancellation of some debt (a "haircut" for the creditors in question) concurrently with the issuance of new debt (which may be secured by new collateral) and new equity securities (which may be options, warrants and other "equity kickers" rather than common stock). Debtholders generally strive to increase their control over the conduct of the company's business in a restructuring by extracting new and tighter covenants from the company.

Restructuring a company with public debt outstanding is much more challenging than restructuring a private company because of the many complexities associated with public debt. Unlike a private company, the public debt issuer owes contractual duties, specified in an indenture qualified under the Trust Indenture Act of 1939, to a great number of investors with divergent agendas.

There is no "typical" investor in the public debt of a troubled company. Most, if not all, are financial institutions, but institutional investors vary tremendously along key dimensions such as interest and experience in negotiating a restructuring and willingness to compromise their claims in exchange for equity, collateral or other incentives. In every troubled-company scenario, some public debtholders will have acquired their holdings before the issuer's financial troubles began (or intensified), whereas others will have acquired their stakes later, at lower prices. Some of those who bought later might well have bought with the intention of profiting from a restructuring that would require the earlier investors—those who bought at or near "par"—to take a haircut (capital loss) on their positions. The acceptability to particular debtholders of a negotiated compromise is affected by this reality (as is the acceptability to different holders of different possible compromises). Opportunists that bought notes, debentures and bonds at distressed prices are much more willing than others to restructure the issuer's debt and may well take the initiative in commencing a restructuring.

The role of the indenture is significant, as well. The indenture is the contract between the company and the public debtholders, and it has statutory content. The terms of the indenture fix the basic expectations of the parties against which the restructuring will be negotiated. The indenture also affects the restructuring process because one of its provisions will detail the level of debtholder approval required to modify the indenture or waive a default by the company. This provision, buried in the back of the indenture, is a trap for the unwary. Invariably:

• The indenture will say that some actions can be taken without the consent or approval of any holder. These actions include items that are clearly immaterial such as the correction of a typographical error.
• The indenture will say that other actions cannot be taken without the consent or approval of the holders of some specified amount of the debt outstanding under the indenture. For example, the indenture might require the consent or approval of the holders of a majority in amount of the bonds outstanding as a condition precedent to the modification (or the waiver of a default) of a financial covenant.
• The indenture will say that still other actions cannot be taken without the consent or approval of each holder of the debt issued under the indenture that would be affected adversely. This is mandated by the Trust Indenture Act for the protection of investors. Actions requiring 100% consent or approval are those which affect the core economic terms of the investment: modification of the principal amount of the debt,
the rate of interest payable on the debt, the
due dates of principal and interest, etc.

The number and diversity of public
debtholders, coupled with the need for
100% consent or approval of changes in the
core economic terms of the public debt, to-
gether drive public debt workouts into
chapter 11. Restructurings necessitate hair-
cuts. In any restructuring, at least one public
debtholder, usually more, will refuse to ac-
cept a haircut. Sometimes the hold-outs are
accommodated: The other debtholders buy
their positions or allow their positions to re-
main outstanding. But if the hold-out posi-
tions are too big or if the terms of the
restructuring are simply not all that attrac-
tive, then the pro-restructuring forces will
not accommodate the hold-outs and bank-
ruptcy proceedings will be indicated.

Bankruptcy is so attractive in this situa-
tion because only in bankruptcy can the
hold-outs be compelled to accept the financial
terms of the restructuring.20 A series of
debt issued under an indenture will be all of
one class. In bankruptcy, the affirmative
vote of the holders of two-thirds in amount
of the claims of a class and of a majority in
number of the claims of that class actually
voted will bind the hold-out claimants in the
class.21 Therefore, if a majority in number of
the debtholders owns two-thirds or more of
the outstanding debt of the class, then they
may agree with the company upon the terms of
a restructuring that will bind all debthold-
ers—not only themselves—in bankruptcy.
This eliminates the hold-out problem.

The debtholders will form a committee
whose leadership will negotiate directly
with the company and other interested per-
s. The tactical objective is to agree upon
the terms of a “prenegotiated” or “prepack-
aged” bankruptcy that can be “confirmed”
by a bankruptcy judge and given effect in
accordance with its terms. Prenegotiated
and prepackaged bankruptcies are similar
but not identical. They differ mainly in the
degree to which the debtor’s plan of reor-
ganization—the restructuring—is approved
before the bankruptcy case is commenced.
In a prenegotiated chapter 11 proceeding,
the material provisions of the plan are ap-
proved by the debtholders’ committee be-
fore the proceeding is commenced, but a
formal solicitation and vote of the class of
claimants including the debtholders will not
have occurred quite yet. In a prepackaged
bankruptcy, all steps leading up to a hearing
on confirmation of the plan are taken before
the proceeding is commenced. These steps
include the soliciting and obtaining of all
necessary approvals by the impaired classes
of claims.

The wisdom of pursuing a prenegotiated
bankruptcy versus a prepackaged bank-
ruptcy is a complex question, heavily de-
pendent upon facts and circumstances
(including the experience of counsel and
courts), best left to another day. The point
here is that financing conducted under the
Trust Indenture Act will lead to restruc-
turing under—not outside—the Bankruptcy
Reform Act. Complex questions of securities
law and of bankruptcy law will arise in
every public debt work-out.

Disclosure Issues in the Vicinity
of Chapter 11
The Federal Securities Act of 1933 and the
Trust Indenture Act apply in bankruptcy ex-
ccept to the limited extent that the
Bankruptcy Reform Act provides exemp-
tions. The Securities Act compels SEC regis-
tration and prospectus delivery for non-exempt offerings of non-exempt securi-
ties.22 The Trust Indenture Act mandates use
of a “qualified” indenture for registered
debt offerings and some unregistered offer-
ings.23 Although there are definite advan-
tages to going and being “public,” troubled
companies will tend to avoid it if possible.

Subsection (a) of section 1145(a) of the
Bankruptcy Reform Act exempts the offer or
sale of securities (except by an “under-
writer,” as defined in subsection (b)), under
a plan of reorganization, from all laws (fed-
eral and state) requiring registration. Citing
section 1145, bankruptcy lawyers sometimes
promote the view that the securities laws
have no real bearing on their clients. This
view of section 1145 is problematic. Equity
or debt securities issued and sold by the
debtor or an affiliate, and not by an under-
writer, under the plan, will be exempt from
registration. However, securities offered be-
fore bankruptcy are not exempted by section
1145 from registration, securities offered
after bankruptcy are not exempted by section
1145 from registration, and securities off-
erings at any time are subject to SEC rule
10b-5. Furthermore, the periodic reporting
requirements of the Securities Exchange Act
remain applicable during the bankruptcy
proceeding.24 These realities must be dealt
with in every public company bankruptcy.

Pre-Bankruptcy Compliance
A prenegotiated bankruptcy entails solicita-
tion of approvals of the material elements of
the bankruptcy plan by the debtholders’
committee before the bankruptcy case is commenced. Typically, the company and the committee, led by its financial advisor, will seek signatures from debtholders on the signature pages of a lock-up agreement covering the economic and procedural terms of the restructuring. If the financial advisor has done its job thoroughly and well, then the committee members will be comfortable with this decision, they will sign the lock-up agreement, and a chapter 11 case will commence with the lock-up agreement serving as a species of agreement-in-principle governing preparation of the formal plan of reorganization.

Soliciting and obtaining signatures on the lock-up agreement can be an offer and sale of securities under section 5 of the Securities Act, requiring SEC registration absent an exemption. Much depends on the precise wording of the agreement — the strength of the commitment, the completeness of the terms — and other factors, but usually, by signing, debtholders will commit themselves to exchange their debt securities for cash or a security. That is an investment decision — “offer” and “sale.” Because the offer and sale occur before the bankruptcy petition is filed, when there is no “debtor,” the SEC staff has been taking the position that the section 1145 registration exemption for debtors does not apply. The staff position seems to cover prepackaged bankruptcies as well as prenegotiated ones. The solution is to identify and utilize some other registration exemption. If the beneficial holders are numerous or difficult to identify, that may not work and registration may be necessary.

**Post-Bankruptcy Compliance**

Stock or other securities issued to debtholders (or other claimants) under the plan, if exempt from registration by reason of section 1145, will be deemed to have been sold in a public offering and therefore can be resold without registration except when held by an affiliate. It may be difficult to identify affiliates if “Newco’s” stock is largely issued into street name. Affiliation is a classic mixed question of fact and law as to which the SEC staff will express no opinion, but applied wisdom, extracted from experience and lore, can be found in the securities bar.

To be exempt under section 1145, securities must be issued entirely in exchange for the recipient’s claim or equity interest or principally in such exchange and partly for cash or property. “Fresh capital” is not exempted by section 1145. The rationale is that, unlike persons already holding a claim against or interest in the debtor, the providers of fresh capital have no history with the debtor, no familiarity with its business, no special knowledge gained from being at the bargaining table, and therefore do have need for disclosure protections afforded by the securities laws. Because fresh capital is not exempt by virtue of section 1145, raising fresh capital to finance the business of “Newco” following plan confirmation will require use of another exemption or, failing that, registration. Possible integration with other securities offerings may need to be considered, too.

**Rule 10b-5 Compliance.**

Every purchase, sale or exchange of a security that utilizes the jurisdictional means is subject to rule 10b-5’s prohibition of fraud. All communications directed to debtholders, or to the marketplace generally, must be prepared with that prohibition in mind. This definitely includes the disclosure statement filed with the plan of reorganization, approved by the bankruptcy judge and distributed to debtholders (and other claimants) to function as the disclosure predicate for their votes to approve or reject the plan. So long as public debt is outstanding, every significant press release also should be scrutinized by a securities lawyer before issuance (whether or not it will be filed with the SEC).

**Conclusion**

The cestui que trust change for a board of directors as the corporation nears bankruptcy: Creditors displace shareholders as objects of fiduciary concern. “Beneficial” debtholders, not “record” holders, are sovereign. Chapter 11 is the likely solution, and the securities laws have a pervasive influence notwithstanding the registration exemption written into the bankruptcy code.

**NOTES**

1. In re Southland Corp, 124 BR 211 (Bankr ND Tex 1991). Today, virtually every underwritten issue of public debt securities is immobilized in the form of a global certificate held in a vault by or for The Depository Trust Company. The entire issue is held of record on the books of the issuing corporation in the name of DTC’s nominee, Cede & Co. DTC is a limited purpose trust company organized under the New York Banking Law, a “banking organization” within the meaning of the New York Banking Law, a member of the Federal Reserve System, a “clearing corporation” within the meaning of the New York UCC and a “clearing agency” registered as such under the Securities Exchange Act of 1934. DTC is owned by its participants and the major domestic securities exchanges. Because Cede & Co. is a mere nominee, holding solely for DTC’s participants (brokers, banks, trust companies and certain other institutions) in any particular issue of
securities, it has no economic issue in the securities that it holds and so is not their beneficial owner. The benefi-
cial owners can only be identified by making inquiry of
DTC’s participants. Some but not all of DTC’s par-
ticipants for which Cede & Co. is holding securities as
nominee, however, are themselves serving as nominees
for other investors. Any given participant may or may
not identify any particular customer for whom it holds
securities, depending upon the customer’s desire for fi-
ancial privacy. For these reasons, among others, it is
difficult to identify the beneficial holders of an issue of
public debt securities. That task should be undertaken
only by someone who is familiar with the policies and
procedures of DTC, as well as the applicable SEC and
NASDAQ regulations.

2. Bankruptcy Rule 3018(a) identifies the “holder of
record” as the person entitled to vote to accept or reject
the bankruptcy plan.


4. Other companies have made the same mistake. See,
e.g., In re Pioneer Finance Corp, 246 BR 626 (Bankr Nev
2000). One might think that Bankruptcy Rule 3018
should have been amended following Southland Corp,
but it wasn’t fixed then and hasn’t been repaired after
Pioneer Finance, either.

5. See Michigan Business Corporation Act § 541a(1)
(MCL 450.1541a(1)); Model Business Corporation Act § 
830(a); Revlon, Inc v Mc ndres & Forbes Holdings, Inc,
506 A2d 173 (Del 1986). See generally Committee on
Corporate Laws, Corporate Director’s Guidebook, at 7-17
(ABA Section of Business Law 3d ed 2001).

6. Manhard v Salmon, 249 NY 458, 464, 164 NE 545,
546 (1920).

7. See Simons v Conn, 549 A2d 300 (Del 1988); Harff v
Kentorian, 347 A2d 133 (Del 1975); Fir Tree Partners v
M & C Communications Inc (Freedman, J, Sup Ct, NY
County, decided Nov 2, 2001).

8. See Pepper v Litton, 308 US 295, 306-311 (1939);
Commodity Futures Trading Com. v Eintraub, 471 US 343,
355 (1985); Federal Deposit Ins Corp v Sm Fines Co, 692
F2d 973, 976-77 (4th Cir 1982).

9. See, e.g., Clarkson Co, Ltd v Shellco, 660 F2d 506 (2d

10. Contingent liabilities include items such as a guaran-
tee of another’s debt, litigation exposure and off-bal-
ance-sheet financing. Insurance is one kind of
contingent asset.

11. See Michigan Business Corporation Act § 541a(2)(b)
(director may rely upon experts in discharging fiduciary
duties); Model Business Corporation Act § 8.30(e)
same); Delaware General Corporation Law § 141(e)
same).

12. See, e.g., Guer v Ingersoll Publications Co, 621 A2d 784,
787 (Del Ch 1992).

144, “Accounting for the Impairment or Disposal of
Long-Lived Assets,” was issued by the Financial
Accounting Standards Board in August 2001 and must
be adopted by companies this year. SFAS 144 addresses
financial reporting and accounting for the impairment
or disposal of long-lived assets. SFAS 144 removes
goodwill from SFAS 121’s scope and establishes a “pri-
mary-asset” approach to determine the cash flow es-

timation period for a group of assets and liabilities. It
also expands the scope of activities that require discon-

14. Credit Lyonnais Bank Nederland, NV v Pathé
Communications Corp, 1991 Del Ch LEXIS 215 (Del Ch

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Antitrust Compliance Program for In-House Counsel

by Vicki Martin-Anderson*

Introduction
Any lawyer, or, for that matter, layperson who pays attention to the nightly news concerning various antitrust woes for such companies as Microsoft, Archer Daniels Midland, GE and Honeywell, knows that antitrust compliance is critical. The business managers and marketing and sales professionals who are responsible for conducting due diligence, deciding upon mergers and acquisitions, and dealing with channel partners and customers, need to have a solid awareness and understanding of the antitrust and competition laws of the jurisdictions in which their company functions.

I, along with other in-house counsel with antitrust expertise at Dow Corning Corporation, developed several antitrust courses to ensure that our client has sufficient awareness and knowledge of these global laws to properly conduct relationships with competitors, channel partners, and direct customers. One course is directed primarily at sales and marketing professionals; the other course, on which this article is based, is directed at executive and mid-level management. This course focuses more on antitrust concerns arising out of the activities these employees are more likely to be involved in: proper conduct with competitors in the course of conducting due diligence and negotiating various joint ventures, mergers, acquisitions, and divestitures. The intent of this article is to provide a resource to other in-house counsel who are trying to implement their own antitrust compliance programs. The following can serve as an aid for reviewing and explaining compliance issues to top and middle management.

Antitrust Basics
Sections 1 and 2 of the Sherman Act, enacted in 1890, define and make illegal behavior of what we now refer to as “cartels” or individual monopolists; it is illegal to conspire or otherwise unreasonably restrain trade.

Abuse of Market Power
In general, this includes unilateral behavior that injures competitors including refusals to deal, tying, and predatory pricing.

A Case Example: Microsoft
The Department of Justice’s complaint against Microsoft stated that the company practiced exclusionary marketing agreements, predatory pricing, and tying, among other things. The government used quotes from internal Microsoft e-mail.

For example:
Netscape pollution must be eradi
cated.
[Windows 98] is a key weapon in the IE [Internet Explorer] share battle
[Unless Microsoft] will leverage Windows...I don’t understand how IE will win.

Examine Implications for Your Company
Does your company have a dominant enough position in any market globally to be concerned about potential claims of abuse?

Cartel Behavior
In general this means

• agreements or understandings among competitors that limit competition or restrict the availability of products are almost always criminal;
• agreements among competitors to set (“fix”) prices to third parties violate the antitrust laws of most, if not all countries; and
• agreements among competitors to divide customers or territories are almost always illegal.

Ways to Prove Cartel Behavior
A formal agreement is not required for a finding of illegality. Rather, an illegal agreement could be found

• in any action signaling assent,
• in a common course of action after discussion of a subject, or
• in practices with anti-competitive effects along with prior anti-competitive actions which create the appearance of joint action.
Innocent discussions, when viewed along with later conduct, can be used to infer an illegal “agreement.” In fact, conduct will be judged not by what was intended, but by the effect in the marketplace.

Case Example: Sotheby’s
Sotheby’s and one of its officers were charged with participating in a conspiracy that lasted over six years. The conspiracy involved fixing the price of commission rates charged to sellers of high end goods at auctions. The evidence, which included both documents, behavior, and witness testimony, showed that Sotheby’s, its CEO, Diana Brooks, and their co-conspirators:

• Agreed to fix commissions;
• Agreed to publish non-negotiable sellers’ commission rate schedules;
• Agreed to the order in which each auction house would publish its non-negotiable sellers’ commission schedule;
• Did in fact issue sellers’ commission schedules in accordance with the agreements reached;
• Exchanged customer information for the purpose of monitoring and enforcing adherence to the non-negotiable seller’s commission schedules;
• Agreed not to make interest-free loans on consignments from sellers; and
• Agreed not to make charitable contributions as part of pricing to sellers.

Case Example: ADM
Three top executives were personally charged with trying to rig the $650 million globally-sine market with four Asian competitors. The charge was criminal price fixing. The company pled guilty and paid a $100 million fine. Acting Assistant Attorney General Joel I. Klein observed at the time that the $100 million fine was “the largest ever criminal antitrust fine.” Undercover tapes made by the former president of ADM Bio Products division at the meeting of competitors contained this statement:

ADM to competitor: “You’re my friend. I wanna be closer to you than I am to any customer cause you can make us...money.”

Examine Implications for Your Company
• What contact/meetings do you have with competitors?
• Could you easily prove the legitimate business purpose of the contact/meetings?

Contact with Competitors

Traditional Advice on Contact
Do not meet with competitors, agree with competitors or discuss business with competitors. There are limited exceptions for discussing buyer/seller relationships; technology sale or exchange; or health, safety, and governmental affairs activities.

The most dangerous thing a company can do is communicate frequently with competitors:

• even legitimate reasons for contact are viewed with suspicion,
• anything even hinting at discussion of improper subjects will be used against a company, and
• meetings matched with parallel behavior imply collusion.

Trade Association Contact
Trade associations are legal and legitimate, but are also viewed with suspicion. If such meetings occur, the following cautions should be taken:

• Follow proper topics such as governmental affairs/lobbying, collecting statistical data, promoting products, improving public image, or improving health and environmental performance.
• Use formalities to provide a record and help prove legitimacy. For example, use published policies or guidelines, agendas, and some sort of oversight by staff or counsel.
• Avoid informal or secret sessions.
• If improper topics come up, protest and/or leave, dramatically.

Business Relationship Contacts

• Keep in mind that independent action by individual companies is the key to avoiding problems for these reasons:
  the concept of the party acting alone is integral to antitrust compliance; and
  a firm may almost always choose, on its own, to deal, or refuse to deal, with a party without antitrust risk.

• Discussions between competitors should be confined to the exchange of information directly relevant to the transaction between the parties.

Practical Recommendations for Avoiding Antitrust Problems

Limit Topics Discussed with Competitors
When discussing a business relationship with a competitor, avoid the following topics:

• current or future prices, credit terms, discounts or incentives;
• profits or profit margins;
• sales territories or geographic markets;
When creating documents in the course of negotiating a relationship with a competitor, be aware that ALL correspondence and documents generated may have to be produced at some point.

- the business or marketing practices of customers;
- current or planned commercial activities or strategic plans; and
- other customers or their plans.

The following topics can be discussed:
- how to structure a deal or terms of a deal;
- overall efficiencies of business arrangements;
- information necessary and relevant to consummate a deal;
- public information; and
- in limited amounts and under controlled conditions, cost or other antitrust-sensitive data. However, use care and note that general or aggregated is better than specific data and historical is better than prospective data.

When creating documents in the course of negotiating a relationship with a competitor, be aware that ALL correspondence and documents generated may have to be produced at some point. But that does not mean to avoid any and all document creation. Rather, make sure the following actions are taken:
- Properly document your activities.
- Have counsel review all meeting minutes and other documents.
- Keep documentation to a minimum.
- Avoid references which imply industry agreement or cooperation, i.e. co-producers, friendly competitor, etc.
- Avoid inflammatory words like drive out or lean on competition, dominate, leverage, etc.
- Avoid references to general market or specific product markets; instead refer to product segment, market segment, or product niche.
- Avoid words and phrases implying improper cooperation, like industry pricing, rationality in the market, and reasoning with X to avoid disrupting market.

Consider Contractual “Walls”

The following precautions can serve as protection:
- Use confidentiality agreements.
- Limit information disclosure to specific individuals within the company’s negotiating team and employees with need to know status, but who have no or a procedurally limited ability to use information in an inappropriate way.
- Use third parties to review and assess information.

Consider Ethical “Walls”

You should have in place a visible, well-known and understood process for restricting access to information obtained in a legitimate relationship or negotiation with a competitor/customer. Such information should only be available to those responsible for selling to or buying from the competitor and customer or those negotiating a joint venture, acquisition or divestiture with that competitor. Individuals with day-to-day operational and pricing responsibilities should not negotiate major deals.

Where feasible, use separate account managers for customers and competitors. Have account managers for customers and competitors report to a high level, rather than to managers with day-to-day pricing responsibilities.

Level of Precaution Required Depends on Significance of Business Relationship

The extent of preventative compliance assurance actions should depend on several factors:
- the potential competitive effect the deal could have on the marketplace;
- the length of the business relationship—a long-term relationship requires care and caution; and
- the scope of the business relationship. Scoping out a joint venture or “virtual joint venture” between competitors where each has a large market share, or for the manufacture and distribution of many products, may require a full range of precautions. A one-time spot sale to a competitor most likely possesses less risk.

Conclusion

In today’s business climate, where managers have their hands full just keeping the company in the black, lawyers know there is competition for their attention. Read the Wall Street Journal and other business magazines to find examples of these issues. Periodically update this presentation with timely examples of “horror” stories involving antitrust investigations and prosecutions of competitors or businesses having something in common with your company, stories that graphically document the kind of consequences that can result from not taking this topic seriously.

NOTES
1. See http://www.usdoj.gov/atr/cases/ms_index.htm for these exhibits and other case documents.
2. U S v Sotheby’s Holdings, Inc; SDNY, No 00 Cr 1081 (2000); U S v Brooks; SDNY, No 00 Cr 1084, (2000).

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Case Digests
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Corporations—Statutory Cause of Action—Stock Shares
Estes v Idea Engineering & Fabricating Inc, No 211845, 2002 Mich App LEXIS 304 (March 5, 2002) ("Estes I"), resolved the conflict between Estes v Idea Engineering & Fabricating, Inc, 245 Mich App 328, 631 NW2d 89 (2001) ("Estes II"), and Baks v Moroun, 227 Mich App 472, 576 NW2d 413 (1998). The court held that MCL 450.1489 (“§489”) of the Michigan Business Corporation Act, which provides for relief for actions that are illegal, willfully unfair, or oppressive to the corporation or shareholder, states a separate, direct cause of action that is governed by the residual six-year limitations period set forth in MCL 600.5813. Baks held that §489 did not state a cause of action and applied the two-year statute of limitations in MCL 450.1541a(4) (“§541”). In Estes I, plaintiff acquired restricted stock shares from defendant employer. After the restricted period had expired on plaintiff’s last stock purchase, defendant informed plaintiffs that their shares had no value and were being redeemed. The court followed Baks as it was bound to do so by MCR 7.215(I)(1) and affirmed the dismissal of plaintiffs’ claims under §489 as barred by §541’s statute of limitations. The Estes II court adopted the reasoning of Judge Hoekstra’s dissent in Baks to reach its conclusion. The court noted that “§ 489 is quite clear in its mandate: § 489 creates a statutory cause of action along with flexible discretionary remedies to shareholders of closely held corporations. Moreover, it is clear that this statutory cause of action for ‘oppression’ in favor of minority shareholders who are abused by ‘controlling’ persons, is a direct cause of action, not derivative, and though similar to a common-law shareholder equitable action, provides a separate, independent and statutory basis for a cause of action.” 2002 Mich App LEXIS 304, at 11-12. Judge Hoekstra noted that the inclusion of a specific standard of care and jurisdiction and venue provisions in §489 is a clear indication that the Legislature was establishing a new and separate cause of action for shareholders in closely held corporations. In his construction of §489, Judge Hoekstra also emphasized the many differences between closely and publicly held corporations and therefore the differences between suits brought under §§489 and 541a (e.g., purposes, injuries, parties, and standards of care). The court also cited in support of its decision the amicus curiae brief provided to the court at its request by the Corporation Committee of the Business Law Section.

Employment Law—EEOC Not Barred From Seeking Relief by Arbitration Agreement
In EEOC v Waffle House, 122 S Ct 754 (2002), the Supreme Court held that an agreement between an employer and an employee to arbitrate employment-related disputes does not bar the EEOC from pursuing victim-specific judicial relief, such as back pay, reinstatement, and damages, in an enforcement action under the Americans With Disabilities Act. Eric Baker had been working as a grill operator at a Waffle House restaurant for about two weeks when he suffered a seizure at work and was discharged. All Waffle House employees were required to sign an arbitration agreement. In concluding that the arbitration agreement did not prevent the EEOC from seeking victim-specific relief, the court noted that Title VII provisions defining the EEOC’s authority (42 USC 1981a, 2000e-5, 2000e-11) “unambiguously authorize” the agency to pursue victim-specific relief. 122 S Ct at 760. The Court noted that once an ADA claim is filed, the EEOC is “master of its own case” and has the “authority to evaluate the strength of the public interest at stake and to determine whether public resources should be committed to the recovery of victim-specific relief.” Id. at 763. The Court emphasized that no case law or statutory language indicates that “the existence of an arbitration agreement between private parties materially changes the EEOC’s statutory function or the remedies that are otherwise available.” Id. at 761. The Court found that the Court of Appeals erred in basing its decision on a weighing of the different policy goals of the ADA and the Federal Arbitration Agreement (FAA), rather than on specific language in the statutes or the parties’ arbitration agreement. Because the EEOC was not a party to the arbitration agreement, the Court noted that the FAA’s pro-arbitration policy goals did not compel the EEOC to relinquish its statutory authority to pursue victim-specific relief, regardless of the forum chosen by employer and employee to settle their disputes.

Employment Law—Disabilities Discrimination—Coverage and Definitions
In Toyota Motor Mfg, Kentucky, Inc v Williams, 122 S Ct 681 (2002), the Supreme Court ruled that to qualify as “disabled” under the Americans With Disabilities Act, a person must have substantial limitations on abilities that are “central to daily life” and not only to life in the workplace. Plaintiff, a Toyota assembly line worker, suffered from carpal tunnel syndrome. The Sixth Circuit found plaintiff disabled as a matter of law in the major life activity of performing manual tasks, based on her inability to perform her assembly line job or other workplace tasks that required gripping or raising her arms. The Supreme Court held that was too narrow a focus on which to base a finding of disability because it ignored the question whether the limitations affected plaintiff’s daily life outside the factory. The Court held that to be substantially limited in performing manual tasks, an individual must have an impairment that is “permanent or long-term” and that prevents or severely restricts the person from “doing activities that are of central importance to most people’s daily lives.”

The Court’s analysis of what an individual must show to establish a substantial limitation in the major life activity of performing manual tasks was guided by the ADA’s disability definition. “Substantially” in the phrase “sub-
stantially limits” suggests “considerable” or “to a large degree”; this definition plainly rules out impairments that have an insignificant impact on the performance of manual tasks. Furthermore, because “major” means important, “major life activities” refers to those activities that are of central importance to daily life. For the performance of manual tasks to fit into this category, the tasks in question must be central to daily life. Such activities would include walking, seeing, hearing, and performing simple manual tasks like household chores, bathing, and brushing one’s teeth. Being unable to perform job-related tasks is not enough to qualify for protection nor is submitting evidence of a medical diagnosis of an impairment. Instead, the ADA requires individuals seeking protection to present evidence that the extent of the limitation caused by their impairment in terms of their own experience is substantial. It is evident that Congress meant for the existence of a disability to be determined in a case-by-case manner because the ADA defines “disability” “with respect to an individual,” 42 USC 12102(2). An individualized evaluation of the effect of an impairment is particularly necessary in the case of carpal tunnel syndrome, in which symptoms vary widely from person to person.

Garnishment—Definition of “Debt Owing”

In Waatti & Sons Electric Co v Shaya Constr Co, No 224513, 2002 Mich App LEXIS 113 (Feb 5, 2002), the court held that the trial court had misinterpreted the remand order contained in its previous opinion (230 Mich App 582, 584 NW2d 372 (1998) (Waatti I)), and erred as a matter of law by conducting an evidentiary hearing to determine the amount owed by the garnishee defendant to the builder. The trial court also erroneously granted plaintiff’s motion for summary disposition on remand. In 1994, plaintiff contractor (“Waatti”) obtained a default judgment against defendant builder (“Shaya Construction”), which Shaya Construction could not pay, as garnishee defendant (“Dehko”) owed it $61,500 of a $300,000 construction contract. The trial court granted Dehko’s motion for summary disposition, stating that when the writ of garnishment was served, there was no fixed amount of any debt owed by Dehko to Shaya Construction. On appeal, the Waatti I court held that the trial court erred in granting Dehko’s motion for summary disposition because the debt Dehko owed when he was served with the writ of garnishment was ascertainable from the parties’ contract and other competent evidence. The trial court was mistaken in concluding that to be a “debt owing” under MCR 3.101(G)(1)(d), Dehko’s debt to Shaya Construction must have been reduced to judgment before the writ of garnishment was served. When a court garnishee defendant denies liability, the proper course is to try the issue of the garnishee defendant’s liability; therefore, the Waatti I court remanded for a “determination of the amount owed by Dehko to Shaya Construction.”

On remand, however, the trial court conducted an evidentiary hearing, instead of a trial, apparently because it believed that it was being instructed to determine the amount owed itself. The trial court also erred in granting Waatti’s motion for summary disposition, as there was no genuine issue of material fact regarding the amount owed by Dehko to Shaya Construction. The parties did not dispute that the issue of Dehko’s liability to Shaya Construction was submitted to binding arbitration, that the arbitrator awarded $21,340.43 to Shaya Construction against Dehko, and that this award was not vacated, corrected, or modified by the arbitrator or the circuit court.

However, while the arbitrator determined that Dehko owed money, it did not determine whether he was legally obligated to pay, that is, whether Dehko was entitled to any setoff. When the circuit judge referred Dehko and Shaya Construction’s dispute to arbitration, she retained jurisdiction on the licensing and lien issues. After the arbitrator issued its award, Shaya Construction moved to enter judgment while Dehko moved for summary disposition on the licensing and lien issues. Before Waatti I, the circuit judge dismissed Shaya Construction’s motion to enter judgment and discharged its lien against Dehko, in exchange for dismissal of Dehko’s cross-claims against Shaya Construction. By doing so, the circuit court set aside Dehko’s liability to Shaya Construction. Because Dehko was not legally liable to pay the arbitration award, the trial court should have granted summary disposition to Dehko.

Corporations—Merger—De Facto—Successor Liability

In Craig v Oakwood Hospital, No 206642, 2002 Mich App LEXIS 106 (Feb 1, 2002) (majority in agreement with Cooper, J. opinion on successor liability), the court upheld the trial court’s finding that defendant Henry Ford Hospital (“Henry Ford”) was liable as the successor of Associated Physicians, P.C. (“Associated”). The underlying action concerned a suit brought because of severe injuries that plaintiff infant suffered during birth. At the time of plaintiff’s birth, defendant physician was an employee of Associated, whose shareholders later converted Associated from a professional corporation into a business corporation. Henry Ford purchased all outstanding shares of the new business corporation, and its employees became officers of the business corporation. Also, along with other physicians, most of Associated’s physician shareholders formed a new professional corporation, APMC, P.C., and negotiated a service agreement with Associated Physicians Medical Center, Inc. (“APMC, Inc.”). The medical clinic previously operated under Associated’s name remained at the same location and operated under the name Associated Physicians Medical Center in association with Henry Ford Health Care Corporation. The trial court relied on the principles enunciated in Turner v Bituminous Casualty Co, 397 Mich 406, 244 NW2d 873 (1976), to hold Henry Ford liable as a successor corporation. In Turner, the supreme court stated the basic principle underlying successor liability—continuation of corporate responsibility: “[I]f two corporations
merge, the obligations of each become the obligations of the resulting corporation.” Id. at 419-420. Continuation of corporate responsibility is found if: the seller’s enterprise continues; the seller ended normal business operations; the purchaser took on the liabilities and obligations of the seller ordinarily necessary to continue the seller’s normal business operations; and the purchaser held itself out to the world as the effective continuation of the seller. Id. at 430.

On appeal, the court first dismissed Henry Ford’s contention that the trial court erred in extending successor liability beyond the products liability area. It noted that Michigan courts have recognized the doctrine in other areas, and the fact that courts previously had not addressed successor liability for personal professional services did not prevent its imposition here. The court next rejected Henry Ford’s arguments that it had no notice of plaintiff’s claim when it purchased shares of APMC, Inc., and that it should not be liable because plaintiff had an adequate legal remedy against the physician, Associated, and Oakwood Hospital. Henry Ford then argued that even if successor liability should be applied, plaintiff failed to prove that the business corporation, APMC, Inc., was the successor of Associated. Henry Ford contended that the professional medical corporation, APMC, P.C., continued Associated’s medical practice and therefore was its logical successor.

The court first looked to Associated’s amended and restated articles of incorporation for evidence that APMC, Inc. was Associated’s successor. The articles stated that Associated was converted from a for-profit professional service corporation to a for-profit business corporation, and that Associated’s new name would be APMC, Inc. APMC, Inc. retained the corporate identification number of Associated, and it was undisputed that the medical clinic continued to operate at the same location as it had previously. The court noted that the prerequisites for imposing liability on Henry Ford had been met: the basic enterprise of Associated carried on, with most of the same physicians and in the same physical location. The court pointed out that the new professional corporation, APMC, P.C., was not the same corporation as Associated, because it had additional shareholders, did not own the physical location at which it operated, and was not in charge of managing the clinic. Rather, APMC, Inc., wholly owned by Henry Ford, carried on Associated’s business. Lastly, the court rejected Henry Ford’s argument that APMC, Inc.’s dissolution in 1993 precluded holding Henry Ford liable as successor. The court agreed with plaintiff that this dissolution achieved a de facto merger, as APMC, Inc. ceased operating, and Henry Ford continued to manage a medical clinic at the same site where Associated and then APMC, Inc. had operated one.

Insurance Law—Property Insurance—Duties of Insured

In Allen v Michigan Basic Property Ins Co, No 223009, 2001 Mich App LEXIS 313 (Dec 28, 2001), the court reversed the trial court’s denial of insurer’s motion for summary judgment because of plaintiff’s willful failure to comply with policy conditions. During its investigation into plaintiff’s claim for benefits following a fire at her residence, defendant notified plaintiff that the policy required her to undergo an examination under oath and supply it with documents related to her ownership of the property. Plaintiff did neither, claiming that counsel instructed her not to respond to defendant’s questions until after a criminal investigation into her possible involvement in the fire was completed. Defendant maintained that it sent plaintiff a letter on November 5, 1993, denying her claim. After plaintiff was absolved of any criminal responsibility for the fire, she requested that defendant pay her claim. Defendant again informed plaintiff that it would not pay the claim, and plaintiff brought suit for breach of contract.

In awarding defendant summary disposition, the court noted that plaintiff’s failure to respond to defendant’s requests was undisputed. Plaintiff claimed that her refusal to cooperate with defendant’s requests was an exercise of her Fifth Amendment right against self-incrimination. The court noted that “a party to a civil action that invokes his Fifth Amendment privilege does so to the peril of his claim. . . . Plaintiff cannot avoid the policy requirements that she agreed to with defendant and, which she herself triggered by filing her claim, by asserting her right not to be compelled to be a witness against herself.” Id. at 11-12. The court concluded that the plaintiff’s actions amounted to a “deliberate effort to withhold material information or a pattern of noncooperation with the insurer.” Id. at 10 (quoting Thomson v State Farm Ins Co, 232 Mich App 38, 87-88, 592 NW2d 82 (1998)). The court also found that even though plaintiff’s suit was filed well after the November 1993 denial letter, the trial court did not err in denying defendant’s motion for summary disposition on the ground that plaintiff’s suit was time-barred. There was no evidence to determine the actual date of denial, as neither party possessed a copy of the letter or even a certified mail receipt.

Contracts—Accord and Satisfaction

In Faith Reformed Church of Traverse City, M I v Thompson, No 222628, 2001 Mich App LEXIS (Dec 4, 2001), the court upheld the grant of summary disposition to defendant tenant on the ground that a valid accord and satisfaction barred plaintiff’s claim. Defendants vacated the leased premises in December 1996, a year before the end of its lease. Defendant made four rent payments until its discovery in March 1997 that plaintiff had begun renovating a portion of defendants’ space. In a June 1998 letter, defendant offered $2,819.65 (one month’s rent) as “full and final resolution of any and all rental claims which the landlord has against the tenant.” Plaintiff deposited the check but informed the defendant that it did not accept it as full settlement of its claim.

On appeal, the court noted that defendant had established all of the elements of a valid accord and satisfaction: (1) a good-faith dispute of (2) an unliquidated claim
of plaintiff, (3) a conditional tender of money in satisfaction of the claim, and (4) plaintiff’s acceptance of the tender (5) while fully informed of the condition. Id. at 6 (citing Nationwide Mut Ins Co v Quality Builders, Inc, 192 Mich App 643, 647, 482 NW2d 474 (1992)). The court determined that the June 1998 letter established the first element: defendants clearly disputed whether plaintiff had acted in good faith to obtain replacement tenants or mitigate damages and whether defendants owed rent after renovation activities began. As to the second element, plaintiff argued that its claim was liquidated because there was a written lease for a fixed term and a fixed amount, and plaintiff had agreed to refund defendants a certain amount because of the renovations. The court disagreed, pointing out that a liquidated claim is one that the debtor in good faith does not dispute – it is certain as to what and how much is due. It is insufficient to prove that something is due, unless it appears how much is due. Here, the parties clearly disputed how much was due, as plaintiffs believed defendants owed rent for the entire lease, and defendants maintained they did not owe rent after March 1997. Also, the court held that the condition accompanying tender of payment as expressed in defendants’ letter was clear and unequivocal. Plaintiff asserted that it did not accept payment with knowledge of the condition as an employee of its management company deposited the check without its authorization. The court held that this was irrelevant in light of the fact that plaintiff retained the check proceeds after learning of the conditions.

The court also rejected plaintiff’s argument that an accord and satisfaction was not established because its letter explicitly stated it did not accept the condition. Plaintiff’s letter made it clear that it understood the condition, and it is untenable to argue that it accepted the payment but not the condition. The court also dismissed plaintiff’s argument based on Nationwide, supra, that it was not required to tender back the payment before it could file suit for the balance of the rent. The court held that Nationwide was not binding precedent as defendant in that case did not prove an effective accord and satisfaction. Because the supreme court has never addressed explicitly whether tender back of payments is required where an accord and satisfaction is established, the court examined Lehaney v New York Life Ins Co, 307 Mich 125, 11 NW2d 830 (1943), which addressed the validity of an accord and satisfaction. Lehaney stated that when the parties in good faith dispute a claim, “the law does not permit the claimant to accept and retain the money which has been tendered by way of settlement and subsequently litigate with the debtor for the recovery of a greater sum.” 307 Mich at 131. The instant court concluded that because the law favors settlements, tender back of payment is a necessary prerequisite to filing suit when a valid accord and satisfaction is established.

Contracts—Contract Interpretation—Indemnity Provision

In Martin v City of East Lansing, No 225841, 2001 Mich App LEXIS 323 (Nov 30, 2001), which involved a construction contract indemnity provision, the court affirmed the trial court’s order enforcing third-party plaintiffs’ (HRC and SME) indemnity claim against third-party defendant JDC. The court first examined the language of the express indemnity provision, noting that general principles of contract interpretation apply to indemnity contracts. The indemnity provision clearly and unambiguously required JDC to indemnify HRC and SME against plaintiff’s personal injury claims. It read in part: “The Contractor agrees to indemnify, defend, and save harmless the Owner and the Engineer, their consultants, agents, and employees . . . against all claims . . . because of bodily injury.” Id. at 3. The court rejected JDC’s argument regarding contract section 50A, which assigned to the city responsibility for the presence of undisclosed hazardous substances at the construction site. JDC claimed that section 50A amounted to an assumption of liability by the city for personal injuries resulting from contact with hazardous substances and therefore relieved JDC of its indemnification duties. The court agreed with HRC and SME that section 50A did not excuse JDC from its duty to indemnify but rather allowed for the possibility of modifying the contract price and schedule if unforeseen site conditions delayed work or raised costs. The court noted that even if section 50A were interpreted as a release from the duty to indemnify, it would not have been triggered under these circumstances because the city had given JDC notice of the possible contamination. The court also rejected JDC’s argument that the city’s failure to disclose the presence of hazardous substances at the construction site during either the bidding process or final contract negotiations voided the contract for fraud in the inducement. Fraud in the inducement does not make a contract void but merely voidable at the election of the defrauded party. JDC never rescinded the contract, continuing to perform its duties after the city informed it of the contamination. Lastly, the court rejected JDC’s contention that a separate contract (limiting SME’s liability to HRC) resulted in a waiver of SME’s right to indemnification by JDC. The court emphasized that this separate contract was unrelated to and entirely distinct from JDC’s express contractual duty to indemnify.

Single Business Tax Act—Site-Based Capital Acquisition Deduction—Constitutionality

In Jefferson Smurfit Corp v Dep’t of Treasury, No. 224267, 2001 Mich App LEXIS 221 (Nov 13, 2001), the court reversed a court of claims order that held unconstitutional the site-based capital acquisition deduction (CAD) provision of the Single Business Tax Act. In 1997, plaintiff took a CAD for the apportioned costs of depreciable assets located in Michigan. Later plaintiff filed an amended return using the “fall-back” provision of MCL 208.23(i) and MCL 208.45(4) to take a CAD on the apportioned cost of its total assets acquired during 1997. Plaintiff filed the instant action, challenging the site-specific aspect of the CAD, effective for tax years 1997 and 1998, as an unconst-
stitutional burden on interstate commerce.

As originally enacted in 1975, the SBTA computed the CAD for real and personal property differently. 1975 PA 228, section 23. It limited the CAD for real property to property located in Michigan and allowed for a full deduction, whereas the CAD for personal property was apportioned to Michigan in a formula that included the payroll factor and the property factor. In Caterpillar, Inc v MI Dep’t of Treasury, 440 Mich 400, 488 NW2d 182, cert denied, 506 US 1014 (1992), the supreme court upheld the constitutionality of both aspects of the CAD. In 1995, the legislature amended the CAD provisions. 1995 PA 282. For tax years 1997 and 1998, taxpayers could use the site-specific CAD under MCL 208.23(e). The 1995 amendments included a “fall-back” provision, MCL 208.23a, which provided that if subsection 23(e) were declared unconstitutional, subsection 23(e) and other provisions became ineffective. In their place, subsection 23(i) would take effect; it allows a CAD for the apportioned costs of assets located within and without Michigan.

Complete Auto Transit, Inc v Brady, 430 US 274 (1977), established the four-pronged test to determine whether a state tax violates the Commerce Clause. To survive a Commerce Clause challenge, the tax must (1) apply to an activity having a substantial nexus with the taxing state; (2) be fairly apportioned; (3) not discriminate against interstate commerce; and (4) be fairly related to the services provided by the state. The third prong was at issue in this case. A state tax discriminates against interstate commerce if it (1) is facially discriminatory, (2) has a discriminatory effect, or (3) was enacted for a discriminatory purpose. The court rejected the court of claims finding that MCL 208.23(e) discriminates both on its face and in its effect. The court found that MCL 208.23(e) is facially neutral, because it is available to any and all companies doing any measure of business in Michigan. As to whether MCL 208.23(e) has a discriminatory effect, the court noted that it was “not convinced that the CAD provision is responsible for any deleterious effects suffered by multistate taxpayers who opt to increase activity outside Michigan.” 2001 Mich App LEXIS 221, at 13-14.

Uniform Commercial Code—Secured Transactions—Perfection—Priority
In Ford Credit Canada Leasing, Ltd v DePaul, 247 Mich App 732, 637 NW2d 831 (2001), the trial court awarded defendant car owners summary disposition under MCL 440.9103(1)(d)(i). The court of appeals upheld this result but noted that MCL 440.9103(2)(d), which governs movement of goods from noncertificate to certificate jurisdictions, was the controlling UCC section. Plaintiff, an Ontario resident, financed the vehicle’s original purchase and perfected its security interest in it by filing a financing statement with the Canadian Securities Registration System. (Ontario, however, does not require a lien notation on ownership documents and is a noncertificate province—no certificate of title is issued when a vehicle is purchased.) Defendants later purchased the vehicle, without knowledge of any liens, in Michigan. Defendants’ Michigan certificate of title listed the bank from which defendants obtained financing as the sole secured party. Plaintiff brought suit for claim and delivery against defendants, maintaining that defendants’ ownership interest was subordinate to its security interest.

On appeal, the court noted that MCL 440.9103(2)(d) protects the interests of the most vulnerable class of purchasers, that is, “nonprofessional” buyers (not dealers or secured parties). Otherwise, these purchasers would have little or no protection against secured parties because many jurisdictions fail to check elsewhere for outstanding liens before issuing a new certificate. Because the particular circumstances of the instant case met the conditions of subsection (2)(d), defendants qualified as innocent purchasers who took free of plaintiff’s lien.
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