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The editorial staff of the Michigan Business Law Journal welcomes suggested topics of general interest to the Section members, which may be the subject of future articles. Proposed topics may be submitted through the Publications Director, Robert T. Wilson, The Michigan Business Law Journal, 150 W. Jefferson, Suite 900, Detroit, Michigan 48226-4430, (248) 258-1616, or through Daniel D. Kopka, Senior Publications Attorney, Institute of Continuing Legal Education, 1020 Greene Street, Ann Arbor, Michigan, 48109-1444, (734) 936-3432.

**MISSION STATEMENT**

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

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

Welcome to the Spring 2004 issue of the Michigan Business Law Journal. The Financial Institutions Committee has compiled several useful articles for this issue. Topics include practical advice on how to find notices of state and federal tax liens, an overview of subordination agreements under Michigan law, the impact of UCC 9-406 and 9-408 on antiassignment provisions in LLC operating agreements, SBA designations and government contracting, and export controls and export administration regulation.

The “Did You Know?” column focuses on requirements for educational corporations and LLC operating educational institutions. Regular columns contain updates on tax matters and technology.

Plan to attend the Business Law Section's 16th Annual Mid-Year Meeting on Friday and Saturday, May 21 and 22, 2004, at Soaring Eagle Casino and Resort in Mt. Pleasant, Michigan. Dennis Archer, President of the American Bar Association, will give the Keynote Address on Friday afternoon. The program has several timely topics, including ethical challenges in representing the organization client, crisis management, preparing a business for sale, corporate identity theft, the roles and responsibilities of corporate law departments and updates on recent litigation and legislation.

The Business Law Section has announced its first annual Business Law Section Scholarship Award. The purpose of this award is to promote involvement with and knowledge about the Section to law students, and promote law student interest in business related topics. A monetary prize of $2,500 will be given to the student with the best article and the student's article will be published in the Michigan Business Law Journal. This award is open to all law students enrolled in an ABA accredited law school in the State of Michigan. Entries must be received by April 1, 2004. Additional information is available online on the Business Law Section's website at www.michbar.org/business/home.html.

Thank you for your continued interest and support of the Business Law Section.

Sincerely,

G. Ann Baker
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Nonpublic private elementary, secondary, and postsecondary schools may be organized and operated by an unincorporated entity. If, however, the educational institution is a corporation or limited liability company, it must comply with the requirements in sections 170–177 of the General Corporation Act. Section 171 requires that a letter of adequacy be obtained from the State Board of Education before articles may be filed. In addition, if the entity wishes to expand its program beyond what is specified in the articles, it must obtain a letter of approval before filing the document.

The State Board of Education made determinations of adequacy for all educational corporations prior to January 1, 2000. Executive Order 1999-12 transferred to the Department of Career Development the administrative responsibility for the determination of adequacy for postsecondary educational corporations and the regulation of private trade or business schools and proprietary schools. A corporation operating a licensed proprietary school or trade school is not required to form as an educational corporation. The responsibility for determinations of adequacy for nonpublic elementary and secondary educational corporations remained with the State Board of Education.

However, there has been some confusion since EO 1999-12 was issued. On November 20, 2003, the State Board of Education clarified their responsibility and adopted a process for the determination of adequacy for educational corporations operating elementary and secondary nonpublic schools. A corporation seeking approval must submit a report to the Department of Education, and approval will take place only after the report has been reviewed and determined to meet the adequacy requirements provided by law. Areas that should be discussed in the report are:

[1.] Housing Space and Administrative Facilities
- Evidence of compliance with state fire regulations is required.

[2.] Proposed Educational Programs
- The grades and subjects taught must be described, including the following required core courses.
  All levels: English, reading, mathematics, social studies and science.

On November 20, 2003, the State Board of Education adopted a process for the determination of adequacy for educational corporations operating elementary and secondary nonpublic schools.

3. Laboratories, Libraries, and Other Teaching Facilities
- The size and nature of the teaching facility must be described, including descriptions of the number and size of classrooms, any libraries, computer technology, science laboratories, etc.

4. Staff
- Staff qualifications must be described.
An individual may qualify to teach in Michigan nonpublic schools in one of three ways:

1. By obtaining a Michigan teaching certificate.
2. By obtaining a substitute, full-year or emergency teaching permit.
3. By obtaining a bachelor’s degree.

However, if a nonpublic school claims an objection to teacher certification based on a sincerely held religious belief, the minimum education requirements for teachers are waived (People v DeJonge 442 Mich 266).

5. Financing
- A letter or report from a certified public accountant must be provided that would verify that “at least 50% of its capital, whether of stock or in gifts, devises, legacies, bequests or other contributions of money or property, has been paid in or reduced in possession” as required by the Michigan General Corporations Act. [MCL 450.171]

* Note: The Nonpublic School Membership Report form (SM-4325) may be used to provide verification under adequacy requirements numbers 2 and 4.

The Department of Education sent follow-up letters to individuals and entities that had contacted the department regarding the requirements for educational corporations. The Corporation Division of the Bureau of Commercial Services will refer inquiries regarding K-12 educational corporations to the Department of Education and inquiries regarding postsecondary educational corporations to the Office of Postsecondary Services at Career Development.

Section 202(b) of both the Nonprofit Corporation Act and the Business Corporation Act provides...
that a corporation formed under the act to conduct educational purposes must comply with sections 170–177 of the General Corporation Act.\(^5\)

Foreign corporations are permitted to qualify only to conduct affairs or transact business in Michigan that a domestic corporation may conduct or transact.\(^6\) Attorney General Opinion No. 5581, issued October 12, 1979, states that “a non-profit foreign corporation must comply with the same statutory restrictions as a non-profit domestic corporation in order for such foreign corporation to be authorized to carry on its business in [Michigan].” In accordance with the opinion, foreign educational corporations are required to obtain a determination that they meet the adequacy requirements in MCL 450.170–177 before a certificate of authority will be issued.

Section 201 of the Michigan Limited Liability Company Act provides that a limited liability company may be formed for a purpose for which a domestic corporation formed under the Business Corporation Act may be formed.\(^7\) In addition, foreign limited liability companies are permitted to obtain a certificate of authority to transact business in Michigan that a domestic limited liability company may transact.\(^8\) A domestic or foreign limited liability company transacting the same business as an educational corporation may transact must comply with the same restrictions as an educational corporation and must obtain a letter of adequacy from the appropriate agency.

Articles and amendments of entities operating educational institutions should be reviewed to determine if they obtained the appropriate approvals. For more information about the adequacy requirements for an entity operating an elementary or secondary school, contact Carol Easlick with Government Services and Customer Satisfaction at the Department of Education, (517) 373-0764. For more information regarding adequacy requirements for postsecondary schools, contact the Educational Corporations Unit of the Office of Postsecondary Services at Career Development in the Department of Labor & Economic Growth, and for information regarding licensed proprietary schools, contact the Proprietary School Unit of the Office of Postsecondary Services.\(^9\) The phone number for the Office of Postsecondary Services is (517) 373-6551.

NOTES

1. MCL 450.170–177
4. The Department of Career Development became part of the Department of Labor and Economic Growth on December 7, 2003, pursuant to Executive Order 2003-18.
5. MCL 450.1202(b), .2202(b).
6. MCL 450.2011, .3011.
7. MCL 450.4201.
8. MCL 450.5003.

G. Ann Baker is the director of the Corporation Division of the Bureau of Commercial Services. Ms. Baker is a member of the International Association of Corporate Administrators. Ms. Baker is a member of the State Bar of Michigan and the American Bar Association. She is a member of the State Bar of Michigan Committee on Libraries, Legal Research, and Publications and is chairperson of the Business Law Section Council. She is a member of the Corporate Law Committee and the Unincorporated Enterprises’ Subcommittee on the Limited Liability Company Act. She has been a frequent speaker at ICLE courses and is actively involved in programs to train officers and directors of nonprofit corporations.
"Conventional Wisdom" vs Reality

There is no more dangerous soul than the one who does not know that he or she does not know. Many who are not routinely involved in an area follow the word on the street, or the “conventional wisdom.” Unfortunately, the conventional wisdom often lags several years behind reality.

There is no doubt that the word on the street about Internal Revenue Service (IRS) enforcement in the closely held business community is indeed trailing reality. In the highly publicized 1997 Senate hearings on abusive practices and procedures in the IRS, Chairman Roth and others criticized the IRS in general and the Collection Division in particular. Never mind that subsequent investigations revealed that the staged show was, to be kind, inaccurate. In such situations, Congress often either does nothing or it overreacts. Unfortunately, the result was overreaction and attempted Congressional micromanagement of the agency via the IRS Restructuring and Reform Act of 1998 (the Restructuring Act). The Restructuring Act was a morale killer at the IRS that resulted in certain parts of the agency, particularly the Collection Division, adopting somewhat of a “stay in the bunker” mentality. Many very knowledgeable and talented senior people who were eligible for pensions left the government and took with them their skills and institutional knowledge.

The IRS Is Definitely Back

After many consecutive years of funding cutbacks in the 1990s and the presidential and congressional assumptions that “computers can do it all,” there has been a reversal. The administration’s latest budget proposals would again allocate considerably more money for IRS enforcement. Both the Administration and Congress recognize that every dollar of IRS enforcement activity generates many dollars of governmental revenues. Given the magnitude of the deficits, increased IRS funding and activity will continue for many years into the future. For example, the number of civil examinations as well as criminal investigations this fiscal year, and those to be commenced next year, will again increase.

There is a renewed vigor in the step of enforcement personnel, from revenue agents to the Criminal Investigation Division, as well as those in the Collection Division and others. Those in daily contact with the IRS, such as Fortune 500 in-house tax professionals and outside tax counsel, understand this. However, many owners and tax directors of closely held businesses still believe the prevailing wisdom of the immediate post-Restructuring Act period that the IRS is in retreat. Because of these renewed investigative resources, procedures, and, most importantly, attitude, those who deal with the IRS on a daily basis know that the agency has indeed been reinvigorated.

We saw a plethora of high-dollar tax shelters of dubious validity being marketed in the post-Restructuring Act “depends what is is” time frame. Those taxpayers who believed the promoters are now under a very painful attack not only for tax and statutory interest, but also 40 percent penalties. None of those “investors” are happy today about becoming involved in the first place.

Action Step

The next time you participate in a meeting where your client or someone else proposes an “aggressive” tax idea and utters “they’ll never find it” or words to that effect, you can truly serve your client by giving them a reality check. We have all seen too many situations where clients who did not know that they did not know were their own worst enemies.

Paul L.B. McKenney, of Raymond & Prokop PC, Southfield, is a tax practitioner. He is a member of the Taxation Committee of the Oakland County Bar Association; the Sales, Exchanges and Basis Committee of the Taxation Section of the American Bar Association; and the Taxation Section of the State Bar of Michigan. He has published numerous articles and is a frequent lecturer on tax topics before various organizations. Mr. McKenney is a contributor on taxation issues to Torts: Michigan Law and Practice (ICLE 2d ed & Cum Supp).
**TECHNOLOGY CORNER**  By Michael S. Khoury

**Offshore Outsourcing of Information Technology Services: Part 1**

Offshore outsourcing has been described as everything from the panacea that will save industry by cutting the costs of information technology (IT) to a major threat to the American IT industry. American companies are constantly pressured to reduce costs where possible, and there is a trend to push jobs to low-wage areas in all sectors. Offshore outsourcing has been the target of much criticism and concern, and the reality of the trend deserves some examination. The first part of this column is a review of some of the background, priorities, and basic issues to address in considering an offshore outsourcing transaction. Part 2 of this column will address some of the more detailed contract issues.

Outsourcing generally makes sense for companies when technology is not a core competency of the business or it lacks the expertise to create, manage, or support mission-critical technologies. In the past, outsourcing has often been on-site or near-site, and the offshore model has grown because of other countries’ ability to provide adequately trained resources at a significant cost advantage.

Offshore outsourcing is not for everyone, however. There are communications, quality, and risk management issues that can outweigh any potential cost benefits. While commodity services have been typical of the outsourced work, many of these services may become obsolete based on ongoing improvements in the technology itself. Security concerns and possible taxation of these ventures may limit offshore outsourcing further. On the political side, outsourcing has become a target and may have encouraged various Michigan governmental agencies to make a concerted effort to save Michigan jobs, both manufacturing and otherwise, and to encourage job growth.

The Benefits of Outsourcing

There are important business and planning issues when customers consider offshore outsourcing. From the perspective of the procurement process, some of the most important benefits are based on the customer’s expectations that outsourcing will

- manage and reduce costs;
- focus on core business; and
- manage and transfer risk.

Customers need to understand, however, that outsourcing of IT or any other business services cannot be an abdication of management responsibility. Customers still need in-house management expertise and knowledge to be able to ensure that there are clearly defined requirements, that the requirements are met, and that there is an effective interface between them and their service providers.

Key Procurement Points

There are a number of key points that are important considerations in the procurement of offshore outsourcing services, including

- customer strategy in relation to the global dynamic;
- the processes to follow for an effective return of information;
- determination of key performance metrics;
- how to measure these metrics against the customer’s business objectives;
- key business terms to define; and
- how to measure disparate proposals.

As with all transactions, individual situations will dictate a variance in the “typical” approach to a sourcing transaction. If these variations are driven by the customer’s business objectives, rather than minor pricing variations or legacy concerns, the procurement process can elicit the appropriate critical information.

Cost Reductions

The customer should not assume that the offshore model is always be better or less expensive. A proper analysis of the risks, political repercussions, benefits, and savings may result in a decision to source the services domestically.

The Offshore Procurement Process

The procurement process for an offshore transaction needs to focus on the customer’s readiness and competencies, as well as the service provider’s capabilities. The customer needs to determine its readiness for an offshore transaction by examining whether it has maturity in its processes and technology. The customer needs to determine if the service provider market has the capability to deliver the desired service. Delivery capabilities will vary for different services, and the customer should understand the implications of these differences.

An offshore transaction differs from an onshore transaction in a number of ways. The customer must recognize and address the challenges of geography, culture, and customer-provider time zone differences inherent in most offshore models. These issues place significant importance on the due diligence of the service providers early in the procurement process to help ensure that the service delivery experience, technology, industry knowledge, and cultural fit are best suited to the customer’s vision and stated goals.

There are over 5,000 offshore service providers. Countries have different strengths and weaknesses, as do service providers in those countries. Customers must match their requirements against the characteristics of service suppliers to successfully leverage their individual competencies. Some service providers are strong in application development work, which includes large,
long-term development efforts with milestones along the project plan to measure success. Others are focused on technical and industry domain knowledge. Some offshore providers may be competent in supporting specific applications in technology, such as SAP, or have deep industry knowledge such as in financial services. Still others are highly competent in application maintenance. Often, offshore service providers may commit beyond their abilities in order to build their businesses. As a result, due diligence is a critical process, and customers should complete it early and thoroughly.

**Determining Key Performance Requirements**

It is important for both the customer and the service provider to understand the customer’s needs, priorities, and vision. The descriptions of the key business terms often define the primary objectives, and this is a prime opportunity for the customer to tell the service provider whether cutting-edge technology, management of technology resources by a third-party provider, pricing, cost savings, or some other issue is driving the outsourcing process. The most significant drivers of customer priorities will be reflected in the terms of agreement, the pricing of services, technology planning and refresh requirements, management of resources and service priorities, personnel transition, the need to increase the quality of service to customers, and the ability to leverage improved processes to improve productivity.

Just as a customer’s general counsel must evaluate the price and value proposition of staff counsel versus outside counsel, the customer must be able to assess the value that the sourcing service provider can provide. Therefore, an important focus of the sourcing exercise is for customers to understand their starting points so that they can then compare them to the solutions that service providers may propose. Once the current benchmarks are understood completely, they can be measured and the customer can be better prepared to address the sourcing process.

As part of the process, the customer should be able to define (and the service provider should understand) the objectives of the customer. Sufficient information about the customer’s current systems and technology strategy should be obtained to be able to estimate future requirements, general budgetary parameters, and the nature and detail of the information expected by the customer.

**Developing the Offshore Sourcing Strategy**

There are a number of items to consider when developing the offshore sourcing strategy.

*In-Scope Work.* Whether the scope of work to be outsourced is application development, applications maintenance and enhancement, technology infrastructure, or a business process such as a call center, it is critical that the customer be able to define the scope of work in very concrete and detailed terms. In addition to defining the scope of work to be performed, defining the service levels at which the work should be performed is crucial.

*Tactical versus Strategic Sourcing.* The customer’s overall sourcing strategy is a key component of the procurement process. The strategy enables the customer and the service providers to fully understand the key attributes of the project and to support the customer’s vision, priorities, and goals. This is the point at which customers determine the scope of their transactions. The work can be sourced tactically (small, discrete portions of work) or strategically (sourcing a transaction where the scope is large and for a longer term) to achieve the business goals.

*Single versus Multiple Service Providers.* Does the customer want to have a single service provider or multiple service providers? A single service provider strategy places risk and responsibility on that service provider. A multiple service provider approach spreads the risk among multiple service providers but places more management responsibility on the customer.

**Geographic Preferences.** There are many locations to evaluate when considering offshore sourcing. The location strategy should take into consideration not only costs but also the labor pool, the cultural fit of the labor force with the customer’s organization, government support, market maturity, economic and political stability, and whether the country’s infrastructure supports offshore outsourcing, especially with telecommunications and dependable power.

The offshore and near shore delivery models were pioneered by India, Ireland, countries in Europe such as Spain, and Canada. Because of the high availability of qualified labor, low labor costs, and relatively high cultural fit to English-speaking countries, India has clearly had dramatic growth in offshore sourcing in the past 10 years. Other countries such as the Philippines, Mexico, and the Caribbean area countries are emerging as strong service deliverers. Others, including Eastern Europe, Russia, and China, are poised to deliver substantial capability. The key for each customer is to determine the best match for the desired scope of work to be sourced, considering all key attributes of the service provider: its delivery model, location, and cultural fit.

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How to Find Notices of State and Federal Tax Liens

By James H. Breay

Introduction

Where to Search

A lender who routinely extends credit on the basis of a “clean” lien search that it obtains under the debtor’s legal name from the office of the secretary of state where the debtor is “located” may be unpleasantly surprised to find that the search did not disclose a notice of a tax lien that was on file against the debtor.

Often a tax lien search that is conducted at the office in which a financing statement (UCC-1) must be filed against the debtor will disclose any notices of state or federal tax liens that are on file against the debtor. This is not always true, however. The substantial revision of Article 9 of the Uniform Commercial Code (UCC), effective July 1, 2001, included significant changes in the rules that govern where to file a financing statement. These changes increased the differences between the rules on where a financing statement must be filed and the rules on where a notice of a state or federal tax lien must be filed. This article describes the rules that govern where a notice of a state or federal tax lien must be filed. It also briefly describes the primary rules for filing a financing statement under revised UCC Article 9.

Names Under Which to Search

Under revised UCC Article 9, a financing statement is not properly filed and is ineffective to perfect a security interest if it is not disclosed in a financing statement search that is obtained under the debtor’s actual name. The courts will decide whether this is also the rule regarding a notice of a state or federal tax lien.

In May 2003, the U.S. Bankruptcy Court for the Eastern District of Michigan held that a notice of a federal tax lien was valid even though it was sufficiently different from the debtor’s actual name that a financing statement search under the actual name did not disclose the tax lien. Although the district court reversed the bankruptcy court and the Internal Revenue Service (IRS) did not appeal, the case appears to be the only one on the issue that has been decided after July 1, 2001, and future court decisions could follow the approach of the bankruptcy court rather than the district court.

This article describes this recent case. It also suggests how one might select names in addition to the debtor’s exact name under which to search to protect against the possibility that other courts will hold that a notice of a tax lien may be valid even if it is sufficiently different from the debtor’s actual name that a search under the actual name will not disclose it.

Where to Search

Federal Liens

The Internal Revenue Code and Michigan’s Uniform Federal Lien Registration Act (Uniform Act) set forth the rules that govern where the IRS must file a notice of a federal tax lien. The Uniform Act applies not only to federal tax liens but also to “other notices of federal liens which under any act of [C]ongress or any regulation adopted pursuant to an act of [C]ongress are required or permitted to be filed in the same manner as notices of federal tax liens.” Examples of other federal liens are a lien in favor of the Pension Benefit Guaranty Corporation under ERISA (29 USC 1368) and a lien in favor of the United States under CERCLA (42 USC 9607).

The Uniform Act establishes the following rules for where the IRS must file a notice of a federal lien:

1. **Real Property.** A notice of a federal lien on real property must be filed in the office of the register of deeds in the county in which the real property is located.

2. **Personal Property.** In the case of personal property, the notice of federal lien must be filed as follows:
   a. If the taxpayer or debtor is a corporation or a partnership whose principal executive office is in Michigan, then
the question of whether a notice of federal tax lien properly identified the taxpayer is governed by federal law and not by state law.

State Tax Liens

The rules that govern where to file a notice of a state tax lien are primarily set forth in the Michigan State Tax Lien Registration Act. Those rules are the same as the rules of the Uniform Act for federal liens. Thus, a notice of a state tax lien on real property must be filed in the office of the register of deeds in the county where the real property is located. In the case of personal property, a notice of a state tax lien must be filed (1) in the office of the Secretary of State if the taxpayer is a corporation or “partnership” whose principal executive office is in Michigan and (2) in all other cases, in the office of the register of deeds in the county in which the taxpayer resides.

MCL 211.682(b)(1) provides that it applies to corporations and partnerships “as these entities are defined in the applicable tax laws of the state.” The Michigan Single Business Tax Act does not define either “corporation” or “partnership,” and it provides that a term that is used in the act but is not defined has the same meaning “as when used in comparable context” in the Internal Revenue Code. As noted above, the term “partnership” in the Internal Revenue Code may under certain circumstances include a limited liability company or other business entity. Therefore, it is advisable to assume that a notice of a state tax lien against a limited liability company or other business entity could be filed under either MCL 211.682(b)(1) or (2).

It appears that a notice of a lien for certain unpaid penalties and interest on those penalties assessed under the Michigan Employment Security Act is not subject to the State Tax Lien Registration Act. A notice of such a lien must be “recorded” in the office of the register of deeds “of the county in which the property subject to the lien is situated.”

UCC-1 Financing Statements

The rules on where to file a notice of a federal lien or a notice of a state tax lien are considerably different than the UCC rules on where to file a financing statement, which were substantially revised effective July 1, 2001.

Under the revised UCC, if the debtor is a “registered organization” (which includes a corporation, a limited liability company, and a limited partnership), then the proper place to file is the state in which the debtor is incorporated or otherwise organized (unless the collateral is fixtures, minerals to be extracted, or timber to be cut, in which case special rules apply). Thus, if the debtor is a

The only types of entities that MCL 211.663(3)(a) refers to are corporations and partnerships. This would suggest that if the debtor/taxpayer is a limited liability company or another type of business entity, then the filing must be made in the office of the register of deeds of the county where the debtor/taxpayer “resides” at the time the notice of lien is filed. The Internal Revenue Code defines “partnership” as including an “unincorporated organization,” which can under certain circumstances include a limited liability company or other business entity. For this reason, it is advisable to assume that a notice of tax lien against a limited liability company or other business entity could be filed under either MCL 211.663(3)(a) or (b). Neither the federal statute nor the Uniform Act specifies where an entity is considered to “reside,” and there is not any reported case law that addresses where an entity “resides” for purposes of these statutes.
It may be prudent to search for tax liens under names other than the debtor’s exact name.

Summary of Filing Rules for Notices of Federal Liens and State Tax Liens and Financing Statements
Appendix A to this article summarizes the rules regarding where notices of federal liens, notices of state tax liens, and financing statements must be filed.

Names Under Which to Search

The Crestmark Bank Case
Under revised Article 9 of the UCC, a financing statement must give the debtor’s exact, legal name. A financing statement that does not give the debtor’s exact name will be effective only if the financing statement would be disclosed by a search that is obtained from the office in which the financing statement is filed. This rule represents a major change from the prerevision rule, under which a financing statement “substantially complying” with the requirements of Article 9 was effective even though it contained “minor errors” that were “not seriously misleading.” Prerevision case law was split over whether a financing statement could be effective if it was not disclosed by a search under the debtor’s exact, legal name.

The Internal Revenue Code and Treasury regulations leave to the courts the question of whether a notice of a federal tax lien sufficiently identifies the taxpayer. In May 2003, the U.S. Bankruptcy Court for the Eastern District of Michigan held that a notice of federal tax lien filed under the name “Spearing Tool & MFG Company, Inc.” was valid and effective even though the taxpayer/debtor’s actual name was “Spearing Tool and Manufacturing Co., Inc.” and even though the two names were sufficiently different that the notice of federal tax lien was not disclosed by a search under the actual name.

The bankruptcy court stated:

Here, there was no error in identifying the taxpayer. The IRS used the accepted abbreviation for the word “Manufacturing.” See Webster’s New Collegiate Dictionary 512 (1986); THE BLUEBOOK: A UNIFORM SYSTEM OF CITATION 303 tbl. T.6 (Columbia Law Review Ass’n et al. eds., 17th ed. 2000). Further, the debtor frequently used the “Mfg.” and “MFG.” abbreviations in identifying itself. Moreover, Crestmark itself referred to the debtor as “Spearing Tool and Mfg.” in credit narratives prepared by a Crestmark employee.

The bankruptcy court rejected Crestmark’s argument that a notice of tax lien that is not disclosed in a search under the debtor’s legal name should not be given effect. The court did not explain, however, how a lender is to determine the name or names, in addition to the debtor’s legal name, under which the lender must obtain searches to be sure that it will find a notice of tax lien that is not filed under the debtor’s legal name.

On appeal, the district court acknowledged that the question of whether a notice of federal tax lien properly identified the taxpayer is governed by federal law and not by state law. The district court also acknowledged that under prevailing case law, the standard for determining whether a notice of federal tax lien properly identifies the taxpayer is whether a reasonable search would have disclosed the notice. The court held, however, that a notice of federal tax lien that...
is filed in the office of the Michigan Secretary of State does not properly identify the taxpayer unless the notice would be disclosed in a financing statement search that is obtained from that office under the taxpayer’s exact, legal name. The court therefore reversed the Bankruptcy Court, stating that

[w]hile the new version of the UCC, i.e. state law, does not control the content of federal tax liens, it does shed light on what is reasonable behavior for searchers in today’s environment. . . . [A] search of the Michigan Secretary of State’s record for liens on personal property only discloses records that match exactly with the name designated in the request. The Secretary of State will not search variants of the name (as it did under the former version of Article 9 of the UCC), and the public has no independent access to search the index. It is not reasonable . . . [to] require [researchers] to conduct separate, multiple searches under the debtor’s multiple possible names for a possible federal tax lien. The burden on the government to include corporate taxpayers’ registered names seems slight by comparison.27

Names to Search to Protect Against the Possibility That the District Court’s Holding in Crestmark Bank Will Not Be Followed

Although the district court’s ruling is sound28 and the IRS did not appeal it, it is possible that other courts may not follow it and may instead hold that a notice of a federal tax lien may be valid even if a search under the taxpayer’s exact name would not disclose it. Until the matter is resolved, it may be prudent to search for tax liens under names other than the debtor’s exact name.

The Michigan Secretary of State’s office has posted on its Web site an article on “Tips for a Trouble Free Search.”29 The article describes the search logic that the Secretary of State’s computer uses in processing searches. It may be helpful to review the article when trying to decide what name or names, in addition to the debtor’s actual name, under which a search should be obtained.

It appears that at least one reason the Secretary of State’s search in Crestmark Bank did not disclose the notice of the federal tax lien was that the debtor’s actual name contained the word “and,” while the notice instead used an ampersand (&). The Secretary of State’s search logic does not convert an ampersand to an “and” or vice versa. This, of course, suggests one obvious rule for searching: If the debtor’s actual name contains an “and,” then an additional search should be conducted using an ampersand instead of the “and,” and if the debtor’s actual name contains an ampersand, then an additional search should be conducted using the word “and” rather than the ampersand.

Another important feature of the search logic that the Secretary of State uses is that the logic does not convert a numeral to a word and vice versa. A filing under “Two Men and a Truck” will not be revealed by searching under “2 Men and a Truck,” and a search under “Two Men and a Truck” will not reveal a filing under “2 Men and a Truck.” Thus, if the debtor’s name contains a numeral, a search should also be conducted using the equivalent word and vice versa.

Appendix B to this article summarizes these suggestions for the name or names of a debtor/taxpayer under which to search.

Conclusion

A financing statement search that is obtained from the Michigan Secretary of State’s office may not disclose all state and federal tax liens and all financing statements that are on file against the debtor. Depending on the circumstances, it may be necessary also to obtain searches from the offices of one or more registers of deeds and from a filing office located in another state.

In the Crestmark Bank case, the U.S. District Court for the Eastern District of Michigan held that a notice of a federal tax lien that is filed in the office of the Michigan Secretary of State does not properly identify the taxpayer unless the notice would be disclosed by a search from that office under the taxpayer’s exact name. Because other courts may not adopt the same rule, it may be advisable to obtain searches under variations of the debtor’s name.

Searching in all offices in which a state or federal lien could be filed and under all names under which such a lien could be filed may involve significant expense. Before obtaining all of the suggested searches, one should determine the cost of doing so and

A financing statement search that is obtained from the Michigan Secretary of State’s office may not disclose all state and federal tax liens and all financing statements that are on file against the debtor.
the debtor taxpayer’s financial condition and then decide whether the cost justifies the likely benefit.

NOTES

1. MCL 440.1101 et seq.
2. 26 USC 6323(f); MCL 211.661 et seq.
3. MCL 211.662.
4. MCL 211.663(2).
5. MCL 211.663(3)(a).
8. MCL 211.663(3)(b).
9. Treasury regulations provide that, for federal tax purposes, a business entity that has two or more members and that meets other specified criteria is a “corporation” and that a business entity that has at least two members but does not meet the other criteria for a corporation is a “partnership.” The regulations also permit an eligible business entity to elect to be classified either as an “association” or a “partnership.” 26 CFR 301.7701-1–7701-3.
10. MCL 211.681 et seq.
11. MCL 211.682(a).
12. MCL 211.682(b).
13. MCL 208.2.
14. MCL 421.15(e).
15. MCL 440.9501, .9301, .9307.
16. MCL 440.9301, .9501.
17. MCL 440.9307.
18. MCL 440.9705(3).
19. MCL 440.9503.
20. MCL 440.9506.
21. See In re Wardcorp, Inc, 133 BR 210 (Bankr SD Ind 1990); In re Walker, 142 BR 482 (Bankr MD Fla 1992), holding that a filing will not be effective unless it is disclosed on a search under the debtor’s legal name. See also Hill v Farmers & Merchants Bank, 641 So2d 788 (Ala 1994); In re Mines Tire Co, Inc, 194 BR 23 (Bankr WDNY 1996); Citizens Natl Bank & Trust Co v Star Auto Warehouse (In re Thriftway Auto Supply), 159 BR 948 (Bankr WD Okla 1993); cf. In re Esparza, 821 P2d 1216 (Wash 1992), holding that a filing may be effective even if it is not disclosed by a search under the debtor’s legal name.
22. 26 USC 6323(f)(3) (“The form and content of a notice of federal tax lien shall be prescribed by the Secretary.”); Treas Reg 301.6323(f)-1(d)(2) (a notice of federal tax lien “must identify the taxpayer”).
24. Id. at 583.
27. Crestmark, 302 BR at 351.
28. The author is general counsel to the Michigan Bankers Association, and his firm filed with the District Court an amicus curiae brief on behalf of the association, in support of the position of Crestmark Bank, which challenged the validity of the notice of federal tax lien.
29. Available at http://www.michigan.gov/sos/0,1607,7-127-1631_8851-23765—00.html (last checked Feb 5, 2004). (Alternatively, access the Secretary of State’s home page at http://www.michigan.gov/sos/, then click on “Services to Businesses,” then click on “Uniform Commercial Code” and then “UCC Filings & Searches,” and click on the title of the article.)
## Appendix A

### Where to Search for Financing Statements and for State and Federal Liens

<table>
<thead>
<tr>
<th>Debtor/Taxpayer</th>
<th>Offices to Search</th>
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<tr>
<td>Corporation, limited partnership, or limited liability company</td>
<td>The state in which the debtor is organized: if Michigan, the office of the Michigan Secretary of State. MCL 440.9501, .9301, .9307 (UCC financing statement).*&lt;br&gt; If the debtor's principal executive office is in Michigan, the office of the Michigan Secretary of State. 26 USC 6323(f) (IRC), MCL 211.663(3)(a) (Uniform Federal Lien Registration Act), MCL 211.682(b)(1) (State Tax Lien Registration Act).&lt;br&gt; If the debtor's principal executive office is outside Michigan:&lt;br&gt; • The office of the register of deeds in the county in which the debtor &quot;resided&quot; when the notice of lien was filed. 26 USC 6323(f) (IRC), MCL 211.663(3)(b) (Uniform Federal Lien Registration Act).&lt;br&gt; • The state in which the debtor's principal executive office is located. 26 USC 6323(f)(1)(A)(ii) and 6323(f) (2) (IRC).&lt;br&gt; The register of deeds of the county in which any of debtor's property (whether real or personal) is located. MCL 211.682(a) (State Tax Lien Registration Act (for real property)). MCL 421.15(e) (Michigan Employment Security Act).&lt;br&gt;</td>
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*Until July 1, 2006, it is also necessary to obtain a search from the state in which any collateral consisting of goods, documents of title, instruments, or letters of credit were located before July 1, 2001, and from the state in which the debtor’s chief executive office was located before July 1, 2001 (if the collateral consists of accounts receivable, general intangibles, mobile goods, or chattel paper).

**Until July 1, 2006, it is also necessary to obtain a search from the state in which any collateral consisting of goods, documents of title, instruments, or letters of credit were located before July 1, 2001, and from the state in which the debtor’s chief executive office (or, if the debtor did not have a chief executive office, the debtor’s residence) was located before July 1, 2001 (if the collateral consists of accounts receivable, general intangibles, mobile goods, or chattel paper).
Appendix B

Names to Search to Protect Against the Possibility That Other Courts Will Follow the Approach of the Bankruptcy Court in Crestmark Bank

- The debtor’s exact, legal name
- Each name under which the debtor does any business, regardless of how close it is to the actual name
- Obtain and review the office’s search logic to determine if there are other names under which it is advisable to search. For the Michigan Secretary of State’s search logic, see www.michigan.gov/sos/0,1607,7-127-1631_8851-23765—00.html. That logic indicates that it may be advisable to do the following in Michigan:
  - If the debtor’s actual name contains an “and,” do a search that substitutes an ampersand.
  - If the debtor’s actual name contains an ampersand, do a search that substitutes an “and.”
  - If the debtor’s actual name contains a numeral (e.g., “9500 Rockefeller Plaza Corp.”), do a search that substitutes the equivalent word or words (“Ninety-Five Hundred Rockefeller Plaza Corp.” and “Nine Thousand Five Hundred Rockefeller Plaza Corp.”).
  - If the debtor’s actual name contains a number expressed by a word (e.g., “Two Men and a Truck, LLC”), do a search that substitutes a numeral (“2 Men and a Truck, LLC”).
A Primer on Subordination Agreements Under Michigan Law

By Andrew D. Hakken

In any commercial transaction that involves an extension of credit, the potential exists that the lender (Senior Lender) will require a subordination agreement from another creditor of the debtor (Junior Creditor). A subordination agreement may relate to the indebtedness owed to the Senior Lender and a Junior Creditor, to the liens securing that indebtedness, or to both. The indebtedness may take a variety of forms (e.g., a negotiable instrument, an account, or chattel paper), and the liens may arise from a variety of sources (e.g., a voluntary security interest or a statutory lien).

This article describes the Michigan law that governs a debt subordination agreement and a lien subordination agreement (for personal property liens only), as well as limitations on subordination agreements in the bankruptcy context. This article also addresses the primary issues that a well-drafted subordination agreement should cover.

Governing Law

Uniform Commercial Code

The Uniform Commercial Code (UCC) by and large allows debtors, creditors, and secured parties to agree among themselves on the relative priorities of their obligations and security interests. Section 1-209 of the UCC provides as follows regarding a debt subordination agreement:

An obligation may be issued as subordinated to payment of another obligation of the person obligated, or a creditor may subordinate his right to payment of an obligation by agreement with either the person obligated or another creditor of the person obligated. . . . [S]ubordination does not create a security interest as against either the common debtor or a subordinated creditor.

Similarly, UCC 9-339 provides as follows regarding a lien subordination agreement:

This article [Article 9] does not preclude subordination by agreement by a person entitled to priority.

There is little reported Michigan case law addressing these sections of the UCC, but the case law that does exist analyzes subordination agreements in a manner that is consistent with the official comments to these sections. Thus, the case law supports the view that a subordination agreement is governed by general contract principles. For example, in Conagra v Farmers State Bank, the Michigan Court of Appeals held that “in the absence of any directly controlling UCC provisions, we resolve questions concerning the scope and effect of subordination agreements according to general legal principles, here, the law of contract interpretation.”

Bankruptcy Code

Similar to the UCC, section 510(a) of the federal Bankruptcy Code provides as follows regarding debt and lien subordination agreements:

A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.

However, bankruptcy courts have imposed limitations on the enforceability of subordination agreements, at least where the debtor and the Junior Creditor are each a debtor-in-possession under Chapter 11 of the Bankruptcy Code. For example, in In re Holly’s, Inc., the court considered a hotel management agreement under which the management company subordinated its right to payment of management fees to the hotel owner’s debt service payments to the Senior Lender. The management company filed its Chapter 11 petition approximately one year after signing the management agreement, and the hotel owner filed its Chapter 11 petition approximately one month later.

The court characterized the subordination provisions of the management agree-
ment as the management company’s non-recourse guaranty of the hotel owner’s indebtedness to the Senior Lender. After acknowledging the open-ended language of section 510(a) of the Bankruptcy Code, the court cited case law that nonetheless limits the enforceability of a subordination agreement in the bankruptcy context. The court ultimately enforced the management agreement’s subordination provisions regarding the management company’s prepetition earnings under the management agreement but refused to enforce the subordination provisions regarding postpetition earnings.

The court based its limitation on a “fundamental tenet of bankruptcy law [that] a petition for bankruptcy operates as a ‘cleavage’ in time. Once a petition is filed, debts that arose before the petition may not be satisfied through post-petition transactions.” Moreover, “[t]o hold to the contrary would allow an unsecured creditor to possess greater rights than a secured creditor under the Bankruptcy Code.”

**General Contract Principles**

Despite the holding in *Holly’s, Inc.*, a court applying Michigan law should normally enforce a subordination agreement according to general contract principles. Given the UCC’s broad definition of “agreement” in section 1-201(3), a subordination agreement (1) need not be formal, (2) may be based on dealings of the parties, (3) may be oral, and (4) may be implied from the parties’ conduct. However, because a court could conceivably apply a more rigorous analysis to a subordination agreement, the prudent Senior Lender will require an agreement in writing, supported by consideration, with assurances of due authorization and mutual assent and lack of mutual mistake.

**Primary Issues in Subordination Agreements**

**Parties.** A debt or lien subordination agreement is typically made among the Junior Creditor, the Senior Lender, and the debtor. However, Michigan’s third-party beneficiary statute would permit the Senior Lender to enforce a subordination agreement that is only between the Junior Creditor and the debtor. As part of its due diligence for the loan, the Senior Lender should identify every other creditor or potential creditor of the debtor whose indebtedness or liens must be subordinated to the Senior Lender’s indebtedness or liens. The Senior Lender can presumably rely on UCC searches to determine the debtor’s secured indebtedness (to the extent that perfection occurs by filing a financing statement) but will need to rely on the representations of the debtor and a review of the debtor’s records to determine the debtor’s unsecured indebtedness.

The list of potential Junior Creditors can be extensive, including holders of negotiable instruments or chattel paper, vendors to the debtor, landlords, and warehousemen. To help ensure that each person who holds an interest in a Junior Creditor’s subordinated indebtedness has signed a subordination agreement, the Senior Lender should insist on a representation from the Junior Creditor that it has not sold, assigned, otherwise encumbered, or subordinated its interests in the subordinated indebtedness or in any instrument or other document evidencing that indebtedness. UCC searches of the Junior Creditor’s name or names might also be appropriate.

**Identify the Junior Creditor’s Debt.** The list of potential indebtedness to Junior Creditors can be extensive. If the subordination agreement is to subordinate the Junior Creditor’s debt globally, the indebtedness should be described as broadly as possible, including future indebtedness. However, if the subordination is more limited in scope, the subordination agreement must identify the indebtedness at issue with specificity. If the subordinated indebtedness is not evidenced by an instrument or other document, then the Senior Lender should consider requiring the Junior Creditor and debtor to do so. This would enable the Senior Lender to (1) require that a legend be placed on the instrument stating that it evidences a subordinated obligation and (2) take possession of the instrument or document, if so desired.

**Identify the Senior Lender’s Debt.** The subordination agreement can describe the Senior Lender’s indebtedness either globally or on a more limited basis. This will depend on the nature of the transaction and the relative bargaining power of the parties. With a limited debt subordination agreement, identifying the Senior Lender’s indebtedness largely mirrors the identification issues for a Junior Creditor’s indebtedness noted above.

**Extent of Debt Subordination.** The subordination agreement must clearly define how
much the payment of the subordinated indebtedness is restricted. The restriction may range from a prohibition of any payment on the subordinated indebtedness, permitted payments of accrued interest only, permitted prepayments of principal within defined limits, or anything in between, depending on the transaction and the relative bargaining power of the parties. To the extent that payment is restricted, the subordination agreement should define “payment” broadly to encompass the debtor’s giving value to (or foregoing rights it otherwise has against the Junior Creditor), through a setoff, a release, a credit, an operation of law, or otherwise.

The subordination agreement might also prohibit otherwise permitted payments on the subordinated indebtedness if the debtor is then in default to the Senior Lender or if the debtor would be in default on making an otherwise permitted payment. Depending on its bargaining power, the Junior Creditor may demand prior written notice of such a default before the Junior Creditor is prohibited from accepting payment from the debtor under those circumstances. Regardless of how this negotiation unfolds, the subordination agreement should provide that the Junior Creditor will hold in trust for the Senior Lender, and immediately deliver to the Senior Lender, with appropriate endorsements, any payment on the subordinated indebtedness that the Junior Creditor is not entitled to receive under the subordination agreement. In return, the subordination agreement should provide that the Junior Creditor is subrogated to the Senior Lender’s rights for payments that would otherwise apply to the Junior Creditor’s debt. However, the subordination agreement should postpone enforcement of the subrogated rights until the Senior Lender’s debt is repaid in full.

Lien Subordination. If applicable, the subordination agreement should clearly define which of the Junior Creditor’s liens, including those created by operation of law or by agreement of the debtor, are subordinated to which of the Senior Lender’s liens. As with subordinated debt, lien subordination can be global, including future liens, or can specifically include or exclude types of liens (e.g., purchase money liens) or types of collateral. For the amount subordinated, the subordination agreement’s priority scheme should prevail, regardless of the timing of the attachment or perfection of the liens, including the filing of financing statements. Depending on the transaction, the lien subordination should expressly extend to products and proceeds of the debtor’s collateral and to collateral that the debtor acquires after the date of the subordination agreement.

Junior Creditor’s Forbearance. To fully effect the Junior Creditor’s debt and lien subordination, the Junior Creditor should agree not to accelerate the subordinated indebtedness or to begin an action or other proceeding against the debtor or its assets on the debtor’s failure to make payment on the subordinated debt. Depending on the parties’ relative bargaining power, the restriction may be absolute, prohibiting any such action until the Senior Lender is paid in full, or limited to a period of time that would at least enable the Senior Lender to negotiate a workout arrangement with the debtor before being forced to accelerate its debt and begin its own action against the debtor (or before the debtor is forced to file for bankruptcy protection). To help avoid an immediate commencement of the forbearance period, the Senior Lender should require the Junior Creditor to represent and warrant that there is not any existing default relative to the subordinated indebtedness or any event that, with the passage of time or the giving of notice (or both), would be an event of default.

Modification of Indebtedness. The Senior Lender should seek to limit the Junior Creditor’s and the debtor’s ability to modify the subordinated indebtedness, any instrument or document evidencing the subordinated indebtedness, or any security for the subordinated indebtedness. On the other hand, the Senior Lender should seek wide latitude to make such modifications to its indebtedness and security, all without notice to or the consent of the Junior Creditor, and the Senior Lender should include typical suretyship waivers by the Junior Creditor.

Depending on its bargaining power, the Junior Creditor may seek to impose limits on the Senior Lender’s ability to make these modifications, including a limitation on the amount of senior indebtedness to which the subordinated indebtedness or liens are subject. The Junior Creditor might also insist upon advance written notice of such modifi-
The terms of any given subordination agreement will depend in large part on the transaction at issue and the bargaining power of the parties involved.

Conclusion

Subordination agreements are commonplace where a lender is extending credit to a debtor who has other creditors. A subordination agreement can relate to the debtor’s debt obligations, the liens securing those obligations, or both. Debt and lien subordination agreements are largely unrestricted under Michigan law, but bankruptcy courts have limited the enforcement of subordination agreements in certain circumstances to protect a Junior Creditor’s creditors. The terms of any given subordination agreement will depend in large part on the transaction at issue and the bargaining power of the parties involved. However, there are particular issues that every subordination agreement should cover, as identified above.

NOTES

1. MCL 440.1101 et seq.
2. MCL 440.1209. The last sentence of this section overturns case law to the contrary, which held that a subordination agreement is not enforceable against creditors of a Junior Creditor unless the security interest established by the subordination agreement is properly perfected. See, e.g., In re Wyse, 340 F2d 719 (6th Cir. 1965).
3. MCL 440.9339.
5. Id. The Conagra court also held that the lien subordination agreement at issue applied not only to the principal collateral identified in the agreement (beans) but also to the identifiable cash proceeds of that collateral, even though the agreement did not expressly provide that. Id. at 132–133.
6. 11 USC 510(a).
8. Id. at 674.
9. Id. at 678–679.
10. Id. at 676 (quoting In re B&L Oil, 782 F2d 155 (10th Cir 1986)).
11. Holly’s, Inc, 140 BR at 679.
12. MCL 440.1201(3).
14. The Senior Lender’s extension of credit to the debtor in reliance on the subordination agreement is adequate consideration. Id.
15. Typically, the mutual mistake would relate to the relative priority of the Senior Lender’s and Junior Creditor’s liens in the absence of the subordination agreement. The Senior Lender could help to minimize this issue by obtaining and delivering to the Junior Creditor a UCC search(s) of the debtor’s name(s) during negotiations over the subordination agreement.
16. MCL 600.1405.
17. See also Holly’s, Inc, 140 BR at 673.
18. As noted in UCC 1-310, this possession alone does not create a security interest in the Senior Lender.
19. See official comment 3 to UCC 1-310, which also addresses purchasers of certificated securities if a legend or other notice appears on the certificate.
20. Such action should give notice of the Senior Lender’s prior security interest in the primary collateral and in any cash proceeds of such collateral.

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The Enforceability of Antiassignment Provisions in LLC Operating Agreements as Impacted by UCC 9-406 and 9-408

By Kenneth J. Clarkson & Ronald S. Melamed

Introduction

Article 9 of the Uniform Commercial Code (UCC) was recently revised after many years of work by the National Conference of Commissioners on Uniform State Laws. Michigan adopted its version of revised article 9 in 2000, effective July 1, 2001.¹ One of the primary goals of the revised article 9 is the promotion of financing transactions by making collateral available for secured transactions.² The Michigan Limited Liability Company Act³ (LLC Act) was first adopted in 1993 and has, on the other hand, a primary goal of giving business entities flexibility through freedom of contract.⁴ The goals of these two statutory schemes may have been placed at odds with one another through the enactment of UCC sections 9-406 and 9-408.⁵ These two sections of article 9 attempt to facilitate financing and to support the free alienability of property by negating provisions that prohibit or restrict the granting of security interests. These statutes may override provisions in LLC operating agreements that restrict or prohibit the assignment of membership interests as contemplated by sections MCL 450.4501–.4515 of the LLC Act.⁶

The Terms of UCC 9-406 and 9-408

UCC 9-406(4) applies to accounts, chattel papers, payment intangibles, and promissory notes, and promises of payment intangibles, and general intangibles.⁷ The concern for the purposes of this article is the application of UCC 9-406(4) to “payment intangibles” and UCC 9-408(1) to “general intangibles.”⁸

Although UCC 9-406(4) has much broader application than the instant concern with LLCs, for the purposes of this discussion, UCC 9-406(4) negates a term in an agreement between an account debtor and an assignor, with respect to accounts or payment intangibles, to the extent that (1) the term prohibits, restricts or requires the consent of the account debtor to the assignment or transfer of or the creation, attachment, perfection, or enforcement of a security interest in the account or payment intangible or (2) the term provides that the assignment or transfer or the creation, attachment, perfection, or enforcement of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the account or payment intangible.

UCC 9-408(1) also has a much broader application than the instant concern with LLCs. However, for the purposes of this discussion, UCC 9-408(1) negates a term in an agreement between an account debtor and a debtor, with respect to general intangibles, as far as the term prohibits, restricts, or requires the consent of the account debtor to the assignment, transfer, creation, attachment, or perfection of a security interest in the general intangible if that term (1) would impair the creation, attachment, or perfection of a security interest or (2) provides that the assignment, transfer, creation, attachment, or perfection of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the general intangible.

To summarize, UCC 9-406(4) negates antiassignment provisions in the context of accounts or payment intangibles, and UCC 9-408(1) negates antiassignment provisions in the context of general intangibles. Although UCC 9-406(4) negates antiassignment provisions that would impair or prohibit the enforcement of security interests, UCC 9-408(1) does not.⁹
LLC Membership Interest as a General Intangible and the LLC Member's Right to Receive Distributions from an LLC as a Payment Intangible

A general intangible is defined in UCC 9-102 as “any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction. The term includes payment intangibles and software.” Typically, a membership interest in an LLC will be deemed a general intangible.

While a membership interest is a general intangible, the right to receive distributions from an LLC (an important element of most membership interests) may be a “payment intangible” at the same time. A payment intangible is a specific type of general intangible, defined in UCC 9-102 as “a general intangible under which the account debtor’s principal obligation is a monetary obligation.” This could include the payment obligations incident to a membership interest in an LLC when, in the context of a secured lending arrangement, the collateral that is assigned is the member’s right to receive distributions from the LLC to the exclusion of any of the other rights incident to that membership interest, i.e., the right to vote, the right to manage, etc. The conclusion that in such an instance the collateral would be a payment intangible is supported by comment 5(d) to UCC 9-102, which provides:

If the promissee’s right to payment of money is assigned separately, the right is an account or payment intangible, depending on how the account debtor’s obligation arose. When all the promissee’s rights are assigned together, an account, a payment intangible, and a general intangible all may be involved, depending on the nature of the rights.

Given that UCC 9-406 and 9-408 apply to payment intangibles and general intangibles, and that membership interests and rights to receive distributions with respect to such membership interests may be considered general intangibles and payment intangibles, it is clear that the threshold requirements of UCC 9-406 and 9-408 have been met. These sections require further analysis to determine whether they will apply to any assignment prohibitions in an LLC operating agreement when a security interest is created with respect to a membership interest in that LLC.

Requirements for the Application of UCC Antiassignment Provisions to LLC Operating Agreements

UCC 9-406(4) and 9-408(1) both require that, before either section will apply, the term or provision regulating the assignability of the membership interest must be found in “an agreement between an account debtor” and either an “assignor” with respect to UCC 9-406 or a “debtor” for 9-408. For the purposes of this discussion, the question is whether the operating agreement is an agreement between an account debtor and a debtor.

The term “account debtor” is defined in UCC 9-102(1)(a) as “a person obligated on an account, chattel paper, or general intangible.” If either UCC 9-406 or 9-408 is to apply, the argument would be that the LLC is obligated or bound by the operating agreement and, as such, the LLC is the account debtor bound to the member concerning the general intangible, the membership interest.

The LLC Act lends support to the argument that the LLC is obligated by the operating agreement. Under MCL 450.4102(2)(q), the term “operating agreement” is defined to be a written agreement “by the member of a limited liability company that has 1 member, or between all of the members of a limited liability company having more than 1 member, pertaining to the affairs of the limited liability company and the conduct of its business.” Because under this definition the operating agreement is only required to be “by” the one member or “between” the members, it might first seem that an LLC would not be an account debtor under the UCC, but this analysis is somewhat simplistic.

The LLC Act is replete with statutory provisions setting forth obligations on and providing rights to all LLCs “unless otherwise provided in an operating agreement.” For example, MCL 450.4302 provides rights to the company to accept cash instead of property or services, MCL 450.4306 limits a member’s right to demand distributions from the company, and MCL 450.4408 provides for the indemnification of managers by the company.

These provisions and the other sections...
of the LLC Act do not, by definition, mean that any LLC is (in the terms of the definition of an account debtor) “obligated” on the agreement. However, if it is the intention of the members to opt out of the default provisions provided in the LLC Act and to set forth provisions in the operating agreement regulating the conduct of the company on terms or in a manner different than that provided by the statute, one would be hard pressed to argue that the company is not “obligated” under the operating agreement. This is particularly true when, as frequently is the case, the LLC itself is a party to the operating agreement. The same conclusion may be reached where the LLC is not a signatory to the operating agreement. In the Delaware case of Elf Atochem North America, Inc v Jaffari, the court held that the LLC was bound by the terms of its operating agreement even though the LLC was not a party to the agreement. This case and the line of reasoning applied in it support the contention that, regardless of whether the company actually signs the operating agreement, it is obligated on the agreement and is therefore an account debtor.

The risk that UCC 9-406 and 9-408 could apply and vitiate the provisions of an operating agreement that restrict the assignment of membership interests was viewed to be significant by Delaware and Virginia. Both of these states enacted specific statutes to ensure that UCC 9-406 and 9-408 would not be applied to override the antiassignment provisions in LLC operating agreements. Effective February 1, 2002, Delaware amended the Delaware Limited Liability Company Act to provide that UCC 9-406 and 9-408 do not apply to any interest in an LLC. Additionally, the Delaware legislature amended UCC 9-406 and 9-408 to confirm this result. The Virginia legislature also amended UCC 9-406 and 9-408 to specifically exempt LLCs and partnerships from their scope.

**Conflict Between the UCC and the Michigan LLC Act**

There is a conflict between the LLC Act’s general deference to the right to contract and the UCC’s general deference to free assignability in an effort to facilitate financing. This conflict is most pronounced when UCC 9-406 and 9-408 are juxtaposed against the sections in the LLC Act that permit the inclusion of restrictions on assignments and security interests in LLC operating agreements. With the prefatory clause, “Except as provided in an operating agreement,” MCL 450.4505 codifies the general rule that the members are free to restrict the assignability of membership interests by contract and provides in pertinent part: “(1) Except as provided in an operating agreement, a membership interest is assignable in whole or in part.” Consistent with MCL 450.4506(1), MCL 450.4508 provides that the members are free to restrict the pledge of membership interests by contract with a similar prefatory clause and provides in pertinent part:

- **Unless otherwise provided in an operating agreement, the pledge or granting of a security interest . . . does not cause the member to cease to be a member or to lose the power to exercise any rights or powers of a member.**

In addition to the provisions of the two statutes quoted above, MCL 450.4506(1) might also be at odds with UCC 9-406 and 9-408 by conditioning the membership of an assignee into an LLC “upon a unanimous vote of the members entitled to vote.”

It could be argued that, because the provisions in the LLC Act specifically apply to transfers of membership interests in LLCs, that Act should control the provisions of UCC 9-406 and 9-408, which arguably permit to transfers generally. On the other hand, UCC 9-406 and 9-408, as part of the revised UCC adopted July 1, 2001, might arguably have control because it is the later of the statutes adopted by the legislature.

This conflict will most likely be resolved so that UCC 9-406 and 9-408 will control. Both UCC 9-406 and 9-408 include provisions that confirm that any “statute . . . [that] requires the consent of . . . [an] account debtor to the assignment or transfer of, or creation of a security interest . . . is ineffective . . .” The sections of the LLC Act referenced above do not go so far as to “require” the consent of an LLC account debtor, so the subsections of UCC 9-406 and 9-408 that make statutes “ineffective” are not directly applicable. However, it can be argued that these subsections do evidence a strong legislative intent that UCC 9-406 and 9-408 are to take precedence over conflicting statutes.

Comment 5 to UCC 9-406 provides that
UCC 9-406 “overrides both restrictions and prohibitions of assignment .... [A]nti-assignment clauses are ‘ineffective.’... [T]he clause is of no effect whatsoever; the clause does not prevent the assignment from taking effect between the parties and the prohibited assignment does not constitute a default under the agreement between the account debtor and assignor.”

What is not clear, however, is what type of clause in an operating agreement might actually be viewed as restricting an assignment to a point where it is overridden by UCC 9-406 or 9-408. Additional language in comment 5 to UCC 9-406 indicates that this section “does not override terms that do not directly prohibit, restrict, or require consent to an assignment but which might, nonetheless, present a practical impairment of the assignment ... [T]his does not override all terms that might ‘impair’ an assignment in fact.” Comment 5 goes on to state, “[A] court may conclude that a covenant with no business purpose other than imposing an impediment to an assignment actually is a direct restriction that is rendered ineffective ...” This is an invitation to litigation involving whether a covenant in an operating agreement constitutes a covenant with a legitimate business purpose or is in reality simply an impediment to an assignment.

UCC 9-408 presents parallel uncertainties. Comment 6 to UCC 9-408 continues the theme of the comments to UCC 9-406 and goes on to state that the section does not override terms that do not directly prohibit, restrict, or require consent to an assignment but which might, nonetheless, present a practical impairment of the assignment. ... [T]his section, like [UCC] 9-406(d), reaches only covenants that prohibit, restrict, or require consents to assignments; it does not override all terms that might ‘impair’ an assignment in fact. ... This section does not prevent an account debtor from protecting by agreement its independent interests that are unrelated to the ‘creation, attachment or perfection’ of a security interest.

This too is an invitation to litigation involving the question whether a covenant in an operating agreement is drafted to protect an independent interest unrelated to the creation of a security interest or is simply a disguised prohibition on assignment.

The comments to UCC 9-406 and 9-408 attempt to provide some guidance about what might constitute a provision with a legitimate business purpose or a provision that protects interests independent from those related to assignment, neither of which would be nullified under UCC 9-406 and 9-408. The comments posit a fact situation where the licensee of computer equipment assigns its interests (in derogation of antiassignment provisions in the license agreement) in the licensed equipment, while the secured party remains subject to the licensor’s restrictions on the use of the computer software. In addition, a fact situation is detailed where a franchisee seeks to pledge its interest in a franchise agreement (over antiassignment provisions in the franchise agreement), but the secured party remains deterred from accepting the pledge because the secured party would remain subject to confidentiality clauses that protect an interest independent from the assignment itself.

As the comments state, members of LLCs may have legitimate business interests independent from those related to the assignment of membership interests that have the practical effect of preventing the assignment of a membership interest in an LLC. These interests might include confidentiality concerns (as illustrated in the franchise agreement example in the comments), financial strength of the members for future capital calls and third party guaranties, noncompetition concerns, and the particular business expertise of the members, because such expertise impacts management concerns, just to name a few. All of these interests may legitimately be protected through provisions within an operating agreement, and these provisions might well have the practical effect of prohibiting a secured lender from accepting the assignment of a membership interest, either because these covenants impose business risks on the assignee or because these covenants decrease, or make uncertain, the value of the membership interest as collateral. Nonetheless, these interests are entitled to be protected and should be protected when UCC 9-406 and 9-408 are applied.

It is not unusual that the enforceability of covenants included in a business document are tested against the law. This is particularly common in situations where transfers of
property or property rights are at issue. Restraints on alienation have long been held unenforceable. This principle has been applied to vitiate real property interests in leases and land contracts and was formerly a basis for defeating so-called “due on sale” provisions in mortgage finance documents. Assignment restrictions in leases are also disregarded in the bankruptcy context. However, the problem in this instance is that the freedom of contract principle that is the cornerstone of the LLC as a business entity is very much at odds with the concepts of free alienability codified in UCC 9-406 and 9-408. Furthermore, although 9-406 and 9-408 do not purport to nullify provisions that serve legitimate business interests outside of the assignment concept, the difficulty is that whether any provision actually protects a legitimate business interest or is a disguised antiassignment provision is heavily fact dependent. Heavily fact-dependent determinations breed uncertainty, and uncertainty breeds litigation.

**Options for Avoiding the Application of the UCC's Antiassignment Provisions**

UCC 9-406 and 9-408 do not apply to investment property. A membership interest in an LLC will be a security and an investment property if the entity has “opted in” to Article 8 of the UCC by satisfying the requirements of UCC 8-103(3), UCC 8-103 establishes the general rule that interests in an LLC are not securities unless they are dealt in or traded on securities exchanges or the issuer has opted in to Article 8 by specifying that the membership interests are securities governed by Article 8. To effectively opt in, it is only necessary to have the operating agreement for the LLC “expressly provide” that the membership interests are securities governed by Article 8.

This solution to avoiding UCC 9-406 and 9-408 is the most certain means of ensuring the enforceability of antiassignment provisions in an operating agreement. However, electing to opt in to Article 8 will subject the members and the entity to the statutory scheme of Article 8 and grant rights and impose duties that would not exist outside of Article 8. These rights and duties are beyond the scope of this article but would include UCC 8-204 (regarding compliance with the means to ensure the enforceability of transfer restrictions), UCC 8-209 (providing for liens in favor of issuers), and UCC 8-108 (imposing implied warranties in connection with securities transfers), to name a few. All of the duties and rights under Article 8 must be reviewed to assess whether the goal of avoiding UCC 9-406 and 9-408 is outweighed by the costs of opting in to this statutory scheme.

As indicated above, Delaware and Virginia have adopted statutory schemes to clearly provide that the provisions of UCC 9-406 and 9-408, which would otherwise vitiate antiassignment provisions in the limited liability company context, will not apply. As a result, attempting to have the law of either of these states apply to the transaction would avoid the consequences of sections 9-406 and 9-408 without opting in to Article 8. The problem with this alternative is that it is not clear that simply subjecting the LLC to the laws of the State of Delaware (or Virginia) will be sufficient to enjoy the protections of that state’s statutes on this issue.

Comment 3 to UCC 9-401 indicates that the choice of law rules provided in part 3 of the UCC do not determine the law governing these matters because they do not relate to perfection. The example cited in this comment posits a factual situation that would be similar to one in which Michigan residents form a Delaware LLC with restrictions on transfers and assignment agreed to in the operating agreement. Thereafter, one of the members grants a security interest to a secured party in Michigan with the agreement between the member and the secured party stating that Michigan law would govern the secured transaction. The comment concludes that “[t]his Article does not provide a specific answer to the question of which State’s law applies to the restriction on assignment in the example.” Traditional non-UCC choice of law principles would provide that answer and would have to be reviewed to determine the applicable law. That analysis is also beyond the scope of this article. Again, the costs of submitting to the laws of the jurisdiction of Delaware (or Virginia) would have to be weighed against the goal of protecting antiassignment provisions in an operating agreement by avoiding UCC 9-406 and 9-408 while engaging in a conflict of law analysis.

Finally, one might attempt to avoid UCC 9-406 and 9-408 by placing antiassignment provisions in a document to which the LLC is not a party. As indicated above, UCC 9-406 and 9-408 only operate to nullify

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**Delaware and Virginia have adopted statutory schemes to clearly provide that the provisions of UCC 9-406 and 9-408 . . . will not apply.**
antiassignment provisions contained in an agreement between the debtor and the account debtor. It would not be uncommon, for example, for a member of an LLC to secure the obligations of the other member or members with a pledge of the other members’ interest in the LLC under a separate security agreement. An equity financing company requiring a preferred return legitimately might secure return of the equity and preferred return with such a pledge.

By placing the antiassignment provisions in the pledge instrument, the precondition imposed by UCC 9-406 and 9-408 that the antiassignment provision must be found in an agreement between the debtor and the account debtor is not satisfied. The ability of the other members (or those members’ secured lenders) to argue that the antiassignment provisions have been nullified under UCC 9-406 and 9-408 would be lessened considerably. However, one would still face the arguments under the Elf case discussed above that regardless of whether the LLC is a party to the security agreement, the operating agreement would not have been entered into but for the security agreement and benefits to the LLC. As such, the LLC may be found to be bound by its terms.

Conclusion

UCC 9-406 and 9-408 can be interpreted to apply to antiassignment provisions commonly found in LLC operating agreements. The goal of promoting financing and making collateral available for borrowers to pledge to secured lenders as embodied by article 9 of the UCC may be at odds with the goal of free contracting and flexibility in organizing business entities as embodied in the LLC Act. The tension between these two goals and the uncertainty over determining what constitutes an antiassignment provision subject to nullification will result in litigation testing the enforceability of antiassignment provisions contained in LLC operating agreements. To lessen the risks of this type of litigation and to ensure the enforceability of antiassignment provisions in LLC operating agreements, drafters who prepare operating agreements should consider either opting in to Article 8 of the UCC, having the law of a jurisdiction other than Michigan govern the matters of the LLC, or placing antiassignment provisions in agreements other than those to which the LLC is a party to lessen the risks of litigation.

NOTES

1. MCL 440.9101 et seq.
2. MCL 440.9101, comment 4(a).
3. MCL 450.4101 et seq.
5. MCL 440.9406 and 440.9408, respectively.
6. Given the popularity of the LLC as the “business entity of choice,” the analysis in this article will be restricted to LLCs. However, the issues raised in this article are equally applicable in the context of general and limited partnerships and should be considered in the formation of those entities as well.
7. UCC 9-406(4) provides in relevant part:

[A] term in an agreement between an account debtor and an assignor or in a promissory note is ineffective to the extent that it does 1 or more of the following:

(a) Prohibits, restricts, or requires the consent of the account debtor or person obligated on the promissory note to the assignment or transfer of, or the creation, attachment, perfection, or enforcement of a security interest in, the account, chattel paper, payment intangible, or promissory note.

(b) Provides that the assignment or transfer or the creation, attachment, perfection, or enforcement of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the account, chattel paper, payment intangible, or promissory note.

8. UCC 9-408(1) provides in relevant part:

[A] term in a promissory note or in an agreement between an account debtor and a debtor that relates to a health-care-insurance receivable or a general intangible, including a contact, permit, license, or franchise, and which term prohibits, restricts, or requires the consent of the person obligated on the promissory note or the account debtor to, the assignment or transfer of, or creation, attachment, or perfection of a security interest in, the promissory note, health-care-insurance receivable, or general intangible, is ineffective to the extent that the term does 1 or more of the following:

(a) Would impair the creation, attachment, or perfection of a security interest.

(b) Provides that the assignment or transfer or the creation, attachment, or perfection of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the promissory note, health-care-insurance receivable, or general intangible.

9. The impact of UCC 9-408(i) is ameliorated by UCC 9-408(4). UCC 9-408(4) limits the scope of the nullification of transfer restrictions and protects the account debtor by limiting the ability of the assignor to impose burdens on the account debtor as a result of the assignment.

10. A membership interest will not be a “general intangible” if the LLC has opted in to article 8 and the requirements of UCC 8-103 have been met. Opting in to article 8 is discussed later as a means of avoiding the uncertain effects of UCC 9-406 and 9-408.
11. There may be other agreements that are involved in connection with the entry into an operating agreement. There may be subscription agreements, contribution agreements, or others. In such instances, to determine whether UCC 9-406 or 9-408 apply, the analysis here should be expanded to include these other agreements as well.

12. 727 A2d 286 (Del 1999).

13. The synopsis of Senate Bill No. 413 in the 141st General Assembly of the Delaware State Senate, available at http://www.legis.state.de.us/legislature.nsf/6LISArchives/openframeset (last visited Jan 29, 2003), which amended UCC 9-406 and 9-408 of the Delaware UCC, states:

This Amendment corrects two errors in the bill submitted and passed in 2000 for the enactment of revised Article 9 to the Delaware Uniform Commercial Code and conforming changes. It also conforms Article 9 of the Delaware Uniform Commercial Code to take into account changes, made earlier this year to Delaware’s alternate entity statutes, that make clear that partnership and limited liability company interests are not within the ambit of Sections 9-406 and 9-408 of the Delaware Uniform Commercial Code.

Likewise, the synopsis of House Bill No. 372 in the 141st General Assembly of the Delaware House of Representatives, available at http://www.legis.state.de.us/legislature.nsf/6LISArchives/openframeset (last visited Jan 29, 2003), which amended the Delaware Limited Liability Company Act to clarify that UCC 9-406 and 9-408 do not apply to any interest in an LLC, including those arising under an LLC agreement, states, “This section amends Section 18-1101 of the Act to confirm the principle of freedom of contract that exists regarding the ability to restrict assignments of interests in a limited liability company.

Similar statements were also made in the synopses of other bills that amended the Delaware Limited Partnership Act and the Delaware Limited Partnership Act to clarify that sections 9-406 and 9-408 of the UCC do not apply to those interests.

Similarly, the summary of Senate Bill 861 adopted by the Virginia State Legislature, which included amendments to UCC 9-406 and 9-408 of the Virginia UCC, UCC 8.9A-406 and 8.9A-408, respectively, states that the bill "provides that when the operating agreement of a limited liability company contains an agreement among members that restricts their ability to pledge or transfer their ownership interests, they will be given effect as a matter of freedom of contracting notwithstanding contrary provisions of the Uniform Commercial Code.”


15. Del Code Ann tit 6, § 9-406(i) provides: “(i) Inapplicability.—This section does not apply to . . . (5) an interest in a partnership or limited liability company.”

Del Code Ann tit 6, § 9-408(c) provides: “(c) Inapplicability.—This section does not apply to . . . (4) an interest in a partnership or limited liability company.”

16. See Va Code Ann 8.9A-406(k), which provides: “Inapplicability to partnership and limited liability company interests. This section does not apply to an interest in a partnership or limited liability company.” See also Va Code Ann 8.9A-408(g), which provides: “(g) Inapplicability to partnership and limited liability company interests. This section does not apply to an interest in a partnership or limited liability company.”

17. This deference to free assignability is confirmed by comments 2 and 8 to 9-408 and also official comments 6 and 7 to 9-408. See also comment 5 to 9-406. These comments make it clear that an objective of 9-406 and 9-408 is to make collateral available so that parties may obtain credit when they would not otherwise be able to do so.


20. MCL 440.9406(6) provides:

Except as otherwise provided in subsections 2A303 and 9407 and subject to subsections (8) and (9), a rule of law, statute, or regulation, that prohibits, restricts, or requires the consent of a government, governmental body or official, or account debtor to the assignment or transfer of, or creation of a security interest in, an account or chattel paper is ineffective to the extent that the rule of law, statute, or regulation does 1 or more of the following:

(a) Prohibits, restricts, or requires the consent of the government, governmental body or official, or account debtor to the assignment or transfer of, or the creation, attachment, perfection, or enforcement of a security interest in, the account or chattel paper.

(b) Provides that the assignment or transfer or the creation, attachment, perfection, or enforcement of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the account or chattel paper.

Likewise, MCL 440.9408(3) provides:

Except as otherwise provided in subsection (4), a rule of law, statute, or regulation that prohibits, restricts, or requires the consent of a government, governmental body or official, person obligated on a promissory note, or account debtor to the assignment or transfer of, or creation of a security interest in, a promissory note, health-care-insurance receivable, or general intangible, including a contract, permit, license, or franchise between an account debtor and a debtor, is ineffective to the extent that the rule of law, statute, or regulation does 1 or more of the following:

(a) Would impair the creation, attachment, or perfection of a security interest.

(b) Provides that the assignment or transfer or the creation, attachment, or perfection of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the promissory note, health-care-insurance receivable, or general intangible.

21. UCC 9-406 and 9-408 will not nullify an antiassignment provision in an operating agreement in all instances. UCC 9-109 provides that the UCC applies to any transaction, regardless of form, that creates a security interest or a sale of accounts or payment intangibles. As a result, Article 9 (including 9-406 and 9-408) will only apply if a security interest or sale of account or payment intangibles is involved. Nonetheless, using LLC membership interests as collateral for secured transactions is common. Furthermore, remedial provisions of standard operating agreements commonly effect a pledge of each member’s membership interest to secure the performance of each member’s obligations under the operating agreement. With respect to these secured transactions, UCC 9-406 and 9-408 will clearly come into play.


25. With this uncertainty, one can envision litigation in the nature of the litigation under 11 USC 365(b)(3) of the Bankruptcy Code, where experts are retained to assess whether use restrictions in leases are genuinely designed to preserve tenant mix and synergy in shopping centers or are simply de facto restrictions on assignment. See In re Rickesl Home Ctrs, Inc, 240 BR 826 (Bankr D Del 1998); In re Sun TV & Appliances, Inc, 234 BR 356, 370 (Bankr D Del 1999); LaSalle Nat’l Trust, NA v Trak Auto Corp, 288 BR 114, (Bankr ED Va 2003). This may be a costly result for failing to consider 9-406 and 9-408 when an operating agreement is prepared and the antiasignment provisions are negotiated.

26. By its terms, UCC 9-406(4) only applies to accounts, chattel paper, payment intangibles, or promissory notes. The application of UCC 9-408(1) is similarly limited, applying solely to promissory notes, health care insurance receivables, and general intangibles. Accounts, chattel paper, payment intangibles, promissory notes, and general intangibles are all specifically defined in 9-102 as specific classifications of collateral. Investment property is also defined in UCC 9-102 as a distinct and separate form of collateral. Thus, investment property does not fall within the purview of UCC 9-406(4) and 9-408(1).

27. There may be other states that have adopted nonuniform versions of UCC 9-406 or 9-408 as well. A general survey of all states has not been conducted by this author.

28. See supra n12.

29. For additional material on these issues see Even If You Are a Real Estate / Securities / Corporate / Partnership / Emerging Company / Finance Lawyer: What Every Lawyer Needs to Know About UCC Article 8, ABA Business Law Section Seminar, Apr 4, 2003, and Revised Article 9: Questions from the Perplexed—Common Drafting Issues, ABA Seminar, Nov 18, 2003.

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SBA Business Designations and Government Contracting

By Donald L. Katz, Catherine M. Collins, & Paul A. Saydak

Introduction

Bidding for government contracts is a competitive process for any company, especially for those companies that have not previously won government contracts. One possibility to explore is whether your client’s company currently qualifies as a small or disadvantaged business enterprise or plans to restructure as such, which would allow it to qualify. If it qualifies, your client’s company may receive carveouts for government contracts under set-asides. This article provides practical advice for attorneys counseling a client who seeks to gain the competitive edge to win federal contracts as a small or disadvantaged business enterprise.

Small Business Designation

A “small business” for government contracting purposes is a for-profit business that is (1) located in the United States, (2) independently owned and operated, and (3) not dominant in its field. Only a business that meets the numerical size standard regarding employees or annual receipts standard for its industry as defined by the Small Business Administration (SBA) qualifies as a small business.

The categories of size standards established by the SBA are based on economic activity or industry and generally correspond to the North American Industry Classification System. For example, a small business has the following maximum limits:

- 500 employees for most manufacturing and mining industries
- 100 employees for all wholesale trade industries
- $6 million in gross receipts for most retail and service industries
- $28.5 million in gross receipts for most general and heavy construction industries
- $12 million in gross receipts for all special trade contractors

To establish these standards, the SBA considers a number of factors such as the economic characteristics that make up the structure of an industry, including the degree of competition, the average firm size, start-up costs and entry barriers, and the distribution of firms by size. The SBA also considers technological changes; competition from other industries; growth trends; historical activity within an industry; unique factors occurring in an industry, which can distinguish small firms from other firms; and the objectives of its programs and the impact on those programs of different size standard levels.

An attorney cannot literally assist a client in obtaining an SBA small business certification because no certificate exists. The SBA does not issue certificates or maintain lists establishing the eligibility of any particular business as a small business. Instead, each company that bids for a federal procurement contract self-certifies its small business status at the time its bid is submitted. The SBA does not review the accuracy of a bidder’s self-certification on bid submission.

Nonetheless, bidders are deterred from misrepresenting their qualification as a small business; enforcement is achieved by granting to any and all bidders the right to challenge a competitor’s small business classification claims. To challenge a bidder’s qualification as a small business, a competitor must formally complain to the contracting office as required under the Federal Acquisition Regulations. The contracting officer is then required to submit the claim for investigation to the SBA, which will determine the validity of the charge.

Spin-offs and Restructuring Options

Many clients believe that restructuring or spinning off existing businesses can potentially help a company qualify for SBA small business status. There are serious pitfalls to restructuring, and the goal, perhaps more often than not, is out of reach because of the current SBA rules and requirements.

When determining small business status, the SBA includes the employees or revenue of all affiliated companies in calculating the
size of a business. According to the SBA, business concerns are affiliates of each other when one controls or has the power to control the other or a third party or parties control or has the power to control both. Factors such as ownership, management, previous relationships with or ties to another concern, and contractual relationships are considered in determining whether affiliation exists. Moreover, individuals or firms that have identical or nearly identical business or economic interests, such as family members, persons with common investments, or firms that are economically dependent through contractual or other relationships, may be treated as one party with the interests aggregated.

**Disadvantaged and Women Business Designations**

A disadvantaged business enterprise (DBE) is a for-profit small business concern (1) that is “at least 51 percent owned by one or more individuals who are socially and economically disadvantaged, or, in the case of a corporation, in which 51 percent of the stock is owned by one or more such individuals; and (2) whose management and daily business operations are controlled by one or more of the socially and economically disadvantaged individuals who own it.” DBEs must also meet the size standard definition of a small business set forth above.

Women-owned businesses or women business enterprises (WBEs) are a subgroup of DBEs that often receive similar preferences in bidding for government contracts. Several private national organizations have standards and procedures to certify businesses as WBEs based on ownership and control by women. In addition to providing ownership and management data for the business that is seeking qualification as a WBE and its affiliates at the time of application, an applicant must document all affiliates not shown in the stock register and must identify and describe relationships in which the applicant shared resources, e.g., employees or employment with other businesses or persons in the 12 months preceding the date of application.

**Small Business Investment Companies**

Converting a company from its current structure into a small business investment company (SBIC) might allow a company to qualify as a small business because companies owned in whole or in substantial part by an investment company that is licensed under the Small Business Investment Act of 1958 are not necessarily considered affiliates of such an investment company. For example, dividing the ownership of the investment company among family members may allow a company to separate its operations so that each would not necessarily be considered an affiliate of the other for SBA purposes.

Companies must exercise caution when considering restructuring because the government may scrutinize companies that restructure into a SBIC or otherwise for the primary purpose of qualifying as a small business. If it determines that a small business qualification was the primary purpose of the restructuring, the SBA takes into account the size of the preexisting business in calculating the size of the restructured business, thereby including the employees and revenues of the prior concern before reorganization in the calculation of the size of any separate business entity for SBA purposes.

Additional risks associated with restructuring for the sole purpose of qualifying for government contracts include the risk of significant fines or imprisonment if an individual is found guilty of contract fraud. For example, the Department of Transportation’s Office of the Inspector General has issued 251 indictments resulting in 204 convictions, totaling $101.46 million dollars in fines, recoveries, and restitution on the basis of these restructurings. One case involved an individual who sought to keep his business as a small business despite the fact that the business did not meet the SBA qualifications—the individual was indicted for fraud in claiming disadvantaged business status.

Restructuring for a separate business purpose may help your client’s efforts to gain an advantageous business designation. Given the significant civil and criminal exposure, it is not advisable to reorganize into a small business or as an SBIC for the sole purpose of small business classification. However, small business qualification might not be considered the primary purpose of restructuring if some other purpose, such as estate or succession planning, motivated and was the main purpose of the restructuring.

An attorney cannot literally assist a client in obtaining an SBA small business certification because no certificate exists.
Conclusion

Designations such as SBA small business status, DBE, WBE, or SBIC can give companies a competitive edge in bidding on government contracts, which, if available, are set forth in the solicitation. However, obtaining such a designation is a complex and possibly expensive process. Each situation needs to be examined according to the company’s specific situation relative to its industry group. The determination is fact-intensive.

In short, when it comes to SBA business designations, your client must be a willing and responsive partner in a complex factual and legal undertaking.

NOTES

1. 13 CFR 121.102, .105.
2. For the purposes of calculating the number of employees, the SBA considers the average number of persons employed for each pay period over the preceding 12 months, including full-time, part-time, and temporary workers. Guide to the SBA’s Definitions of Small Business, at http://www.sba.gov/size/indexguide.html (last visited Jan 19, 2003).
3. "Gross receipts are averaged over a concern’s latest three (3) completed fiscal years to determine its average annual receipts. 'Receipts' means the concern’s gross or total income, plus cost of goods sold, as defined by or reported on the concern’s federal income tax return. The term does not include, however, net capital gains or losses, or taxes collected for and remitted to a taxing authority if included in gross or total income. The concern may not deduct income taxes, property taxes, cost of materials, or funds paid to subcontractors. Travel, real estate, and advertising agents, providers of conference management services, freight forwarders, customs brokers, and tour operators may deduct amounts they collect on behalf of another. If a concern has not been in business for three (3) years, the average weekly revenue for the number of weeks the concern has been in business is multiplied by 52 to determine its average annual receipts." Id. 4. Id.
5. 13 CFR 121.102.
6. Id.
7. However, SBA maintains a list of DBEs and HUBZone businesses.
10. "A person is an affiliate of a concern if the person owns or controls, or has the power to control 50 percent or more of its voting stock, or a block of stock which affords control because it is large compared to other outstanding blocks of stock. If two or more persons each owns, controls or has the power to control less than 50 percent of the voting stock of a concern, with minority holdings that are equal or approximately equal in size, but the aggregate of these minority holdings is large as compared with any other stock holding, each such person is presumed to be an affiliate of the concern, including affiliation arising under stock options, convertible debentures and agreements to merge. Since stock options, convertible debentures, and agreements to merge (including agreements in principle) affect the power to control a concern, SBA treats them as though the rights granted have been exercised (except that an affiliate cannot use them to appear to terminate control over another concern before it actually does so). SBA gives present effect to an agreement to merge or sell stock whether such agreement is unconditional, conditional, or finalized but unexecuted. Agreements to open or continue negotiations towards the possibility of a merger or a sale of stock at some later date are not considered ‘agreements in principle’ and, thus, are not given present effect." 13 CFR 121.101(c).
11. "Affiliation based on common management arises where one or more officers, directors or general partners controls the board of directors and/or the management of another concern." 13 CFR 121.101(e).
16. Also excluded from the definition of affiliate solely based on ownership, but likely of little help to a company, are “[b]usiness concerns owned and controlled by Indian Tribes, Alaska Regional or Village Corporations organized pursuant to the Alaska Native Claims Settlement Act (43 USC 1601), Native Hawaiian Organizations, or Community Development Corporations authorized by 42 USC 9805 . . . .” Similarly, business concerns that lease employees from professional employer organizations are not considered affiliates of those professional employer organizations. 13 CFR 121.103.
17. 13 CFR 121.103(b)(1).

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Export Controls and the Export Administration Regulations

By Andrew S. McCaw

Introduction

The attacks of September 11, 2001, the record U.S. trade deficit, and the decisive military victory in Iraq each exemplify the tensions between the federal government’s export policies and the ability of the nation’s commercial sector to compete in the global market. On one hand, stringent export controls are essential in maintaining national security by ensuring that advanced U.S. military and technological commodities remain inaccessible to our enemies. On the other hand, these controls often hinder or entirely prevent the capacity of American exporters to effectively compete with the cheaper and often technologically equivalent products more freely distributed by European producers, many of whom indirectly receive the technology from the United States pursuant to their government’s membership in the cooperative Wassenaar Arrangement on Export Controls for Conventional Arms and Dual-Use Goods and Technologies.1 Balancing these competing interests has been an ongoing challenge for our government for decades, with no simple resolution in sight.

Unlike many other countries, the United States considers the export of products, services, and technologies from its borders to be a privilege and not a right. Accordingly, the federal government instituted a complex legal framework and system of regulations over the years that was designed to ensure that no good, service, or technology of U.S. origin is exported to another country (except to U.S. territories and possessions and, in many cases, Canada) without governmental approval. While most exports require nothing more than a standard declaration from the exporter, those involving advanced technology with national security concerns and those that are of strategic national interest are more likely to require direct review and approval from at least one or more licensing authorities.

History of Export Controls

U.S. restrictions on exports to foreign destinations are older than the nation itself, though the purpose of these early controls was much more limited than the rationale applied today. Until the early part of the 20th century, government oversight was invoked only during times of war or increased hostilities to ensure that enemies of the United States did not receive a benefit from its products. As war loomed in 1775, the First Continental Congress banned all trade with Great Britain, thereby enacting the first export restriction. One hundred forty-two years later, during World War I, the United States passed the Trading with the Enemy Act (TWEA), the basis of our modern system of export controls. TWEA provided the executive branch with broad power to restrict or prevent U.S. citizens and corporations from having commercial or financial dealings with individuals or governments with whom we were at war.

War and the fear of war are powerful motivations; in 1949, the United States promulgated the Export Control Act in response to the security threat of the Soviet Bloc countries. It regulated the export to those Communist countries of military and dual-use goods and technology. Dual-use items are those with primarily commercial purposes that can also be utilized for the development or production of advanced military or nuclear applications or that are otherwise determined to have strategic significance. The 1949 act also formally indicated for the first time that the purpose of the U.S. export controls was related to national security (discouraging proliferation of those goods and services that would significantly contribute to the military capability of an enemy of the United States), foreign policy (to promote the foreign policy of the United States), and short supply (to prevent the export of scarce and strategically important U.S. resources). Export controls among the United States and its Western European allies, however, were standardized with the passage of the Coordinating Committee for Multilateral Export Controls (COCOM), which simultaneously promoted Western
technological superiority by liberalizing controls among member nations.

The Export Administration Act (EAA) was created in 1969, after the expiration of the Export Control Act. Over the course of its renewals and in response to political pressure from U.S. companies that could not effectively compete globally under the embargo-like restrictions of the Export Control Act, as well as the change in the nature of the external threat faced by the United States after the Soviet Union collapsed in 1989, the EAA significantly streamlined and liberalized export controls to balance traditional security concerns with the growing importance of trade to the U.S. economy. Restraints on trade among COCOM members were further liberalized in 1997 by the Wassenaar Arrangement, which replaced COCOM after its 1994 expiration.

What Is an Export?
The government’s definition of an export is expansive and encompasses any method of transfer to a destination outside of the United States, including any oral, written, electronic, or visual disclosure, shipment, or transmission to anyone, including a U.S. citizen, of any commodity, technology, or software of U.S. origin. For example, information is “exported” if sent via facsimile or e-mail, uploaded or downloaded from an Internet site, shipped, or otherwise physically carried outside the United States regardless of whether the transfer was temporary.

Exports of items consisting of both U.S. and foreign technology may also be regulated depending on the amount of U.S. technology involved. The particular agency charged with controlling an article’s transfer has significant latitude in determining the percentage of its “U.S. technology” and may regulate its export and reexport if the quantity exceeds de minimis levels. If the export or reexport destination is an embargoed nation, such as North Korea or Cuba, the de minimis threshold is 10 percent of the overall value. If the item is headed for a nonembargoed nation, the de minimis threshold is raised to 25 percent or less of the total value.

Contrary to popular belief, information does not necessarily have to leave U.S. borders to be considered an export for purposes of regulation. Information or technology viewed or accessed by a foreign national, even a foreign national validly in the United States pursuant to immigration laws, is deemed to have been exported to that foreign national’s home country and is thus subject to export controls. Similarly, information or technology is deemed to have been exported if a foreign national accesses it via the Internet or other communication connection, even if that information or technology is never transmitted to the foreign location. In addition, release of protected information in a foreign country to a person who is not a national of that country would constitute a reexport of the information to the home country of that person. However, information disclosed to a foreign national with permanent U.S. residency status is not deemed an export.

What Exports Are Not Subject to Control?
Export regulations generally do not restrict transfers of certain publicly available technology and software that is (1) published, (2) the result of fundamental research, (3) educational, or (4) contained in a patent application with the U.S. Patent and Trademark Office. Transfers of certain types of technology and software, such as advanced encryption software, will be subject to control regardless of whether they are publicly available.

Published Technology and Software
Information that is published or that will be published if it is favorably received and that is readily accessible to the general public will normally not be subject to export control unless otherwise controlled by a government agency. Therefore, information that is published in any media, including electronic, print, books, periodicals, journals, and patent applications, or that is released at trade shows, conferences, meetings, or other gatherings open to the public (either free or at a price that does not exceed the cost of reproduction and distribution) may be disclosed to foreign nations and their nationals or otherwise sent abroad.

Information Resulting from Fundamental Research
Export controls also do not generally restrict release of the publicly available information resulting from fundamental research at a university, laboratory, or other institution.

Unlike many other countries, the United States considers the export of products, services, and technologies from its borders to be a privilege and not a right.
Fundamental research is defined as “basic and applied research in science and engineering, where the resulting information is ordinarily published and shared broadly within the scientific community.” Accordingly, technology that is restricted for proprietary purposes or for national security controls is not considered “fundamental research,” and its export or dissemination is subject to federal control.

Educational Information

Unless otherwise expressly prohibited by applicable regulations, information that is “released by instruction in catalog courses and associated teaching laboratories of academic institutions” is not subject to federal control. Accordingly, any such information disclosed during a college lecture would not be subject to export requirements even if attended by a foreign national.

Patent Applications

Information included in patents and patent applications that are filed or will be filed on acceptance by the U.S. Patent and Trademark Office is considered “published” and available to the general public.

Who Currently Regulates Exports?

Numerous federal agencies and departments, depending on the nature of the regulated product, currently perform development, administration, and enforcement of the federal export regulations. For example, the Department of Treasury’s Office of Foreign Assets Control ensures that trade sanctions and embargoes instituted by the United States against certain countries are upheld. Military commodities, including space-related technology and those articles, services, and technology that can be modified for military use or used in connection with military items, are subject to the general criteria defined in the Arms Export Control Act of 1976 and implemented by the State Department’s Directorate of Defense Trade Controls through the International Traffic in Arms Regulations (ITAR). The Department of Commerce’s Bureau of Industry and Security (BIS), formerly the Bureau of Export Administration, administers the broadest range of export controls through the Export Administration Regulations (EAR), including those involving the licensing of dual-use goods, technologies, and services. Since the vast majority of exports fall within the purview of the BIS, exporters are more likely to be concerned with the provisions of the EAR than with other export regulations. The review process promulgated by the EAR is similar to that of the other regulatory agencies and, therefore, is discussed below for illustrative purposes.

How Exports Are Regulated by the Export Administration Regulations

Authorized pursuant to the 1979 renewal of the EAA, the BIS regulates the export and reexport of nearly all nondefense and dual-use commodities, including computers, clothing, commercial communications satellites, building materials, and civilian aircraft. Technical data like blueprints and schematics related to the development, production, or use of these items is also subject to the authority of the EAR. Despite these expansive oversight responsibilities, however, only a tiny percentage of U.S. commercial exports require a license from the BIS. If an item is not subject to the EAR or another federal agency with jurisdiction, it may be sent abroad without further review.

Determining Which Exports Are Subject to the Jurisdiction of the BIS

The EAR require an exporter to address four fundamental questions to determine whether the item to be exported is subject to the control of the BIS and, therefore, requires a validated license.

- What is the nature of the commodity or technical data being exported?
- Where is the item’s ultimate destination?
- Who is the item’s end user?
- What is the item’s end use?

What is the nature of the commodity or technical data being exported?

Inquiry normally begins by reviewing the Commerce Control List (CCL) to determine if the item being exported is classified as one of the more than 2,400 dual-use controlled items. All controlled items are assigned one of more than 400 Export Control Classification Numbers (ECCN), and all
ECCNs appear on the CCL, thereby notifying potential exporters that the particular item requires a validated license for export. The CCL is a comprehensive list that classifies all regulated commodities into 10 numbered categories, including nuclear materials, facilities and equipment, materials processing, electronics, and lasers and sensors. Each of these 10 categories is further divided into five product groups that range from equipment, assemblies, and components to materials to technology. The alphanumeric ECCN, in turn, identifies the general category under which the item falls, the applicable product group, the associated license requirements, and the reason the item’s distribution is controlled. These reasons may be related to national security; missile technology; nuclear nonproliferation; chemical and biological weapons; or antiterrorism, crime control, and regional stability.

Items not listed on the CCL that are subject to the EAR but do not fall under a designated ECCN, like low-technology consumer goods, are designated as “EAR99” and generally do not require a validated license unless they are being sent to an embargoed country, to an end user of concern, or in support of a prohibited use, explained below.

Where is the item’s ultimate destination?
Export license restrictions vary from country to country based on the nature of the exported item and certain characteristics of the importing nation. Embargoed countries and those designated as supporting terrorist activities are the most restricted recipients of sensitive technology. Conversely, countries that pose a lesser threat to U.S. security are subject to less stringent export controls. Strategically sensitive goods and technologies, however, may be subject to restrictions regardless of where they are being sent.

For those items assigned an ECCN, the EAR’s Commerce Country Chart (CCC) contains licensing requirements based on the destination of the U.S. export, as well as the reason that particular export is controlled for that destination. Those reasons may include, among other things, antiterrorism, crime control, regional stability, or short supply. Used in combination with the CCL and the ECCN, the CCC enables exporters to determine whether a license is required for items being sent to any country in the world.

Who is the item’s end user?
The EAR prohibits or otherwise restricts the use by certain individuals and organizations of particular U.S. exports, regardless of whether the item could otherwise be exported without a license. For example, exports to organizations identified by the federal government as either engaging in activities related to the proliferation of weapons of mass destruction or representing countries involved in terrorism or narcotics trafficking may require a license even if one is not otherwise required. Additionally, items may not be exported or reexported in conjunction with any person or entity denied export privileges.

What is the item’s end use?
The EAR prohibits the export and reexport of items subject to its control for certain defined nuclear, missile, chemical, and biological end uses. For example, items subject to the EAR may not be exported if, at the time of export, the exporter knows that they will be used directly or indirectly for the “research, development, design, manufacture, testing, or maintenance of nuclear explosive devices or components or subsystems of such a device.” Similarly, items may not be exported to certain countries if the exporter knows the items will be used to design, develop, or produce missiles.

License Exceptions
In cases where a license is required for the contemplated export transaction, the exporter may apply for a license exception, subject to the conditions set forth in the EAR. Exceptions are typically granted if the net value of a shipment of commodities eligible for a license exception does not exceed the threshold defined in the CCL and for items destined to civil end users for civil end uses.

Penalties for Noncompliance
In addition to regulating exports, Part 764 of the EAR also enables the BIS to enforce the controls through a variety of civil and criminal penalties. While civil fines may not exceed $10,000 per violation, penalties for violations involving national security controls may be as high as $100,000 and may include administrative sanctions resulting in the denial of future export privileges. Criminal penalties for willful violations may

Contrary to popular belief, information does not necessarily have to leave U.S. borders to be considered an export for purposes of regulation.
be as high as the greater of $1 million or five times the value of the exports and may also include imprisonment for up to 10 years.\textsuperscript{33}

**Conclusion**

As a result of the events of September 11, 2001, U.S. companies, including those employing foreign nationalists, may face more stringent restrictions governing their export of information, technology, and commodities that concern national security. To assist in their compliance with these regulations, companies exporting or reexporting commodities or technology that are subject to a government licensing agency should establish and document adherence with applicable requirements by developing an export management control system. This system should document the type of product being exported, the country to which the product is being exported, the end user receiving it, and the applicable exporting requirements. It should also provide for written assurances from foreign licensees that the exported technology or commodity will not be reexported to other countries or their foreign nationals without appropriate authorization. Federal guidance in the form of a commodity jurisdiction determination made by the appropriate licensing authority in advance of the export will also assist exporters in complying with applicable restrictions and license requirements while avoiding the significant penalties associated with noncompliance. Finally, BIS posted the “Guidance on Reexports and Other Offshore Transaction Involving U.S. Origin Items” on its Web site to assist exporters.\textsuperscript{34}

\begin{verbatim}
NOTES
2. 15 CFR 734.2(b).
3. 15 CFR 734.3(a)(3).
4. 15 CFR 734.4(c)(1).
5. 15 CFR 734.4(d)(1).
6. 15 CFR 734.2(b)(2)(ii).
7. Id.
8. 15 CFR 734.7(a).
9. 15 CFR 734.7(a)(1).
11. 15 CFR 734.8(a).
12. Id.
13. 15 CFR 734.3(b)(3)(ii), .9.
14. 15 CFR 734.3(b)(3)(iv), .10.
15. 22 USC 2778.
16. 15 CFR 730.1 et seq.
17. 15 CFR 770.3.
18. 15 CFR 738.2(a).
19. 15 CFR 738.2(b).
20. 15 CFR 738.2(d)(1).
21. Id.
22. 15 CFR 734.3(c).
23. 15 CFR 738.3.
25. 15 CFR 744.1.
26. 15 CFR 764.2.
27. 15 CFR 744.1(a)(1).
28. 15 CFR 744.2(a).
29. 15 CFR 744.3(a)(2).
30. 15 CFR 740.1 et seq.
31. 15 CFR 740.3, .5.
32. 15 CFR 764.3(a)(1), (2).
33. 15 CFR 764.3(b)(2).
\end{verbatim}

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In SEC v. Edwards, No 02-1196, 2004 US LEXIS 659 (Jan 13, 2004), respondent was the chairman, chief executive officer, and sole shareholder of ETS Payphones, Inc., which sold pay phones to the public via independent distributors. The pay phones were offered with an agreement under which ETS leased back the pay phone from the purchaser for a fixed monthly payment, thereby giving the purchasers a fixed 14 percent annual return on their investment. Although ETS’s marketing materials trumpeted the “incomparable pay phone” as “an exciting business opportunity,” the pay phones did not generate enough revenue for ETS to make the payments required by the leaseback agreements, so the company depended on funds from new investors to meet its obligations. After ETS filed for bankruptcy protection, the Securities and Exchange Commission brought a civil enforcement action, alleging, among other things, that respondent and ETS had violated registration requirements and antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.

The Securities Act of 1933 and the Securities Exchange Act of 1934 define “security” to include an “investment contract.” The test the Court uses for determining whether a particular scheme is an investment contract is “whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.” As such, the Court held that an investment scheme promising a fixed rate of return can be an “investment contract” and thus a “security” subject to the federal securities laws.

In DaimlerChrysler Corp v. G-Tech Prof’l Staffing, Inc, No 241109, 2003 Mich App LEXIS 2852 (Dec 23, 2003), plaintiff sued to enforce an indemnity clause in a written contract it had with defendant for supplemental workers. The action arose from a motor vehicle accident that occurred when a worker supplied by defendant struck and killed a pedestrian. Defendant argued that it only had to indemnify plaintiff for personal injuries that occurred when its workers were actually performing tasks for plaintiff, but the trial court held that the indemnity clause only required that the personal injury arise out of, or be related to, the performance of any work in connection with the contract. The court of appeals found that the trial court did not err by concluding as a matter of law that the claim against plaintiff by the injured person’s estate came within the unambiguous indemnity clause of the parties’ contract.

In Liggett Rest Group, Inc, v City of Pontiac, No 240495, 2003 Mich App LEXIS 3265 (Dec 18, 2003), plaintiff and defendant had entered into a contract whereby plaintiff would provide concessions to patrons at the Pontiac Silverdome during Detroit Lions football games until the year 2005. The Detroit Lions, however, prematurely stopped playing games at the Pontiac Silverdome in 2001, and plaintiff brought suit against the city for rescission and unjust enrichment.

The court held that the frustration of purpose doctrine was inapplicable in a contract action involving the concessions for the Pontiac Silverdome because the parties’ contract contained an express clause that addressed the contingency for lack of home games for the Detroit Lions. Plaintiff’s unjust enrichment claim also failed because of the existence of an express contract governing the subject matter at issue.

In Gilliam v. Hi Temp Prods, Inc, Nos 238102, 238224, 238341, 238375, 2003 Mich App LEXIS 3266 (Dec 18, 2003), several individuals sued defendant, claiming that their exposure to Hi Temp’s products caused their asbestos-related diseases. Although Hi Temp had been litigating these cases throughout the 1980s, in 1993, the company dissolved. Hi Temp published notice of its dissolution in the local newspaper and provided notice to the counsel of the various plaintiffs. Pursuant to MCL 450.1842a(3), all claims against a dissolved corporation are barred unless “the claimant commences a proceeding to enforce the claim against the dissolved corporation within one year after the publication date.” Plaintiffs brought this action in 1999, claiming that they had good cause for not bringing their claims within the statutory period and that Hi Temp’s insurance coverage was an undistributed asset within the meaning of MCL 450.1851(2), an exception to MCL 450.1842a.

The court held that because Hi Temp properly published notice of its dissolution, plaintiffs with asbestos-related personal injury claims were required by MCL 450.1842a(3) to file their claims within one year of the publication of notice of dissolution. Although a liability insurance policy is an asset to a viable corporation and to a corporation in the process of winding up its affairs after dissolution, it is not an asset of a dissolved corporation that has distributed all assets capable of distribution, and the period permitted for filing claims has expired. Thus, MCL 450.1851(2) provided no relief from the bar of MCL 450.1842a, even if plaintiffs had good cause for not timely filing their claims. Finally, the corporation was not estopped to assert the bar of MCL 450.1842a because MCL

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450.1855a plainly states that a dissolved corporation need not provide for future contingent claims that will reasonably be barred by either MCL 450.1841a or MCL 450.1842a.

**Taxation—Tobacco Products Tax Act**

In *S Abraham & Sons, Inc v Department of Treasury*, No 241158, 2003 Mich App LEXIS 3176 (Dec 11, 2003), plaintiffs, tobacco wholesalers, had prepaid tobacco-product taxes on various purchases for which their customers never paid. Plaintiffs brought suit after the Department of Treasury refused to reimburse them.

The court of appeals found that the trial court properly construed the ambiguity in the Tobacco Products Tax Act (TPTA) in plaintiffs’ favor and determined that plaintiffs were entitled to reimbursement for tobacco-product taxes paid on uncollectible accounts. This conclusion applies equally to plaintiffs’ claims accruing before and after the amendment of the TPTA that added MCL 205.427a.

**Labor and Employment—Sales Representative Commissions Act**

In *Klapp v United Ins Group Agency*, Nos 219299, 219330, Mich App LEXIS (Nov 20, 2003), plaintiff, an insurance sales agent, sued his former employer regarding his employment contract under the Sales Representative Commissions Act. Under the contract, plaintiff’s compensation was based solely on commissions from the sales of insurance contracts. Plaintiff was entitled to commissions from the initial sale of insurance contracts and also renewal commissions from the continuing premium payments made by insurance clients. The court of appeals held that an insurance sales agent may not recover double damages and attorney fees under the Sales Representative Commissions Act because the act does not apply to commissions generated from the sale of insurance policies.

**Labor and Employment—Sexual Harassment**

In *Elezovic v Ford Motor Co*, No 236749, 2003 Mich App LEXIS 2649 (Oct 23, 2003), plaintiff alleged that her supervisor sexually harassed her by various obscene actions in her presence, initiating a physical attack, and making repeated sexual remarks. Although plaintiff reported one incident, she asked her supervisors to keep her other disclosures confidential. Plaintiff sued defendant, alleging sexual harassment, gender discrimination, and retaliation.

The court upheld the trial court’s verdict on the hostile work environment claim by agreeing that plaintiff failed to establish that defendant had notice. The court found that although plaintiff reported one incident, she did ask her supervisors for confidentiality; thus, there was no actual notice to the defendant such that it could investigate the matter. About the supervisor, the court found error but nevertheless affirmed, disagreeing with but following the earlier holding of *Jager v Nationwide Truck Brokers, Inc*, 252 Mich App 464, 652 NW2d 503 (2002), that the Michigan Civil Rights Act does not impose liability on individual employees. The court concluded that *Jager’s* reliance on federal law was misplaced and noted the anomalous result that the alleged perpetrator was shielded by the employer’s lack of notice, even though he purposely created a hostile work environment and even though his conduct, if proved, was undeniably sexual harassment. The court found no error in the claims of gender discrimination and quid pro quo sexual harassment or regarding plaintiff’s evidentiary claims.

**Taxation—Motor Fuel Refunds**

In *DaimlerChrysler Corp v Department of Treasury*, 258 Mich App 342, 672 NW2d 176 (2003), petitioner sought refunds from the state of Michigan regarding taxes paid for fuel left in the fuel tanks of vehicles sold to out-of-state dealers. Respondent refunded taxes paid for the year before petitioner’s January 30, 1998, refund request but asserted that the one-year period of limitations barred any recovery of taxes paid earlier. Respondent also declined to pay interest on the taxes it refunded, arguing that the refund request did not constitute the filing of a claim sufficient to trigger an award of interest.

The court held that MCL 207.112(2) imposes a one-year filing requirement on all persons seeking motor fuel refunds. Therefore, the Tax Tribunal did not err when it denied petitioner’s requested refund of taxes paid more than one year before the request was made. While the tribunal did not err by ordering respondent to pay interest, it erroneously held that the interest began accruing on the entire refund request 45 days after the initial request. Because the accrual period for each refund requested must be calculated separately, the court reversed and remanded the tribunal’s order regarding interest so that it could make those calculations and issue an order setting forth the correct accrual dates.

**Contracts—Retail Installment Sales Contract**

In *Baker v Sunny Chevrolet, Inc*, 349 F3d 862 (6th Cir 2003), plaintiff signed a retail installment sales contract (RISC) on December 28, 2003, to purchase a car and took possession of the vehicle on that date. Although she asked for a copy of the contract, defendant refused the request. On January 11, 2001, citing inability to obtain financing under the RISC, defendant requested that plaintiffs return to the dealership to reexecute the deal adding the latter as a buyer. At the dealership, defendant informed plaintiffs that they would each have to sign a second contract. Once again, despite being asked for a copy of the signed contract, defendant refused to provide plaintiffs with a copy of either contract. Plaintiffs finally received a copy of the second contract approximately three weeks later, around January 29, 2001. Plaintiff Baker never received a copy of
the first contract that she signed. It is undisputed that plaintiffs were given the actual RISC document for review before signing it and that the actual RISC accurately disclosed all of the transactions’ credit terms. Plaintiff filed suit for violations of the Truth in Lending Act and the underlying Regulation Z, alleging that defendant repeatedly failed to give the consumer “a copy of the contract [in connection with the purchase and finance of a motor vehicle] to keep prior to consummation of the transaction.”

The court concluded that defendant’s failure to timely provide plaintiffs with a copy of the RISC does not entitle plaintiff to any statutory damages on the alternative grounds (1) that a 15 USC 1638(b)(1) violation is not subject to statutory damages and (2) that defendant complied with the 15 USC 1640(b) provisions for the correction of errors.

Labor and Employment—Discrimination—Retaliation

In Abbott v Crown Motor Co, 348 F3d 537 (6th Cir 2003), plaintiff, a white male employed by defendant as an automotive technician, volunteered to testify on behalf of his coworker, a black automotive detailer named Crump. Crump alleged that his supervisor, Purnell, had racially harassed him and, as a result, filed a complaint with the Equal Employment Opportunity Commission (EEOC). Abbott notified his supervisor that he had witnessed Purnell using racist epithets against Crump. Crump later resigned from his position, and Abbott was discharged shortly after. Abbott brought illegal retaliation and intentional infliction of emotional distress claims against defendant.

The court held that Title VII of the Civil Rights Act of 1964 protects an employee’s participation in an employer’s internal investigation into allegations of unlawful discrimination where that investigation occurred pursuant to a pending EEOC charge. Thus, Abbott established that he had engaged in protected activity when he notified a supervisor during an internal investigation of another employee’s racial discrimination claim that he had witnessed the alleged discrimination and was willing to testify to that effect. Abbott had established a causal connection between the protected activity and his termination by alleging that a supervisor told him that he was fired because he put his nose into other people’s business and that the discrimination suit was the only thing with which he was involved. Moreover, Abbott’s testimony and that of another witness disputed the proffered reason for his termination, i.e., insubordination and threatening behavior. However, Abbott failed to allege extreme and outrageous conduct supporting his intentional infliction of emotional distress claim.

Labor and Employment—Family and Medical Leave Act—Wrongful Discharge

In Cavin v Honda of America Mfg, Inc, 346 F3d 713 (6th Cir 2003), plaintiff, an employee of defendant, was injured in a motorcycle accident and notified defendant’s security department of the fact that he would be absent for several days. Defendant asserted that plaintiff violated company policy by failing to notify the company’s Leave Coordination Department of his need for leave within the required time period and also by failing to timely submit a medical certification form four months later. The company terminated the employee for violating its leave policy. Plaintiff filed suit alleging that defendant had interfered with his Family and Medical Leave Act (FMLA) rights and wrongfully discharged him in violation of Ohio public policy.

The court reversed the summary judgment in favor of defendant on the FMLA claim, finding that defendant’s policy was inconsistent with the notice requirements set forth in the FMLA. Reading 29 CFR 825.303 in the context of the FMLA and 29 CFR 825.302, the court concluded that employers could not deny FMLA relief for failure to comply with their internal notice requirements. The court further found that plaintiff complied with the FMLA’s notice requirements as a matter of law. Finally, the court affirmed the dismissal of the wrongful discharge claim, finding that Ohio did not recognize a cause of action for wrongful discharge in violation of the public policy embodied in the FMLA.

Labor and Employment—Family and Medical Leave Act

In Arban v West Pub’g Corp, 345 F3d 390 (6th Cir 2003), plaintiff alleged that his employer, defendant, violated the Family and Medical Leave Act (FMLA) by terminating him while he was on medical leave, failing to reinstate him at the completion of the leave, and interfering with, restraining, or denying him his right to take an FMLA leave.

The court held that sufficient evidence was presented for the jury to conclude that defendant denied plaintiff his substantive right to reinstatement and that he was terminated for reasons related to his leave. Plaintiff’s evidence regarding front pay, however, was purely speculative. Thus, the district court did not abuse its discretion in declining to submit the issue of front pay to the jury.

Labor and Employment—Age Discrimination

In Grosjean v First Energy Corp, 349 F3d 332 (6th Cir 2003), plaintiff brought suit against his employer, defendant, for allegedly engaging in age discrimination against him in violation of the Age Discrimination in Employment Act (ADEA). In particular, plaintiff alleged that defendant had demoted him from his supervisory position, that he had been denied a bonus for 1999, and that he had been denied a promotion back to his old position.

The court found that plaintiff failed to make a prima facie case of age discrimination because he was not
replaced by a person significantly younger than he was. Plaintiff argued that he was initially replaced by another shift supervisor who temporarily took over his duties in addition to his own. However, defendant’s actions did not constitute replacement because the other supervisor was not hired or reassigned to perform plaintiff’s duties. The court held that, in the absence of direct evidence that defendant considered age to be significant, an age difference of six years or less between an employee and a replacement was not significant. Because plaintiff was not more than six years older than the replacement and as he presented no direct evidence that defendant considered age to be significant, plaintiff’s ADEA claim failed, as did his state law claim.
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