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

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

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DID YOU KNOW? By G. Ann Baker

Uniform Acts, Model Acts, and NCCUSL

Michigan has several statutes that are referred to as "uniform" acts, such as the Uniform Commercial Code, the Uniform Securities Act, and the Uniform Child-Custody Jurisdiction and Enforcement Act. Other acts may be based on "model" acts or contain some provisions borrowed from a model act, such as the Michigan Limited Liability Company Act and the Business Corporation Act.

The existence of "uniform" and "model" acts is a direct result of the creation in 1892 of the National Conference of Commissioners on Uniform State Laws, often referred by its acronym NCCUSL. The purpose of NCCUSL is to promote the uniformity of state laws. It is a nonprofit unincorporated association comprised of commissioners from each state, the District of Columbia, the Commonwealth of Puerto Rico, and the U.S. Virgin Islands. Each jurisdiction determines the method of appointment, and most jurisdictions provide for their commission by statute. However, each commissioner must be a member of the bar. Currently, 300 practicing lawyers, judges, scholars, and government officials serve as commissioners.

Section 301 of Public Act 268 of 1986, the Legislative Council Act, provides for the Michigan Commission on Uniform State Laws. It consists of three members appointed by the Legislative Council; two members appointed by the majority leader of the Senate, one from the minority party; two members appointed by the speaker of the House, one from the minority party; and the director of the Legislative Service Bureau or the director's designee. The Web site of the Michigan Commission on Uniform State Laws, http://www.milegislativecouncil.org/mcuslf.html, lists the current members as James J. White, Tom Downs, Robert Webster, Senator Bruce Patterson, Senator Michael Switalski, Representative William Van Regenmorter, Representative Morris W. Hood, III, and John Strand.

The Michigan Commission on Uniform State Laws is an agency of the Michigan Legislative Council. The commissioners are authorized to meet and confer with commissioners of other states to bring about the uniformity of state laws. The Michigan Commission on Uniform State Laws reports to the Legislative Council annually. Information about the Michigan Commission on Uniform State Laws is available on the Web site of the Michigan Legislative Council, www.milegislativecouncil.org/.

The uniform law commissioners for the various jurisdictions study and review the law of the states to determine which areas of law should be uniform. They promote uniformity by drafting and proposing specific statutes in areas of the law where uniformity between the states is desirable.

> *Legislatures are urged to adopt uniform acts exactly as written. Model acts, however, are intended as guidelines for legislation that states can adapt to suit their respective situations.*

Meetings of drafting committees of NCCUSL are open to anyone who wants to participate. In addition, interested parties are invited to submit written comments. The NCCUSL Web site, www.nccusl.org, has information about committees, drafts, and acts. For example, the April 2004 meeting draft of the Drafting Committee on Amendments to the Uniform Limited Liability Company Act is available on the site. The drafting committee is considering a provision to allow a limited liability company (LLC) to place a statement of authority on the public record to provide constructive notice and to provide for oral operating agreements for LLCs. The second generation act, however, retains the requirement that the articles be signed by a person who will become a member of the LLC and has not adopted Michigan's unique approach of an "organizer." The Model Entity Transactions Act (META) is a joint project of the American Bar Association and the NCCUSL. The META provides for conversions and domestications of various business entities without amending the various individual entity statutes. The February 2004 draft of the Drafting Committee on Model Entity Transactions Act is also available on the NCCUSL Web site.

Final drafts of acts are considered at the annual meeting of the NCCUSL, and commissioners vote by states. The NCCUSL publishes uniform acts and model acts. The NCCUSL, however, can only propose the acts, and no uniform law is effective until a state adopts it. Legislatures are urged to adopt uniform acts exactly as written. Model acts, however, are intended as guidelines for legislation that states can adapt to suit their respective situations. The uniform law commissioners work toward the enactment of uniform and model acts in their home jurisdictions. The NCCUSL has appointed the following drafting committees that are of interest to business lawyers:

- Drafting Committee on Business Trust Act
- Drafting Committee on Agricultural and Agricultural Related Cooperatives Act
- Drafting Committee on Certificate of Title Act
- Drafting Committee on Consumer Debt Counseling Act

Information regarding the current progress of the various drafting committees and about upcoming meetings of drafting committees and the NCCUSL is on the NCCUSL Web site. The most recent meeting of NCCUSL was July 30–August 6, 2004, in Portland Oregon.

The Business Law Section of the State Bar of Michigan has an Ad Hoc Committee on the Uniform Securities Act of 2002. The Committee is reviewing the proposed Michigan version of the Uniform Securities Act of 2002, House Bill 5746, introduced by Representative James Koetje on April 1, 2004. House Bill 5746 would repeal the existing Uniform Securities Act, 1964 PA 265. House Bills 5747–5761 would amend acts to update references to the Uniform Securities Act. According to the NCCUSL the uniform act will coordinate federal and state securities law. The House Commerce Committee held a hearing on the bills on June 1, 2004. To check on the current status of the bills, visit the legislature's Web site at http://michiganlegislature.org/law/. For the most recent information on the activities of the Ad Hoc Committee on the Uniform Securities Act of 2002, contact Hugh Makens at Warner Norcross & Judd, LLP, or Cy Moscow at Honigman Miller Schwartz and Cohn, LLP.

Other Recent Developments

Judgment Lien Statute

Note that the judgment lien statute, which was discussed in the Summer 2003 issue of the *Michigan Business Law Journal* (Vol XXIII, No 2, pages 11–27), was enacted effective September 1, 2004, by 2004 PA 136. The act adds a new chapter to the Revised Judicature Act that, among other things, provides for the creation and expiration of judgment liens on real property.

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. She is a member of the State Bar of Michigan and the American Bar Association. She is also 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.

 By Paul L.B. McKenney

Where the IRS' Money Is – A Status Report

The Internal Revenue Service (IRS) and the Tax Division of the U.S. Department of Justice have belatedly achieved great success in their unprecedented campaign against the tax shelter promoters. As this is written in mid-June 2004, the facts on the ground have changed almost 180 degrees from two years ago.

First, in several recent and very angry federal court opinions, the promoters were ordered to turn over not only the identities of the taxpayers who invested in the shelters but also considerably more information, including numerous documents the taxpayers have not seen, such as memos detailing apparent fee splitting by promoters without the knowledge of the taxpayers.[1] In addition, the documents generally are not supportive of any business purpose or any economic effect.

Second, there are now several publicly acknowledged large-scale, IRS-led criminal investigations of numerous promoters involving some of the biggest names in the American business community.

Third, the taxpayers are paying up. An example of this is the biggest-selling shelter, so-called "Son of BOSS." By June 21, 2004, under an IRS settlement initiative, the taxpayers (other than promoters who are ineligible for the global settlement initiative) had to file a detailed written election to participate in the settlement. The settlement would be consummated no later than 70 days after that date with payment due no more than 30 days later. In other words, the billions from the Son of BOSS settlements will be received by the federal government before the end of its September 30, 2004, fiscal year end. The settlement terms are not generous. The taxpayer is liable for 100 percent of the tax but may deduct either all of the transaction costs (generally aggregating 16 to 20 percent of the federal income tax, depending on the deal) against capital gain or one-half of the expense against ordinary income. The 99 percent of the shelter taxpayers that did not elect to disclose their identities to the IRS under the "no penalty" amnesty in early 2002 would pay either (1) a 10 percent penalty if this was their only shelter or (2) 20 percent if they were in more than one shelter, even if the statute of limitations on another shelter is arguably closed. In addition to the tax, in federal income tax cases, interest compounded daily is applied per statute. Interest is not, as in many private settlements, a negotiable item. For those who do not take the Son of BOSS settlement and elect to litigate, the IRS chief counsel and his counterpart, the assistant attorney general of the Tax Division of the U.S. Department of Justice, both publicly declared that there will be no concession of any tax or penalty on any shelter case that will be litigated to conclusion. Tax practitioners who are independent of the promoters (a critical distinction) have little doubt how the courts will decide the basic tax issues.

Fourth, the very survival of some promoters is probably at stake because they are confronted by massive lawsuits filed by disgruntled investors. The potential damages are staggering. The government estimates $100 billion plus of tax "saved" via shelters, plus the statutory interest and penalties. While in a malpractice or fraud action, damages arguably would not include tax that is owed anyway, and interest may be a point of contention amongst the parties, the promoters' fees clearly constitute an element of damages together with any penalties and the costs of defending the audit. Doing the math based on $100 billion of federal tax losses, basic fees to promoters are somewhere in the tens of billions, and the penalties on average will probably exceed the fees to promoters excluding interest on the penalties, the costs of defending the shelter examinations, etc.

This is indeed serious business before one even considers the state taxation liabilities. In May 2004, Michigan finally signed a memorandum of understanding with the IRS. The state was immediately furnished with the identities and other information on over 900 alleged Michigan shelter investors. The state will pursue these taxpayers, with additional batches of IRS information to follow.

Preventing the Next Round of Shelters

The government's game plan for stopping shelters is simple. First, there will be criminal prosecutions of key individual promoters at firms that peddle the shelters. Under the Federal Sentencing Guidelines or their replacement, the sentences may be severe. Second, the taxpayers will have enormous costs associated with this—it has already left a bad taste in their mouths. Third, as has been publicly stated by senior government officials, the tort law system, albeit several years after the fact, will have a cleansing effect. The overall impact is that the government hopes that people will remember not to even think of "going there again" with tax shelters for at least a generation.

What to Do with a Shelter Client

Shelter clients need advice independent of the promoters who sold them the shelters. There are the obvious conflict of interest concerns about whether these shelter promoters, many of whom have partners under criminal investigation, are now giving advice designed to protect and shield the shelter promoters or to help the taxpayer. The practical issue is avoiding some or all of the 40 percent penalty. The internal communications among promoters that have been disclosed in what was given to

the government under court order, with copies to the taxpayers, represent sad commentaries on business and professional ethics.

NOTES

1. *See, e.g.*, *United States v KPMG, LLP*, 316 F Supp 2d 30 (DDC 2004); *Denney v Jenkins & Gilchrist*, 03 Civ 5460 (SAS), 2004 US Dist LEXIS 7589 (SDNY 2004), *stay granted*, 2004 US Dist LEXIS 11241 (SDNY June 14, 2004).

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 By Michael S. Khoury

Offshore Outsourcing of Information Technology Services (Part 2)

Introduction

Offshore outsourcing continues to be a controversial issue, as was seen in Michigan when Governor Granholm signed two executive orders in March related to the venue of contracted work. In the first part of this article (Spring 2004), I reviewed some background issues, priorities, and basic issues to be addressed in considering an offshore outsourcing transaction. This second part addresses some more detailed contract issues.

Ownership and Delivery Models

As part of the customer's request for proposal (RFP), it is important to define the delivery model that the customer expects from the service provider. While myriad variations exist in the marketplace, there are a few common models to consider.

Complete Functional Outsourcing. Whether one chooses a single service provider or multiple service providers to perform the functions, this model assumes that third-party employees will perform most day-to-day operations, development, maintenance, and support.

Captive Outsourcing Center. To leverage competitive labor and infrastructure costs offshore, one option available to a customer is to build a captive center in the offshore location, typically created as a subsidiary or affiliate of the customer.

Joint Venture with Service Provider. In some circumstances where the customer wishes not only to leverage the lower costs of the offshore provider but also to potentially capitalize on its investment by offering services to other parties, a joint venture with the service provider may be considered. In this model, the customer is usually contributing certain technology or intellectual property to the joint venture, and the service provider is leveraging its sales and delivery capabilities to market the joint venture's products and services in the marketplace.

Just as there is no required model in any other transaction, a hybrid model using combinations of the above concepts as well as others is not uncommon. The business goals and requirements of the customer and service provider vary on a case-by-case basis, and the model used should be driven by the customer's business goals.

Transparent Service Providers

To leverage some of the cost advantages of an offshore market but provide the benefits of delivery in the local client market, the customer may use a service provider who is based in the United States that also has delivery capabilities in offshore venues. The U.S. service provider supplies the vendor-side governance of the offshore services, so customers need less of their own governance. Unit costs, however, are usually higher with this approach.

Pricing Models

The pricing model is an important component of the sourcing strategy. Factors customers should consider include what units of measurement they want the service provider to price, for example, full-time equivalent employee or central processing unit benchmarks. Fixed price or variable prices? Correctly structuring the pricing model often proves critical for the long-term sourcing engagement to function properly. Recognition of different skill levels in different labor rates is desirable, and the financial "win-win" is important for the provider and the customer. Typically, long-term contracts contain productivity commitments by the service providers through increased work capability or overall price decreases over time.

Transition Strategy

The customer should insist on a detailed, defined, and reasonable transition plan as part of the sourcing process. The transition plan consists of knowledge transfer, both technical and domain expertise, documentation, and all the necessary steps to transition the services from the customer to the service provider. The significant risk that a transition entails is managed by moving the work in phases, typically with the lowest-risk work being transitioned first. However, this should be aligned with the customer's goals and objectives.

Program Governance Strategy

The governance strategy describes the functions and associated business processes necessary for the successful management of the complex sourcing relationship. While comprehensive in scope, governance components are often referred to as sourcing management, relationship management, contract management, or service provider management. It is important to recognize that a well-executed sourcing transaction that results in a well-defined and fair contract with a service provider is not sufficient to ensure a successful result. The contract and the service provider must be proactively managed, or governed, for the project to be successful.

Documents for Major Sourcing Procurements

Once the customer's overall expectations are understood, the next step is to begin the procurement process. In general, companies use two types of documents to solicit proposals:

Request for Information

If customers don't know precisely what they are buying or from whom they want to buy, the request for

information (RFI) process allows the service providers to discuss their company profiles, capabilities, and experience, thereby educating the customer in available market services and how the service provider matches the customer's unique needs. During the RFI process, providers make in-person presentations and answer customers' questions. Customers generally use this informal process to pare down a large number of potential service providers to the three to four they wish to take through the RFP process. The RFI should be followed by a formal RFP if the sourcing process continues.

Request for Proposal

The RFP is the complete set of materials sent out to service providers requesting proposals. As part of the RFP, the customer must define its requirements and identify the nature of the information it seeks in response. The RFP includes the statement of services, service levels, pricing, human resource requirements, and terms and conditions to be met. Primarily, an RFP asks service providers to develop a solution that meets the customer's requirements and asks them to price that solution. Customers who have fairly clear ideas of what services they are seeking to buy can proceed to the RFP, bypassing the RFI. Customers should be sure they have adequate knowledge and skills to deal with a wide range of bids before issuing an RFP.

Important RFP and Contract Terms

The following sections are samples of categories that are often found in an RFP and are critical in the final agreement.

Nature of Services Required. The customer should try to precisely describe what it wants and needs. To accomplish this, it should first try to categorize its requirements. Is it seeking to source a business process, such as payroll or benefits administration; a business functional area, such as transportation; an IT-related business function, such as the help desk; a call center; or a one-time development or integration effort?

The services might also involve infrastructure, telecommunications, data center, other hardware-intensive business functions, applications support or development, or management of all or part of the IT department.

As the customer is better able to describe its requirements, it can better define the nature of the required services in the RFP. For example:

> *The Service Provider will be responsible for providing Application Development and Maintenance (ADM) Services required for the Applications Software described and all software supported by Customer Personnel as of the commencement date. ADM Services include break and fix services, data correction, production support, preventive maintenance, all enhancements, small and large projects, and data conversions.*

Knowledge Transfer. An offshore transaction involves complex transition and documentation processes. Knowledge is transferred but not necessarily the employees; therefore, the service provider's plan for transition is critical. The human resources issues related to existing employees, especially their retention during the transition period, needs to be a focus of both the customer and the service provider.

For the RFP, the following is a good example:

> *The Service Provider will describe its approach to knowledge transfer of technical and domain expertise from Customer staff to Service Provider staff including approach, tools utilized, timeframes, and documentation requirements.*

Governance. Both the customer and the service provider must be involved with ongoing governance and administration in any sourcing model. This is especially true for an offshore transaction. Given that the service provider may be several time zones removed from the customer, the model must have key elements that leverage and focus on continuous communication, timely reporting, and consistent feedback mechanisms.

Below is a sample provision requesting the service provider to describe its critical and key personnel and how they will interact with the customer's team:

> *The Service Provider will describe its Key Personnel that will deliver the services. Included are the Executive, Account, Delivery, Contract, and Finance Managers. Key Personnel will be dedicated to the customer for a period of two years. Customer has the right to approve Key Personnel. Monthly service review meetings will be held to review service and financial delivery results, provide customer feedback, and discuss any changes to services in the future.*

Service Level Expectations. Service levels provide a consistent approach to managing, measuring, and reporting on service delivery. Initial service levels may be set at the ongoing current levels, with a commitment to year-on-year continuous improvement. Failure to meet expected service levels will usually have a financial credit associated with it. Typically, service providers are required to perform at least as well as the customer did before the work was outsourced. Below are some generic provisions:

> *Service Provider must commit to abide by Customer's Service Levels.*
>
> *Customer requires that the Service Levels be at least as good as those provided by Customer before the Effective Date of the contract unless otherwise requested by Customer.*
>
> *The Service Provider's level of performance will at all times be consistent with acceptable industry standards and will comply with the specific Service Levels identified in the contract.*
>
> *Service Levels reflect the*

expectation by the Customer of the level at which the Service Provider must perform the outsourced work. Examples of such service levels in the applications development, maintenance, and enhancement space include:

- *Implementations Delivered on Time shall be calculated as the number of Work Request Implementations delivered on or before the scheduled release date as a percentage of the total Work Request Implementations during a rolling three-month period.*
- *Percent of Applications without Errors shall be calculated as the number of applications programs promoted to production each month for work requests that include the appropriate business and technical documentation developed by Supplier and approved by the appropriate Client Project Manager or designee, divided by the number of application programs promoted to production for work requests for the month, with the result expressed as a percentage.*

Offshore Privacy and Security: Financial, Political Concerns

There have been several developments in the past 10 years involving data privacy and security. An example is the data privacy directive from the European Union, which mandates that certain types of personal information must be maintained in strict accordance with the privacy directive. Many other countries have enacted or are considering privacy laws, but most of the legislation relates to privacy information for citizens of those jurisdictions.

Currently there are no U.S. laws that prohibit data from being shipped to or accessed from other countries. But companies are increasingly being required to comply with industry-specific and state laws such as the Health Insurance Portability and Accountability Act, the Gramm-Leach-Bliley Act, the Sarbanes-Oxley Act of 2002, and California's pending SB 1386 identity-protection law. U.S. companies must comply with those laws regardless of where the data is processed or stored.

In recent months, India has moved to adopt data privacy rules that would provide legal standards to ensure data privacy protection. While the effectiveness of these privacy standards (expected in 2004) remains an open question, the lack of current safeguards and standards certainly increases the obligations of customers to ensure that service providers respect privacy, ensure data integrity, and otherwise maintain the customer's information systems in accordance with the customer's obligations. That means reviewing the service providers' data handling and access control policies, disaster recovery and business continuity processes, and employee screening practices.

The key areas of concern are access control, network security, facilities and operations, and applications security. The customer should require the service provider to make recommendations for such security services as vulnerability assessments from third parties, penetration assessments, external audits, and security process audits and for policies and tools such as handling of backups and remote access.

Authentication for offshore IT operations is similar to what one sees in the United States, which entails, in most cases, password protection. The use of biometrics is rare in offshore transactions. Smart cards are used for physical access, and public-key infrastructure is typically used only to secure transactions, such as in securely transmitting software.

Limiting service providers' access to customer data can be achieved via secure telecommunications and security access, capable of limiting the copying of data to service provider equipment. Regarding protecting the financial aspect of the relationship, a requirement that the offshore service provider have a line of credit with a U.S. bank helps ensure service performance and transition assistance if the termination of the contract is warranted.

Project Team

To be successful, a strategic sourcing initiative requires significant investment by both the customer and the service provider. The customer team should consist of a core team made up of experts in their areas, for example finance, applications development and maintenance, human resources, communications, and legal, in addition to an executive leader. The core team interacts with others in the organization to gather the requirements and detailed information describing the environment. The core team interacts daily within the customer organization, making decisions, interfacing with the service providers, and keeping the process on track. In addition, the core team regularly reports to a steering committee composed of technology executives, business leaders, or both. An oversight group typically reviews progress and makes strategic decisions.

Exit Strategy

The need to address the end of the deal is often overlooked or dealt with in a summary fashion. No relationship continues forever, and a process where one party decides to disengage from the offshore vendor that controls important parts of its business can be tricky at best. There are three critical points to remember: (1) protect your business data, (2) protect and ensure access to business software applications, and (3) define the process by which the parties will disengage. The latter point must include resource allocations by both parties, the cost to the customer for transition assistance, the time period in which the vendor must cooperate (for a price), and the process for the return and protection of customer information. This will not prevent problems if the vendor decides to breach these obligations or loses the ability to perform, but will assist the customer in

planning for the day in which it retains a new vendor or brings the business back into the company.

Conclusions

The procurement process for an offshore transaction has similarities and differences from a similar transaction with a service provider in the client market. Some of the important points to remember that are similar for each include:

- Detailed strategic decisions need to be made about the outsourcing transaction, and the RFP needs to provide detailed information about the customer's requirements to elicit the right kind of response.
- Due diligence on service providers needs to be extensive, focusing on the experience, capabilities, and delivery models of the service provider.
- The preparedness of the customer organization to address and accept the kind of changes required in an offshore transaction needs to be considered as part of the procurement process. If the customer has organizational challenges, how the customer and service provider will address these challenges should be dealt with in the RFP.
- A structured process for data gathering, RFP development, a uniform system for response to service provider questions, and the complete and thorough evaluation of the proposals is essential. Exit strategy is much easier to address at the beginning.

Issues that are distinct to an offshore procurement process and that customers need to address include:

- The ability to perform complete due diligence with an offshore service provider requires extra effort on behalf of the customer.
- Political and economic instability in the service provider's market may be a question to address in outsourcing mission critical applications.
- Language and cultural issues may limit the customer's acceptance of the offshore provider, and the mechanisms for delivery of the services to account for those issues should be reflected in the RFP and response.
- There will be difficulty in assessing the costs associated with the offshore delivery model. The RFP process should identify and account for these differences so that the customer can evaluate the relative economic benefits of the offshore versus a domestic service provider.

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The Basics of Securities Law for Start-Ups

By Donald M. Crawford and Ritu Vig

Introduction

When business lawyers think or talk about securities law, they often think in terms of large, publicly held corporations, Wall Street investment bankers, and such matters as public offerings of securities, periodic reporting under the Securities and Exchange Act of 1934,[1] and, most visibly and recently, corporate governance and the Sarbanes-Oxley Act of 2002.[2] The securities laws also apply to privately held companies, including start-ups, which come in all shapes and sizes, from computer or software companies started by students, to relatively large, well-financed businesses established by experienced business people. Although start-ups take many different forms, they all face a common set of issues that are separate from those faced by public companies.

When a client or prospective client comes to a lawyer for assistance with a start-up business, he or she may have to go back to the basics of securities law to explain the issues to the client, who may have little or no experience with securities laws, corporate finance, or the capital markets. The client may very well believe that the securities laws do not apply to small start-ups or that exemptions from registration requirements must be available. It may be necessary to address very basic issues, such as the definition of a security and what laws apply, as well as relatively sophisticated and complex issues. For the general business lawyer who is not regularly involved with start-ups, these issues may be unfamiliar. This article presents an overview of the securities laws as they apply to start-up businesses. First, it presents a brief discussion of the regulatory structure and applicable laws. Second, it identifies some of the common situations that raise securities laws issues. Third, it discusses commonly-used federal exemptions from registration requirements. Finally, this article briefly addresses exemptions under state securities laws.

Overview of the Regulatory Structure

State, federal, and foreign laws are all part of the regulatory structure. It is virtually impossible to imagine a situation in which federal law is not implicated. The federal Securities Act of 1933[3] (the 1933 Act) applies to any offer or sale of a security involving the use of jurisdictional means, including the mail, a telephone, or other means of interstate commerce. State and foreign laws are implicated if a person (including an organization) to which a security will be issued has its residence or principal place of business in that jurisdiction. State securities laws are addressed briefly in this article, but foreign laws are beyond the scope of this article.

In the United States, the states adopted the first securities, or blue-sky, laws in the nineteenth century, preceding federal regulation of securities. These state laws were designed to protect state residents from unfair securities offerings. The approach adopted in the state laws was merit regulation: regulation of the substantive fairness of the securities offered and the transaction in which they were sold. Under the merit regulation approach, the states could prohibit the sale of securities if regulators found the terms of the securities or the terms of the transaction unfair. State blue-sky laws typically require any sale of a security to be registered unless the security or the transaction in which it is sold is exempt from registration. The blue-sky laws also require the registration of brokers, dealers, and agents. In many cases, issuers of securities and those acting on their behalf may fall within the definitions of brokers, dealers, and agents. The merit regulation approach still characterizes state regulation today. Almost all of the states have adopted some version of the Uniform Securities Act, so there are many similarities among blue-sky laws. There are, however, many variations among the versions of the Uniform Securities Act enacted in various states, and several states, notably New York and California, have adopted very

different approaches. The blue-sky laws typically apply to all transactions in securities unless a specific exemption is available.

1933 Act

In 1933, the federal government adopted the Securities Act, which requires the registration of any sale of a security using jurisdictional means unless the security or the transaction in which it is sold is exempt from registration. The federal approach to regulation was, and is, very different from the state approach. Federal regulation is not focused on the merits of the offering but on disclosure. The 1933 Act seeks to ensure that all of the information that an investor would consider material to an investment decision is available. Although the 1933 Act potentially applies to all transactions in securities, there are several broadly worded exemptions, including section 4(2),[4] which exempts any transaction "not involving any public offering." This exemption takes a different approach than the blue-sky laws, which generally speaking do not rely on the "public offering" concept for exemptions. The section 4(2) exemption is discussed more fully below.

Almost all of the states have adopted some version of the Uniform Securities Act, so there are many similarities among blue-sky laws.

1934 Act

In 1934, the federal government adopted the Securities Exchange Act,[5] providing for periodic reporting by publicly held companies and regulating the proxy solicitation process. It is oversimplifying to say that the Securities Exchange Act only applies to publicly held companies, but it has little application to start-ups and is not addressed further in this article.

1940 Acts

In 1940, the federal government adopted the Investment Company Act[6] to regulate investment companies, which we know primarily as mutual funds, and the Investment Advisers Act,[7] to regulate persons in the business of rendering investment advice or issuing analyses or reports on securities. An investment company is a company whose primary business is investing in the securities of other companies. Generally, the Investment Company Act and the Investment Advisers Act have little application to start-ups, but the definition of an investment company is so broad that one must be concerned about it any time a holding company structure is used. Section 3(a)(1)(C) of the Investment Company Act defines an investment company as any issuer of securities that

> [i]s engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securiries, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securitis and cash items) on an unconsolidated basis.[8]

This definition is broad enough to implicate the Investment Company Act if a holding company structure is used, but a start-up will typically be excluded from the definition or exempted from the definition. Section 3(b)(1) of the Investment Company Act excludes specified types of issuers, such as those "primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities."[9] Section 3(c) exempts issuers that would otherwise fall within the definition of an investment company, such as those with 100 or fewer beneficial holders of its securities[10] and those whose securities are held solely by "qualified purchasers."[11] Because the Investment Company Act often will not apply to a start-up, we will not discuss it further, but counsel to a start-up should be aware that the Investment Company Act cannot be ignored in a holding company structure.

Both the federal and state laws include exemptions for "exempt securities," specified types of securities for which registration is not required, and "exempt transactions," types of transactions for which registration is not required, regardless of the type of security. Securities issued by start-ups will rarely be exempt securities, which are typically based on the type of organization (such as a bank, an insurance company, or a public utility) issuing the security. These are typically businesses that are heavily regulated and about which extensive information is available. Exempt transactions, particularly those applicable to start-ups, are often defined in terms of the number of offerees, the number of purchasers, or the character of the offerees or purchasers (such as their wealth, level of sophistication, experience in the business, or

the amount of their investment). The exemptions available for start-ups will typically be transactional exemptions. The difference between an exempt security and an exempt transaction is critical because the initial issuance and any subsequent transaction in an exempt security will be exempt from registration, while a separate exemption must be found for the initial issuance and each subsequent transaction for a security issued in an exempt transaction.

There is relatively little coordination among the various states, resulting in a patchwork quilt of regulation. Careful advance planning is necessary to structure a securities offering to meet the requirements of all applicable laws. Federal and state regulations have operated side by side, often overlapping and rarely coordinated with each other. There have been some attempts to coordinate regulation, such as the Uniform Limited Offering Exemption, which was designed to provide a uniform state exemption for offerings under federal Regulation D.[12] In 1996, the federal government adopted the Capital Markets Efficiency Act,[13] providing for federal preemption in the case of "covered securities." State regulation of covered securities is prohibited, although the states may require an issuer of a covered security to file a notice of sale, a consent to service of process, and a fee.

Situations Raising Securities Law Issues

To determine whether any situation raises a securities law issue, one must first determine whether a "security" is involved. Clearly, corporate stock, bonds, options, and similar instruments are securities. But what about investments in cattle feeding programs, precious metals or coins, or orange groves? The U.S. Supreme Court, in *SEC v WJ Howey Co*,[14] addressed the question of whether unconventional investments could constitute securities and determined that the orange grove investment in that case was a security. The classic formulation of the definition of a security in *WJ Howey Co* is (1) an investment of money in (2) a common enterprise with (3) a reasonable expectation of profits to come (4) from the managerial or entrepreneurial efforts of others. This is a very broad definition and will cover almost any kind of investment, including notes and debt instruments. The traditional secured bank loan is generally not considered a security, but almost any other note or debt instrument may be found to be a security. Although a true general partnership interest where the partner actively participates in the management of the enterprise may not be considered a security, virtually every other ownership interest in a business enterprise has been found to be a security, including limited partnership interests, limited liability company membership interests, and some general partnership interests.

Any debt or equity investment in a start-up, including the issuance of a debt or equity instrument in exchange for the contribution of property or the rendering of services, potentially involves the securities laws. Any issuance of a derivative security, such as an option or a warrant, involves the securities laws. Thus, the securities laws are implicated when the start-up is formed, when cash investments are made, when property is exchanged for debt or equity, when debt or equity is issued for services, and when employee incentive programs, such as stock options or phantom stock, are established.

There is relatively little coordination among the various states, resulting in a patchwork quilt of regulation.

Federal Exemptions

Section 4(2) of the 1933 Act provides an exemption for "transactions . . . not involving any public offering."[15] It appears, at first impression, to be a simple and broad exemption. The U.S. Securities and Exchange Commission (SEC) and the courts, however, have construed this exemption rather narrowly through their interpretations of the term "public offering." Under the SEC and court interpretations, many offerings other than those involving underwriters and exchange-listed securities are public offerings. In the *SEC v Ralston Purina Co*[16] case, the U.S. Supreme Court established that whether a transaction involved a "public offering" depends on a number of factors, including the number of offerees, the absence of general solicitation or advertising, the information available to offerees, and the sophistication of the offerees. The SEC and the courts refused to adopt any bright-line rules defining a public offering, which limits the usefulness of the Section 4(2) exemption. The initial issuance of stock to the founders of a corporation or an issuance of preferred stock to a venture capital investor in a heavily negotiated transaction would probably qualify under the

Section 4(2) exemption, but it is difficult to tell whether any particular transaction would qualify under Section 4(2). The "private placement" exemptions from the Securities Act registration and prospectus delivery requirements (Section 4(2), Regulation D, and Section 4(6)) are most commonly relied on by start-ups.

Ultimately, the SEC adopted Regulation D (Rules 501 through 508),[17] which replaced several other rules, to provide a safe harbor exemption under Section 4(2) (Rule 506) and Section 3(b) (Rules 504 and 505), which authorized the SEC to develop exemptions for offerings up to $5,000,000. As a safe harbor, Regulation D is not an exclusive method to perfect an exemption. An issuer may argue that a transaction that does not meet the requirements of Regulation D is still exempt under Section 4(2) or another exemption. Rules 501, 502, 503, 507, and 508 contain definitions and terms of general application for Regulation D. Rules 504, 505, and 506 contain three different exemptions, all of which are very useful for start-ups.

Careful advance planning is necessary to structure a securities offering to meet the requirements of all applicable laws.

Rule 504 provides an exemption for offerings of $1,000,000 or less. The number of offers and sales is not restricted. Purchasers do not have to meet any qualification requirements, and no particular form of disclosure is required. Like all exempt securities and exempt transactions, the antifraud rules still apply, and the issuer must take care to make sure that there is no material misstatement or omission in connection with the offering. A notice of sale on Form D must be filed with the SEC within 15 days after the first sale under Rule 504. If a start-up is raising a relatively small amount of money, Rule 504 can be very helpful. So long as the offering is limited to $1,000,000, it is relatively easy to comply with Rule 504. However, careful planning is necessary to make Rule 504 work. The aggregation rules provide that the $1,000,000 limit applies to the offering and any sales within the previous 12 months. A poorly planned series of issuances could easily exceed the $1,000,000 limit.

Rule 505 provides an exemption for offerings of $5,000,000 or less made to any number of investors that the issuer reasonably believes are "accredited investors" and 35 or fewer nonaccredited investors. Like Rule 504, the aggregation rules for Rule 505 specify that the $5,000,000 limit includes securities sold in the previous 12 months. Rule 501(a) defines the term "accredited investor," which includes

(1) banks and other financial institutions;
(2) corporations and other business organizations with total assets in excess of $5,000,000;
(3) any director, general partner, or executive officer of the issuer;
(4) an individual whose net worth, or joint net worth with his or her spouse, exceeds $1,000,000;
(5) an individual whose annual income exceeds $200,000, or $300,000 annual income jointly with his or her spouse; and
(6) an organization of which all of the owners are accredited investors.

The 35 other nonaccredited investors permitted under Rule 505 do not have to meet any qualification requirements. A specified form of disclosure document is required, although no specified form of disclosure is required for an accredited investor. A notice of sale on Form D must be filed with the SEC within 15 days after the first sale.

Rule 506 provides for an exemption for an offering without limitations on size. Any amount of money may be raised in a Rule 506 offering. The offering must be limited to 35 nonaccredited investors and any number of investors that the issuer reasonably believes are accredited investors. In addition, the issuer must reasonably believe that any nonaccredited investor meets a sophistication requirement: the investor, alone or with the assistance of a purchaser representative, must have enough knowledge and experience in financial and business affairs that the investor can evaluate the merits and risks of the investment. Like Rule 505, a specified form of disclosure is required, and no specified form of disclosure is required for accredited investors. Securities issued under Rule 506 are covered securities and are not subject to state regulation (although a notice filing may be required). A notice of sale on Form D must be filed within 15 days after the first sale.

Rules 505 and 506 provide good alternatives for start-ups that need to raise more than $1,000,000 and therefore cannot rely on Rule 504. They do, however, include additional requirements that make compliance more complicated. The issuer must establish that it has a reasonable basis to believe that investors meet the requirements for accredit-

ed investor status or the sophistication requirements of Rule 506. To meet this requirement, many issuers require each investor to sign and deliver a purchaser questionnaire providing information about the purchaser's income, net worth, education, work experience, business experience, and investment experience. The disclosure specified in Rule 502 must be provided to any nonaccredited investor. As a matter of practice, any disclosure provided to nonaccredited investors should also be provided to accredited investors. This could prevent an antifraud claim by an accredited investor based on providing information to nonaccredited investors that was not provided to an accredited investor. This type of possible claim also highlights the wisdom of providing a written disclosure document to all offerees, whether they are accredited and whether any specific form of disclosure is required (as in an offering under Rule 504). A written disclosure document provides a record of disclosures to offerees, which can be very helpful in defending against claims under the antifraud rules. General solicitation and advertising are prohibited under Rules 505 and 506, although they are not prohibited under Rule 504. Generally, the issuer must have a preexisting relationship with an investor if general solicitation and advertising are prohibited. While Rule 504 itself does not prohibit general solicitation or advertising, they would rarely be used in a Rule 504 offering, largely because they would probably be prohibited under the exemptions from state law in a Rule 504 offering.

Section 4(6) of the 1933 Act[18] also provides for an exemption for offerings made exclusively to accredited investors. A notice of sale on Form D must be filed within 15 days of the first sale.

The private placement exemptions (Section 4(2), Regulation D, and Section 4(6)) are not exclusive. The issuer need not choose one exemption to the exclusion of the others. Private placements are commonly structured and documented to take advantage of as many of these exemptions as possible. For example, an offering might be structured to meet the requirements of both Rules 505 and 506. If the aggregate offering price limitation of Rule 505 ($5,000,000) were inadvertently exceeded, the offering might still qualify for an exemption under Rule 506. Even if the offering did not satisfy all of the requirements of Rule 506, the issuer would still have the option to argue that the offering was exempt under Section 4(2).

State Exemptions

Unless an offering is exempt under Rule 506 and qualifies as a covered security preempted by federal law, each offering must also satisfy the exemption requirements of all applicable state laws. Which state laws are applicable? Generally speaking, the laws of any state in which an individual purchaser lives or in which the principal office of an organizational purchaser is located are applicable. Thus, an offering may be required to satisfy the requirements for an exemption under the laws of several states. This discussion addresses a general approach to state exemptions and some details regarding possible Michigan exemptions. We do not address New York or California laws, which follow different patterns than most other states and present their own problems.

The state approach to exemptions differs somewhat from the federal approach. The state laws do not rely on the "public offering" concept. In almost all states, the starting point is that all transactions must be registered or exempt, and only very specific exemptions are available. Blue-sky laws typically provide for exempt securities and exempt transactions. The start-up issuer will generally need to look for a transactional exemption. Some exemptions are "self-executing," which means that no filing, fees, or other actions are necessary to perfect the exemption. The nature of the transaction itself perfects the exemption. Self-executing exemptions are generally preferred over exemptions that require filings and fees. However, self-executing exemptions vary widely from one state to another and may not always be available. If the offering has been structured as a Rule 505 or 506 offering and self-executing exemptions are not available, one good alternative may be the Uniform Limited Offering Exemption (ULOE). As is often the case with "uniform" state laws, it is less uniform than one might wish, but it offers a good starting place.

Self-executing exemptions for private placements are available in some states based on the number of offerees, the number of purchasers, or the characteristics of the

Any debt or equity investment in a start-up, including the issuance of a debt or equity instrument in exchange for the contribution of property or the rendering of services, potentially involves the securities laws.

purchasers in the offering. Sales to accredited investors or to investors who meet individual state qualifications for wealth or sophistication may be exempt. Exemptions are often available for sales to fewer than 10 (or 15, or 25, or 35) purchasers. These exemptions should be read carefully. Some count only purchasers in the state; others count all purchasers. Some count all offers and purchasers in the state. To properly plan an offering, the issuer and its counsel will have to research applicable state law for all prospective purchasers and may have to disqualify prospective purchasers from some states if a self-executing exemption is not available and the burden of another exemption or of state registration cannot be justified.

The state approach to exemptions differs somewhat from the federal approach. The state laws do not rely on the "public offering" concept.

Like the federal exemptions, the exemptions from registration provided by the Michigan Uniform Securities Act[19] are divided into two categories: (1) exempt securities, outlined in Section 402(a),[20] and (2) exempt transactions, outlined in Section 402(b).[21] The securities exempt under Section 402(a) include securities issued or guaranteed by any state, the federal government, Canada, or any Canadian province; securities issued by any U.S. or state bank, federal savings and loans, railroads, or public utility companies; or any security that is listed or has been approved for listing on the New York Stock Exchange, the American Stock Exchange, Nasdaq, or any other automated quotation system. Thus, Section 402(a) exemptions generally will not apply to most start-up businesses.

Like many of the Section 402(a) exemptions, the transactional exemptions available under Section 402(b) that exempt from registration transactions entered into by parties other than the issuer or a 10 percent beneficial owner (referred to as nonissuers) generally will not be viable exemptions for the initial sale of securities by a start-up company. These exemptions do not exempt from registration the sale of securities by the company but, rather, can be relied on to exempt transactions occurring in the secondary market when nonissuers are involved.

Section 402(b)(9), often referred to as the private placement exemption, provides an exemption for transactions that meet criteria similar to the federal private placement exemptions. There are three main components of the Michigan private placement exemption. First, the issuer or the issuer's agent or representative must take reasonable care to ensure that purchasers within the state of Michigan do not resell the securities in violation of state and federal securities laws. The issuer can meet this burden by, among other things, placing a legend on the certificates indicating the transfer restrictions applicable to the securities represented by the certificate and disclosing that the securities have not been registered under the state or federal securities laws or by making reasonable inquiries to ensure that the purchaser is buying the securities on his or her own behalf or for another qualified purchaser. Second, the securities may not be offered through any general advertising or solicitation, nor may a commission be paid to solicit purchasers within the state, except to registered broker dealers. If a commission is paid to a registered broker dealer, the broker dealer must then comply with certain disclosure requirements regarding the commission. Third, the transaction must be with either

(1) not more than 10 promoters or persons actively engaged in the management of the issuer within a 12-month period;
(2) not more than 15 people, including non-Michigan investors, who are qualified by previous experience to assess the risks of the investments and whose principal business is in the same line of business as the issuer;
(3) not more than 25 investors within the state of Michigan within a 12-month period who are provided with a disclosure document at least 48 hours before the offering detailing information enumerated in the statute, including the use of proceeds, the current financial position of the issuer, and a description of the business of the issuer;
(4) a business that the seller reasonably believes has less than 10 percent of its total assets invested in the securities and net income in excess of $100,000 or, at the time of the purchase, net worth in excess of $1,000,000; or
(5) an individual who the issuer reasonably believes has an investment of $50,000 or more in the securities, adequate knowledge, and investment experience to evaluate the

> risks of the investment—either on his or her own or with the assistance of a lawyer, an accountant, or an investment advisor—and either personal income of $100,000 or more or a net worth in excess of $1,000,000.

The issuer may sell to an unlimited number of purchasers if the purchasers meet the requirements of items (4) or (5) above.

Section 402(b)(10) exempts from registration transactions involving the preorganization subscription for a corporation's securities and subsequent issuance of those securities. This exemption may be relied on only if there are less than 10 purchasers, if no commission is paid to solicit the purchasers, and if the seller reasonably believes that the purchasers are buying the securities for investment purposes. In addition, only approved advertisings may be distributed or circulated regarding the offering.

Section 402(b)(11) provides for an exemption for issuances of security to existing security holders, including convertible securities or warrants, provided the warrants are exercisable within 90 days of their issuance. The exemption in subsection 11 may be used if no commission, other than a standby commission, was paid and the sale was to no more than 25 holders within the state within a 12-month period. If these requirements are not met, then 20 days before the offer to the existing security holder, the issuer must file with the Office of Financial and Insurance Services of the Department of Labor and Economic Growth, along with a filing fee of $100, an offering circular or other materials to be sent to prospective purchasers describing the terms of the offering.

Conclusion

Both federal and state securities laws are implicated in the offering of securities by a start-up. While self-executing exemptions are often available, some exemptions will require the filing of offering documents or the payment of filing fees. In addition, although most states have adopted some form of the Uniform Securities Act, because of the varying nature of the state securities laws, careful planning is an integral part of securities offerings for start-up companies.

NOTES

1. 15 USC 78a et seq.
2. Pub L No 107-204, 116 Stat 745 (2002).
3. 15 USC 77a et seq.
4. 15 USC 77d(2).
5. Pub L No 73-291, 48 Stat 881 (1934).
6. 15 USC 80a-1 et seq.
7. 15 USC 80b-1 et seq.
8. 15 USC 80a-3(a)(1)(C).
9. 15 USC 80a-3(b)(1).
10. 15 USC 80a-3(c)(1)
11. 15 USC 80a-3(c)(7)
12. 17 CFR 230.501 et seq.
13. Pub L No 104-290, 110 Stat 3416 (1996).
14. 328 US 293 (1946).
15. 15 USC 77d(2).
16. 346 US 119 (1953).
17. 17 CFR 230.501–.508.
18. 15 USC 77c(6).
19. MCL 451.801 et seq.
20. MCL 451.802(a).
21. MCL 451.802(b).

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The SEC Moves to Real-Time Disclosure

By David Braun

Before the Sarbanes-Oxley Act of 2002 mandate to improve the timeliness in disseminating important information by public companies to the investing public, the Securities and Exchange Commission (SEC) had stated that it would like to move to a real-time disclosure system. Section 409 of the Sarbanes-Oxley Act codified real-time disclosure of certain events. As part of its longstanding goal to achieve real-time disclosure, the SEC has amended the rules surrounding Form 8-K. On March 16, 2004, the SEC issued Release No 33-8400,[1] which implemented the SEC's proposed acceleration of the filing requirements for reportable events. Most filings will now be due four business days following a reportable event. In addition, the SEC expanded the use of Form 8-K by adding eight new reportable items. The effective date of new Form 8-K is August 23, 2004.

Reportable Events

As part of the release, Form 8-K has been organized into topical categories covering a variety of events. The topical categories are as follows:

Section 1. Registrant's Business and Operations
- Item 1.01. Entry into a Material Definitive Agreement
- Item 1.02. Termination of a Material Definitive Agreement
- Item 1.03. Bankruptcy or Receivership

Section 2. Financial Information
- Item 2.01. Completion of Acquisition or Disposition of Assets
- Item 2.02. Results of Operations and Financial Condition
- Item 2.03. Creation of a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement of a Registrant
- Item 2.04. Triggering Events That Accelerate or Increase a Direct Financial Obligation Under an Off-Balance Sheet Arrangement
- Item 2.05. Costs Associated with Exit or Disposal Activities
- Item 2.06. Material Impairments

Section 3. Securities and Trading Markets
- Item 3.01. Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing
- Item 3.02. Unregistered Sales of Equity Securities
- Item 3.03. Material Modifications to Rights of Security Holders

Section 4. Matters Related to Accountants and Financial Statements
- Item 4.01. Changes in Registrants' Certifying Accountant
- Item 4.02. Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review

Section 5. Corporate Governance and Management
- Item 5.01. Changes in Control of Registrant
- Item 5.02. Departure of Directors or Principal Officers; Election of Directors; Appointment of Principal Officers
- Item 5.03. Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year
- Item 5.04. Temporary Suspension of Trading Under Registrant's Employee Benefit Plans
- Item 5.05. Amendments to the Registrant's Code of Ethics, or Waiver of a Provision of the Code of Ethics

Section 6. [Reserved]

Section 7. Regulation FD
- Item 7.01. Regulation FD Disclosure

Section 8. Other Events
- Item 8.01. Other Events

Section 9. Financial Statements and Exhibits
- Item 9.01. Financial Statements and Exhibits

Eight of the reportable events are new (Items 1.01, 1.02, 2.03–2.06, 3.01, and 4.02), and two have been expanded (former Item

6/new 5.02 and former Item 8/new 5.03). In addition to the new items, the Form 8-K filing period is now 4 business days after the triggering event, reduced from the current filing period of 5 to 15 days. Current Items 5 (new 8.01) and 9 (new 7.01) will continue to be reportable events when they are required.

Description of the New Items

The following is a brief description of the new items and the nature and extent of disclosure required by each.

Item 1.01, Entry into a Material Definitive Agreement, requires disclosure of material definitive agreements that are not made in the ordinary course of business. This item is similar to Item 601(b)(10) of Regulation S-K. The registrant will be required to disclose the date the agreement was entered into or amended, the identity of the parties to the agreement, a brief description of any material relationship between the company and the other parties to the agreement, and a brief description of the terms and conditions of the agreement. Registrants are required to disclose only binding agreements and are not required to disclose nonbinding letters of intent. In addition, registrants are not required to file the agreement as an exhibit to Form 8-K but are encouraged to do so if they are not seeking confidential treatment. Any material agreement not filed with the registrant's Form 8-K must be filed with the next Form 10-Q.

Item 1.02, Termination of a Material Definitive Agreement, requires the disclosure of the termination of a material definitive agreement that was not made in the ordinary course of business. Such termination must be reported when it does not result from the expiration of the agreement or the satisfaction of all of the obligations under the agreement. Registrants will be required to disclose the date of the termination of the definitive agreement, the identity of the parties to the agreement, and a brief description of any material relationship between the company and the other parties to the agreement. Further, registrants will be required to describe the circumstances surrounding the termination and any material termination penalties incurred by the company as a result of the termination. No disclosure is required during negotiation or discussions regarding termination of a material definitive agreement unless and until the agreement has been terminated.

Item 2.03, Creation of a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement of a Registrant, requires the disclosure of direct financial obligations or an obligation under an off-balance sheet arrangement. A *direct financial obligation* is defined as a long-term debt obligation, a capital lease obligation, an operating lease obligation, or a short-term debt obligation arising in other than the ordinary course of business. The registrant must disclose the date on which it became directly or contingently liable on the obligation, the nature and amount of the obligation, and any other terms and conditions of the obligation. Disclosures of off-balance sheet arrangements for Form 8-K purposes have similar requirements. The SEC issued Release No 33-8182[2] concerning disclosure of off-balance sheet arrangements in other filings with the SEC on January 28, 2003.

Item 2.04, Triggering Events That Accelerate or Increase a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement, requires disclosure of the triggering events that accelerate or increase a direct financial obligation or an obligation under an off-balance sheet arrangement. Registrants must file a Form 8-K to report a triggering event causing the increase or acceleration of a direct financial obligation if the event is material to the company. Further, registrants must disclose the date of the triggering event, a brief description of the underlying agreement or transaction, the amount and terms of payment, and whether the event will trigger an acceleration of, or increase in, the other obligations of the registrant. Disclosure is similar for both direct and off-balance sheet obligations.

Item 2.05, Costs Associated with Exit or Disposal Activities, requires disclosure when the registrant's board of directors, a committee of the board, or the registrant's authorized officers commit the company to an exit or disposal plan or otherwise dispose of a long-lived asset or terminate employees under a plan pursuant to which material charges will be incurred by the company under generally accepted accounting principles. Registrants must disclose the date of the commitment to the course of action, a description of the course of action, and an estimate of the total amount or range of costs to be incurred in connection with the action. If the registrant is unable to make a good-faith estimate of the cost of the plan when it

As part of its longstanding goal to achieve real-time disclosure, the SEC has amended the rules surrounding Form 8-K.

determines its course of action, the registrant must amend the Form 8-K within four business days after the company completes its estimate of the costs.

Item 2.06, Material Impairments, requires disclosure when the registrant's board of directors, a committee of the board, or the registrant's authorized officers conclude that a material charge for impairment to one or more of the company's assets, including goodwill, is required under GAAP. Registrants are required to disclose the date of the conclusion that a material charge is required, a description of the impaired asset, and an estimate of the impairment charge and any cash effect of recognizing the impairment charge.

Most filings will now be due four business days following a reportable event.

Item 3.01, Notice of Delisting or Continued Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing, requires disclosure when a registrant receives a notice of delisting or failure to satisfy a continued listing rule or standard or when there is a transfer of listing. Registrants must disclose the date that it received the notice, the rule or standard that the company has failed to satisfy, and any action or response that the company has determined to take in response to the notice. The SEC anticipates that two Form 8-K filings will be made, the first when the registrant receives notice of delisting and the second when the issue is resolved or the company's securities are actually delisted.

Item 4.02, Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review, requires disclosure when its board of directors, a committee of the board, or the registrant's authorized officers conclude that any of the company's previously issued financial statements covering one or more years or interim periods no longer should be relied upon because of an error in the statements. Registrants must disclose the date of the conclusion, a brief description of the facts leading to the conclusion, and whether the conclusion has been discussed with the company's independent accountants. Similar disclosure is required when the company is advised by its independent accountant that disclosure should be made to prevent future reliance on a previously issued audit report. The disclosures required by Item 4.02 must also be provided by the independent accountant on the same day the filing is made with the SEC.

NOTES

1. Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Exchange Act Release No 33,8400, 17 CFR 228–230, 239–240, 249 (Aug 23, 2004), *available at* http://www.sec.gov/rules/final/33-8400.htm.

2. Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, 17 CFR 228–229, 249 (Apr 7, 2003), *available at* http://www.sec.gov/rules/final/33-8182.htm.

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The Frontier Between the Uniform Commercial Code and Certificated Goods

By Charles Milne

The Trap

When dealers sell new manufactured housing or new vehicles, they do not transfer a certificate of title (COT) to the purchaser. Administrative regulations direct the dealers to present an application and the manufacturer's statement of origin (MSO) or certificate of origin (COO) to the secretary of state so that a COT may be issued. Some inventory financiers and floor planners retain the COO in their possession. This means that on sale, the dealer must notify the financier of the sale and pay for the unit to obtain the paperwork necessary to have the COT issued. If the dealer fails to make the payment, no title is forthcoming. It is possible that a fraudulent dealer, or an optimist, hoping to earn his or her way out of a financial hole and pay off creditors, may not notify the financier of the sale.

Although the regulations anticipate that the dealer will process the paperwork and that the secretary of state will issue a COT, which will then be mailed to the purchaser, the purchaser is trapped if the dealer fails to make payment. A purchaser who is sufficiently concerned to investigate the COT's absence may well find recourse only against a dealer without assets and must face the agents of a financier who want to make a recovery. Commenting on this situation in *Ladd v Ford Consumer Finance Co*, the Michigan court of appeals has stated, "Possessing the certificate of origin gave Ford [the financier] additional security because Michigan law requires the certificate of origin to accompany the title application submitted to the Department of Commerce before the department issues a certificate of title. . . ."[1]

Plaintiff Ladd had purchased a new, untitled manufactured home. The governing statute, the Mobile Home Commission Act (MHCA),[2] had no guiding case law. The statute providing for the transfer of mobile homes was passed to remove titling from the Michigan Vehicle Code (MVC)[3] and is

> [a]n act to create a mobile home commission; to prescribe its powers and duties and those of local governments; to provide for a mobile home code and the licensure, regulation, construction, operation, and management of mobile home parks, the licensure and regulation of retail sales dealers, warranties of mobile homes, and service practices of dealers; to provide for the titling of mobile homes; to prescribe the powers and duties of certain agencies and departments; to provide remedies and penalties; to declare the act to be remedial; to repeal this act on a specific date; and to repeal certain acts and parts of acts.[4]

Both parties and the court relied on MVC cases (because there were no others), the MHCA, and the administrative regulations under the act. The court of appeals held that

The author acknowledges the invaluable help of his co-counsel: Robert A. Betts, attorney for David Ladd, and John W. Allen, who both argued the case with me before the Michigan Supreme Court; Myra L. Willis; and James H. Geary, who brought great learning and wisdom to the preparation of the case.

I also wish to extend my thanks to our clerks, Robert Metzgar and Alex Lebedenski, who labored diligently and listened to my endless discussions. And certainly not least David Cutler, Richard F. Fellrath, and Stuart J. Snider, who so graciously agreed on behalf of the Debtor/Creditor Rights Committee to criticize this effort. I thank them for their efforts from which any value herein comes, and whose any infelicity is surely mine.

no COO means no title and thus no sale. A nonstatutory security interest is created when a sale is made from inventory, the COT is not issued, and the financier can pursue the goods.

In reversing the court of appeals, the Michigan Supreme Court determined that

> Plaintiff Ladd, having fulfilled his obligations under the purchase agreement with the dealer, was entitled to have the dealer obtain the certificate of origin and deliver it to him so that he could apply for and obtain a title. Defendant [the floor plan financier] could not have refused a request by the dealer because 1985 AACS, R 125.1232(2) mandates surrender of the certificate of origin irrespective of any contractual defenses that a lender may have against a dealer. In these circumstances, Ladd may make the request himself, and the defendant must comply with that request.[5]

Michigan has been said to be the most adamant of states in enforcing the doctrine that a contract is void if the statute prohibiting such activity includes a criminal provision. . . . At least 44 states have, however, found ways of delivering their consumers from such a doctrine.

Thus, the Michigan Supreme Court used the opportunity to insist that statutes be read plainly, that regulations be subordinated to them, and that the certificate of titling statute be read in harmony with the Uniform Commercial Code (UCC).[6] The doctrine allowing the voiding of contracts was kept in its proper role of stopping sales so that the prior owner, to whom a COT had been issued or who had purchased the unit from a manufacturer, does not have his or her property sold without consent.

Does the purchaser have to pay what the dealer owed on its loan? In a peremptory order, the supreme court answered "no," stating that David Ladd could act "in these circumstances." The *Ladd* court unanimously ruled that Mr. Ladd could demand the paperwork from the financier and that the turnover was not dependent on payment. The Ladd floor planner did not have the ability to force a consumer to pay twice.

Ladd provides that the right to the documentation to obtain a COT derived not from the dealer's voluntary agreement or from those who financed the dealer but from the buyer's statutory right to have the financiers turn the documentation over. Under *Ladd*, not only may the dealer obtain the documents to implement the statute, but the purchaser may make an effective demand for the documents that he or she needs for a COT based on the statute. The Michigan Supreme Court has indicated in the past that statutes control over regulations,[7] and Article 9 of the UCC provides that a buyer in the ordinary course takes free of a UCC filing.[8]

The regulation involved in *Ladd*, AC, R 125.1232, *rescinded by* 1999 MR 11 (eff. Nov 17, 1999), has been substantially reenacted by AC, R 125.1419, which reads:

> (1) The certificate of origin shall be attached as an addendum to the application for a certificate of manufactured home ownership when filing for an original certificate of manufactured home ownership.
>
> (2) For the purpose of complying with subrule (1) of this rule, the certificate of origin shall be immediately surrendered by the lender holding such certificate to the retailer upon request.

Although the regulation requires the dealer to take action, the statute itself leaves power in the owner's hands:

> (1) [A]n owner of a mobile home which is subject to the certificate of title provisions of this act shall make application to the department for the issuance of a certificate of title for the mobile home upon the appropriate form furnished by the department. . . .[9]

The Michigan court of appeals took a surprisingly different position in *Ladd*, noting that "[d]espite our sympathy for these innocent plaintiffs, this Court is bound to follow the clear and unambiguous language of the title transfer provisions."[10] The court observed that "[j]udicial construction of the MHCA title provisions is neither required nor permitted. If the Legislature intends a buyer in the ordinary course of business to take title to a mobile home under the UCC, it should plainly state so in an amended statute."[11] Finally, the court stated that

> [b]ecause Ford [the floor plan financier in *Ladd*] refused to relinquish possession of the certificate of origin that must be attached to the application for title, the application for certificate of title could not be properly executed. . . . Because Colony [the defaulting dealer] never filed a com-

> pleted title application accompanied by the necessary form, the certificate of origin, title was not transferred to plaintiff Ladd.[12]

The court of appeals decision was based on a very formal reading of the paperwork issues. Even the regulatory language seemed to allow new manufactured housing to be transferred without a COT before one existed. Michigan has been said to be the most adamant of states in enforcing the doctrine that a contract is void if the statute prohibiting such activity includes a criminal provision. Both the MVC and the MHCA contain a section making a sale without a COT a misdemeanor. At least 44 states have, however, found ways of delivering their consumers from such a doctrine.

> These U.C.C. provisions would seem to fly directly in the face of most state motor vehicle laws, which equate ownership of a vehicle with possession of a validly issued title from the Secretary of State or other state agency. Thus, the supplier usually argues that, since the buyer from the dealer did not receive the MSO [manufacturer's statement of origin or certificate of origin] or certificate of title, such person cannot be a buyer in the ordinary course of business. Usually, the supplier further contends that retention of the MSO or title certificate gives him priority over the rights of the buyer.
>
> . . . .
>
> Some states, such as Michigan, have managed to find exceptions within that state's peculiar motor vehicles laws. Thus, it has been held that the Michigan motor vehicle statute does not require the transferee's name to be placed upon the certificate of title when the motor vehicle is transferred, and that therefore receipt of the title upon purchase of the car is not relevant to the buyer's status as a buyer in the ordinary course.[13]

The Sixth Circuit Court of Appeals explained best the void sale doctrine in *Loucks v Carl Foster & Wards Used Cars*:

> We pointed out there that the transfer statute does not, by its own words, declare void a transfer failing to strictly comply with it. The statute declares such failure a misdemeanor and from that the Michigan Court, *upon the facts of the particular cases*, struck down as invalid noncomplying transfers.[14]

Ladd speaks to the issue of transferring a manufactured home that has had no COT issued yet, relying on cases decided under the MVC.

Cases Involving Vehicles and Manufactured Homes with COTs Issued

The Michigan Supreme Court recognized in *Plasman v Foremost Ins Co* that it is "a matter of common knowledge that in the purchase of an automobile, delivery of the vehicle frequently precedes the turning over of a certificate of title."[15] Indeed, the secretary of state's application form suggests waiting 60 days. Pre- and post-UCC *Daas v Contract Purchase Corp*[16] and *Oscoda State Sav Bank v McAllister*[17] both turned on the sale of inventory free of a security interest. In those cases, the COT was provided to the dealer without the notation of a security interest. The Michigan Supreme Court stated that the public filing on the dealer's inventory was not sufficient to put a consumer on notice and that a purchase would be valid despite the filing.

[T]he courts have clearly interpreted the governing law to prevent the sale of vehicles without the certificated owner's consent.

In several other cases, the transactions were outside the titling system because no COT was issued, and contract law determined that ownership passed to the dealer and the carrier. In *Kelley v Citizens Mut Ins Co*,[18] a new, yet untitled, vehicle was sold by a manufacturer through a dealer. During the delivery by the dealer, it was involved in an accident. The UCC was applied, and the court ruled that "ownership of the automobile in question passed from the Chrysler Corporation to [the dealer] when the Chrysler field representative delivered the automobile to [the dealer] and [the dealer] exercised complete control and dominion over the auto."[19]

Nichol v El Par Motor Sales,[20] decided before the UCC, also looked to general contract law to determine ownership in the absence of a COT. The judge instructed the jury that El Par was not subject to liability unless it was the owner of the subject auto-

mobile and that, for purposes of the Civil Liability Act, an "owner" is "a person who holds the legal title of a vehicle."[21]

> [MCL 440.2401(2)] provides that title passes upon completion of the seller's performance "with reference to the physical delivery of the goods" unless "otherwise explicitly agreed." In this case the direct-dealer agreement between Chrysler and El Par purports to spell out when title passes. Paragraph 16 of the agreement (concerning "Title") provides that title to "products" sold by Chrysler passes on delivery to "direct dealer" (El Par), "direct dealer's agent," or "the carrier."
>
> It is contended that there is no evidence that the Kort vehicle was delivered to El Par or to an agent of El Par and, therefore, the case rises or falls on the construction of the language "delivery to * * * the carrier."[22]

The Michigan courts do not require meticulous compliance with the title transfer provisions but instead require substantive compliance to avoid . . . the sale of vehicles without their owners' permission.

In *Fullwood v Catsman*,[23] plaintiff agreed to work for Catsman and have the price of a truck deducted from his pay. When Fullwood broke what defendant felt was the exclusive nature of the relationship by working for someone else, defendant kept the truck, the money that had been paid in full, and the COT. The court found that plaintiff was entitled to have a certificate of title to the truck delivered to him and affirmed the judgment for Fullwood for the funds paid to Catsman.[24]

Where there is an easily articulated rule, it often takes on a life of its own. In *Taylor v Burdick*,[25] the assertion that there was an inter vivos gift, not documented or mentioned in the will and not evidenced by a COT, was not enforceable. The reason offered was the failure to make the transfer by COT. However, no proof of a gift was offered, and the analysis of the court did not have to go beyond the COT issue.

Another reason for finding that the vehicle should transfer on sale is entrustment. Michigan adopted this reasoning in *Dart Nat'l Bank v Mid-States Corp.*[26] A dealer sold a trailer and then sold the loan representing the financing for its sale (as is the case in almost all sales where the dealer assigns the loan that it has completed to a lender). The dealer then failed to pay off its secured financier. The Michigan Supreme Court relied on the Uniform Sales Act, the predecessor to the UCC, and the forerunner language to UCC 2-403 to hold that the bank that had purchased the paper was prior in its interest and secured in the trailer.

Thus, the courts have clearly interpreted the governing law to prevent the sale of vehicles without the certificated owner's consent and not to create traps for buyers in the ordinary course of business.

The Origin of the Void Contract Doctrine

In 1928, *Endres v Mara-Rickenbacker Co*[27] was the first case to hold a vehicle sale void for a violation of the title transfer statute. The court dealt with a situation in which there was an accident involving the vehicle before it was transferred by the COT. The dealer's license plates were provided so that the customer could immediately start driving the car. The dealer was found to be liable even though the loaning of the dealer's license plates had no connection with the accident. The dealer's liability was based on the statutory misdemeanor (now MCL 257.239) of selling a car without complying with the provision requiring the transfer of the COT. The sale was void, and the dealer who failed to comply with the law suffered for the noncompliance.

The *Endres* court relied on *Cashin v Pliter*,[28] which interpreted a statute that required persons conducting business under an assumed name to put their own name on file so that everyone dealing with them would know the individuals involved in the business. The supreme court found that the name "Flint Construction & Realty" did not comply because no name of a person was included. Therefore, plaintiff was unable to bring suit against defendant to recover payment.

In the later decision of *In re Richard Bros*,[29] the U.S. District for the Eastern District of Michigan interpreted the statute and *Cashin*, finding that using a person's last name would be acceptable. The court noted that it was advised that Michigan was the strictest of the states in imposing sanctions if there was a public policy interest in requiring compliance. The court found that a penal statute should be construed against those who seek to invoke it and that because the name was that of the individuals, there was no violation of the statute.

Michigan's Application of the Void Contract Doctrine and Substantive Compliance

In *Terpstra v Grand Mobile Trailer Sales,*[30] a plaintiff who purchased a trailer never received his COT. When his trailer was destroyed by fire, he sought to recover the purchase price because the sale was void. The Michigan Supreme Court denied this attempt and, in concurring, Justice Edwards wrote:

> This is the story of a trailer, a statute and a lawsuit which, if successful, would make the law look foolish.
>
> . . . .
>
> Appellant argues in effect that the contract being void because of the illegal omission to transfer title, the courts are thereby deprived of all discretion to render justice between the parties. He would have the court required, by application of claimed legal principles, to order the return of the *quid* where the returnee had destroyed the *quo*. However plainly inequitable such a result, we are told this is exactly what the statute and our previous case interpretations thereof require.
>
> We do not so read the cases. In those where recovery of the purchase price was allowed, the seller either had possession of the vehicle or tender thereof was shown. The effect of court action in each instance was to restore the status quo before the transaction. *Bos v. Holleman De Weerd Auto Co*; 246 Mich 578; *Scarborough v. Detroit Operating Co;* supra; *Fullwood v. Catsman,* 329 Mich 120.
>
> See, also, *Bayer v. Jackson City Bank & Trust Co; supra,* 108.[31]

(Emphasis added.) The court also quoted *Corbin on Contracts*:

> [W]here one seeks a remedy because of part performance under a void contract, the courts examine . . . "the degree of criminality or evil, the comparative innocence or guilt of the parties, the extent of public harm involved, the moral quality of the conduct of the parties, and the severity of the penalty or forfeiture that will result from refusal of relief."[32]

The court found "little other than purely technical guilt in the defendant's conduct, and we find ordinary standards of justice offended by appellant's claim for his money back after he had accidentally or negligently destroyed the trailer."[33]

Bayer v Jackson City Bank & Trust Co[34] involved the failure of a car dealer to deliver the COT after it had accepted payment and delivered the vehicle. The supreme court held that the vehicle would go to the secured party that had been financing the dealer. A review of the briefs filed with the supreme court shows no reference to any of the issues or reasons discussed in the other cases discussed in this article, such as allowing the enforcement of a contract for sale, compelling delivery of the documentation, the need for uniformity under the UCC when inventory is sold, the doctrine of entrustment, and the illicit nature of a secret, springing security agreement.

In *Larson v Van Horn*, a Rolls Royce aficionado purchased a vehicle from a dealer.[35] The bank had given a COT without a lien on it to the dealer. The dealer having endorsed the COT over to the purchaser, there was no interest in the financier. The court found that the failure of the purchaser to obtain a new COT had no effect on the sale. Thus, the new owner saved the sales tax due. The court found that his ownership was valid. The transfer portion of the COT was executed, and there was no security interest shown on the COT. The bank could not reclaim the car. The Michigan courts do not require meticulous compliance with the title transfer provisions but instead require substantive compliance to avoid the wrong that the statute seeks to avoid: the sale of vehicles without their owners' permission.

Whitecraft v Wolfe[36] involved three separate circuit court actions. The seller had endorsed his title to a dealer. He agreed to accept payment at a later date. The dealer sold a vehicle to a customer in the ordinary course of business, but the dealer failed to execute the COT to transfer it to the purchaser. The seller obtained a duplicate title that placed the vehicle in the name of his sister. A prior order of the court ordering redelivery of the vehicle from the dealer to the seller was only silently overruled by the circuit court's later order when the trial court found

There are several bankruptcy cases that seem to accept the rather misleading void contract doctrine and endow documents with magic legal powers.

that the purchaser should receive the vehicle. The court of appeals found that the matter had not been ripe for summary disposition: the dealer was not party to any of the three lawsuits when the relevant orders were entered; the court had not had the benefit of facts that might have arisen from the response of the dealer; and neither was the original owner's sister, in whom he had placed the title through the issuance of a duplicate title, a party. The court noted that the purpose of the law was to ensure the orderly transfer of titles to purchasers through the COT.

Keeping *Loucks* and *Plasman* in mind, it seems clear that Michigan voids a sale only when there is an actual sale without authority, and not for a mere paperwork delay. *Bayer* is arguably silently overruled by *Loucks* and *Plasman* and was distinguished by *Terpstra.* Further, *Ladd,* based on MVC precedent, arguably teaches that *Bayer* is wrong.

The legislature has . . . created a system to handle the transition from certificated good to real estate and back again.

Bankruptcy and Federal Cases

There are several bankruptcy cases that seem to accept the rather misleading void contract doctrine and endow documents with magic legal powers. *In re Superior Ground Support, Inc*[37] involved the sale of a chassis to a manufacturer, which would turn it into a piece of fire equipment for use on airport property. The court denied the pending motion for summary judgment, finding that the MVC could apply if the fire equipment was a motor vehicle, and indicated that only on the supply of the COO could a COT be issued, supporting the secret security interest result. The court stated that "[l]ogically, a buyer in the ordinary course of business emerges only upon the completion of a sale."[38] Although *Ladd* dealt with manufactured housing, it obviates this case. Thus, those who attempt to make a purchase can complete it by demanding the documentation without paying off the financier. The *Ladd* court relied (of necessity) on MVC cases and ought to be seen as authoritative on vehicles as well as manufactured homes. To hold otherwise would allow a seller to create its own system of security in derogation of the statutory system.

In *In re Bencker,*[39] a bankruptcy court found that when the contract is still executory, a bankruptcy estate could enforce the completion of the transaction involving a manufactured home. Payment had not been made, and the COT had not been delivered. The court found that this was an executory contract, which gave the court jurisdiction and allowed it to enforce the completion of the contract.

In re Kroskie[40] is a bankruptcy case that was reversed in district court and reversed again in the Sixth Circuit. *Kroskie* found that though the manufactured home was tied to real property, a COT was the only means to transfer that home. *Ottaco, Inc v Gauze,*[41] a Michigan court of appeals decision that was distinguished as a tax case, had held that the interest represented by a COT disappeared in a tax sale because manufactured housing becomes real property when tied to the land. The *Ottaco, Inc* court stated:

> On the basis of the undisputed facts presented below, we conclude that the trial court correctly determined that the mobile home in question became part of the real property. The Gauzes had ownership interests in both the mobile home and the land on which it is located. The mobile home was annexed by way of a concrete slab foundation. It has all the attributes of a conventional, permanent dwelling, including a porch, as well as connections to gas, electric, sewer, and water lines. In every respect, the mobile home was integrated with and adapted to the use of the real property, which property was zoned for single-family residential use. Notwithstanding the fact that the home could be eventually moved from its foundation to another location, the objective facts manifest the Gauzes intent to make the mobile home a permanent accession to the realty. *Accordingly, because the mobile home became a fixture, title to both the mobile home and the real estate passed to Ottaco upon issuance of the tax deed.*[42]

(Emphasis added.)

The legislature has codifed the *Ottaco, Inc* understanding of the law, MCL 125.2330i(5) and (8), to allow the manufactured housing to become real estate and then cease to be real estate and to become certificated property again.

The *Kroskie* case should be a caution to

practitioners that if property is attached to the land, it will be treated as realty only if the new statute is followed. This is another example of the limitation of the COT as the only way to transfer. The legislature has intervened and created a system to handle the transition from certificated good to real estate and back again. A purchaser under an agreement calling for payments over time is able to enforce the contract and to obtain a COT. With the new statute, there will be less guesswork about the possible change in status to real estate and back.

The U.S. District Court for the Eastern District of Michigan in *Frank v Kiesel,* distinguishing *Kroskie* and citing *Ladd*, has recently observed that

> nothing in the MHCA renders invalid an installment contract between private parties to sell a mobile home and transfer title upon completion of the payments, nor does the Act diminish the vendee's contract rights to demand performance, provided that title is transferred in accordance with the procedures set forth in the MHCA.[43]

What Advice Can a Practitioner Give?

The Michigan Supreme Court has made it abundantly clear that purchasers of manufactured homes take in the ordinary course of business under the UCC and that the MHCA allows no secret, springing security interest that interferes with the transfer of manufactured housing. The documents needed for a title must be produced and turned over by financiers to purchasers on demand. It should be noted that *Ladd* spoke only to manufactured housing, and the author recently had a judge insist that there was no holding in *Ladd* about vehicles. The MHCA, MCL 125.2330d, has been found by the Eastern District of Michigan to transfer of mobile homes on the receipt of the paperwork as opposed to the execution of its mailing or its processing by the secretary of state.[44] If used manufactured housing were sold, the COT would probably be ordered delivered and not allowed to become a secret security agreement.

The financing industry practice is to file a UCC-1 on inventory, and in some cases to rely on the control of the COO or COT to avoid losses from dealers who sell and do not pay. A well-run financier inspects the inventory periodically. Financiers do not have COTs issued naming them as the secured party because it is too expensive. Some financiers like the process of holding the COO or COT because they are then notified of each sale and some seek to profit by a secret springing security interest. Both the MHCA and MVC exempt dealers from having a COT issued in the dealer's name.[45]

The MVC (but not the MHCA) makes it a requirement that the dealer have the paperwork to obtain the title in its immediate possession. It seems to this author that the failure of the dealer to have this in its possession, or the retention of it by a financier, would be an offense to the statute that requires possession. This is consistent with *Ladd,* where the purchaser was found to have a right to the COO.

If a COT does not come swiftly, the purchaser needs to make a prompt demand for the COO or COT.

The lack of a COT was not a factor in a recent case involving a vehicle brought into Michigan from Ontario, which does not issue COTs. The car was sold without dealing with the secured party that had an interest in the vehicle. The court of appeals held that the sale was valid and in compliance with the Michigan procedure.[46]

The COT exists to avoid situations exactly like that of the vehicle brought from Ontario. The COT must be presented and assigned so that the prior owner's consent to the sale is known. Of course, we all know that this is not the way new car dealers, manufactured housing dealers, or the dealers in used units of either actually transact business. They take care of the paperwork as is suggested by the regulations, and the title comes a good deal later to the purchaser in the mail. The only intended use of the COT is to verify the transfer of interest from an owner, and only in such cases should it block a transfer to a later purchaser. It neither becomes involved in the transformation of a manufacutred housing unit into real estate nor provides extra security for a floor plan financier. The 60 days suggested by the secretary of state shows that the current system will continue to allow problems and create litigation and losses for purchasers.

The Michigan Supreme Court has made it abundantly clear that purchasers take in the ordinary course of business under the UCC.

NOTES

1. 217 Mich App 119, 122, 550 NW2d 826 (1996),

rev'd 458 Mich 875, 586 NW2d 404 (1998). The author was counsel for NBD Bank (now known as Bank One, NA) in this case.

2. MCL 125.2301 et seq.
3. MCL 257.1 et seq.
4. MCL 125.2301, pmbl.
5. 458 Mich 875.
6. *See also* Epling, *Priorities Disputes in Motor Vehicles and in Other Certificated Goods,* 41 Bus Law 361 (1986).
7. *Brown v Yousif,* 445 Mich 222, 517 NW2d 727 (1994).
8. MCL 440.9320(1), .1201(9).
9. MCL 125.2330a(1).
10. 217 Mich App at 132.
11. *Id.* at 132–133.
12. *Id.* at 128–129.
13. Epling, *Priorities Disputes in Motor Vehicles and in Other Certificated Goods,* 41 Bus Law 361 (1986) (footnotes omitted).
14. 334 F2d 86, 88 (6th Cir 1964) (emphasis added).
15. 365 Mich 586, 594, 113 NW2d 906 (1962).
16. 318 Mich 348, 360–361, 28 NW2d 226 (1947).
17. 6 Mich App 82, 84, 148 NW2d 257 (1967).
18. 19 Mich App 177, 172 NW2d 537 (1969).
19. *Id.* at 181.
20. 45 Mich App 426, 206 NW2d 790 (1973).
21. *Id.* at 430.
22. *Id.* at 430–431.
23. 329 Mich 120, 44 NW2d 898 (1950).
24. *Id.* at 122–123.
25. 320 Mich 25, 32, 30 NW2d 418 (1948).
26. 356 Mich 574, 581–582, 97 NW2d 98 (1959).
27. 243 Mich 5, 8–9, 219 NW 719 (1928).
28. 168 Mich 386, 389, 134 NW 482 (1912).
29. *In re Richard Bros,* 206 F 932, 936 (D Mich 1913).
30. 352 Mich 546, 90 NW2d 504 (1958).
31. *Id.* at 546–549.
32. *Id.* at 553 (quoting 6 *Corbin on Contracts,* §1534 pp 1055–1058).
33. 352 Mich at 553.
36. 335 Mich 99, 101, 55 NW2d 746 (1952).
34. 110 Mich App 369, 372, 313 NW2d 288 (1981).
35. 148 Mich App 40, 44–47, 384 NW2d 400 (1985), *lv den* 425 Mich 865 (1986).
37. 140 BR 878 (Bankr WD Mich 1992).
38. *Id.* at 881.
39. 122 BR 506, 512 (Bankr WD Mich 1990).
40. *Boyd v Chase Manhattan Mortgage Corp (In re Kroskie),* 315 F3d 644, 648 (6th Cir 2003).
41. 226 Mich App 646, 574 NW2d 393 (1997).
42. *Id.* at 651–652.
43. *Frank v Kiesel (In re Denison),* 292 BR 150, 155–156 (ED Mich 2003).
44. *Dakmak v Conseco Bank, Inc (In re DeFazio),* Ch. 7 Case No 01-41640-G, Adv No 01-4448, Civ No 02-CV-74396-DT (ED Mich May 27, 2003) (order vacating bankruptcy decision).
45. MCL 125.2330c(6) (manufactured housing); MCL 257.235(1) (vehicles).
46. *Ford Credit Canada Leasing, Ltd v DePaul,* 247 Mich App 723, 637 NW2d 831 (2001).

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Compensating Executives of Nonprofit Corporations – New IRS Rules

By Walter A. Payne III

Introduction

The Internal Revenue Service (IRS) recently launched an enforcement program aimed at improving compliance with the intermediate sanction rules that penalize excess benefit transactions provided by tax-exempt organizations to their insiders. The primary focus of the program will involve the IRS contacting exempt organizations to obtain information regarding possible excess benefit transactions, which is expected to result in examinations. The program will include inquiries by the IRS about the practices of exempt organizations in setting compensation, how they are reporting these transactions in their tax returns, and similar inquiries; the program will also include educational efforts and possibly a voluntary compliance program.[1] Given this initiative, the issues associated with the compensation of executives of tax-exempt organizations may become more prominent than when the intermediate sanction rules were first enacted in 1996.

The intermediate sanction rules impose monetary penalties on both the nonprofit and the benefiting party where excessive compensation is provided to certain key persons. These penalties are in addition to the ultimate IRS sanction, loss of tax-exempt status. Underlying these provisions are complex rules that can create traps for the unwary and impose additional administrative burdens. However, the cost of not developing a plan to comply with the rules can be high. This article summarizes those rules and provides practical guidelines for developing a plan to avoid IRS sanctions in compensating nonprofit executives.

Overview

In 1996, due at least in part to the results of the IRS's increased audits of hospitals and universities and the discovery of many instances of insider benefit involving public charities, Congress enacted section 4958 of the Internal Revenue Code of 1986 (IRC), as amended. This provision basically extended rules similar to the private foundation self-dealing rules to public charities, such as hospitals, colleges and universities, foundations, and religious organizations.

IRC 4958 imposes on each excess benefit transaction a first-tier tax equal to 25 percent of the excess benefit amount, to be paid by the self-dealer, or "disqualified person," that benefits from the transaction. The 25 percent first-tier tax may be abated if the transaction is "corrected" and the taxable event was because of reasonable cause and not willful neglect.[2] Correction basically involves undoing the transaction to the extent possible, which often includes repayment of the excess benefit plus interest at the applicable federal rate.[3]

The initial tax increases to 200 percent of the excess benefit if the transaction is not corrected within the taxable period.[4] The taxable period begins on the date the transaction occurs and ends on the earlier of the date a statutory notice of deficiency is mailed or IRC 4958 taxes are assessed.[5] However, the 200 percent tax may be abated, in whole or in part, if the excess benefit transaction subsequently is corrected during a 90-day correction period.[6]

Similar to the private foundation self-dealing rules, IRC 4958(a)(2) also imposes on the "participation" of any "organization manager" in the excess benefit transaction, "knowing" that it is such a transaction, a tax of 10 percent of the excess benefit, limited to $10,000 per transaction. While there are numerous definitional aspects of this rule, the essence is that the organization manager (e.g., the director or officer) authorized, approved, or similarly participated in the excess benefit transaction.[7] Reliance on certain written opinions and undertaking specified procedures to invoke a presumption of reasonableness are methods of avoiding the excise tax imposed on managers.[8]

There is joint and several liability for

multiple participants and for multiple foundation managers.[9] Note that a person may be taxed twice if he or she both benefited from and approved the transaction.

An excess benefit transaction is defined as any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing the benefit.[10] In many cases, this determination will be made based on an evaluation of comparable compensation payments made by others.[11] Note that all "consideration and benefits," except specifically disregarded benefits (generally nontaxable fringe benefits and expense reimbursements made pursuant to an accountable plan), are taken into account in making this determination.[12]

The key issue that organizations will face under the intermediate sanction rules is whether the executive has received excessive compensation.

Guidelines for Avoiding Sanctions

In General

The key issue that organizations will face under the intermediate sanction rules is whether the executive has received excessive compensation. In most, but not all, cases this will be an issue of fact.[13] However, there are certain technical matters that, if not complied with, can result in unintended penalties. Moreover, there are certain steps that the organization and its insiders may take to reduce or eliminate the risks of incurring intermediate sanctions.

Given the nature of these rules and the penalties involved, it is advisable for an organization to develop an approach to addressing the intermediate sanction rules. The balance of this article provides a general structure and starting point for the development of such an approach. Given the complexity of the rules and their technical nature, however, certain details necessarily will have to be provided for particular organizations, transactions, and circumstances.

Determine Whether the Intermediate Sanction Rules Apply to the Organization

In general, the intermediate sanction rules apply to IRC 501(c)(3) and 501(c)(4) organizations but not to private foundations.[14] In addition, governmental units are not subject to the intermediate sanction rules if they are exempt from taxation other than under IRC 501(a) or are relieved from filing a tax return in certain cases.[15] Thus, the intermediate sanction rules will apply to most public charities other than governmental units.

Identify the "At-Risk" Executives

As noted above, the intermediate sanction rules apply only to transactions with disqualified persons. A disqualified person, regarding any transaction, is (1) any person who was in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization at any time during a five-year period ending on the date of the transaction, (2) members of the family of such an individual, and (3) any 35 percent controlled entity (of such persons).[16]

Whether a person has substantial influence is generally determined by all the facts and circumstances.[17] However, there are certain persons that are specifically included, including voting members of the governing body of the organization; presidents, chief executive officers, or chief operating officers; treasurers and chief financial officers; and persons with a material financial interest in a provider-sponsored organization.[18] Similarly, other persons are automatically excluded, including employees who receive total economic benefits from the organization in an amount less than the amount referenced for a highly compensated person under IRC 414(q)(1)(B)(i) (currently $90,000[19]) and who are not otherwise included for other reasons.[20]

The forgoing definitions generally encompass voting board members and the top operating and financial executives while excluding most executives receiving total economic benefits under $90,000. However, the more difficult set of persons to identify is those who exercise substantial influence under all the facts and circumstances, although the Treasury Regulations provide certain additional factors to be considered.[21]

Given the factual nature of the determination, it will often be difficult, particularly for large organizations, to identify all those who may be disqualified persons. Certainly those compensated primarily based on revenues, those with significant functional authority for financial matters (e.g., capital expenditures, operating budget, or compensation), and those with primary responsibility for key functions (e.g., department heads)

should be reviewed carefully.[22] Despite these practical difficulties, entities subject to the sanctions must attempt to identify the disqualified persons within their organizations.

Use the Rebuttable Presumption

An important shield under the intermediate sanction rules is the procedure that the organization may undertake to obtain a rebuttable presumption that the compensation paid is reasonable. The presumption applies for the benefit of both the disqualified person and the organization manager.[23] Invoking the presumption also shifts the burden of proof to the IRS to disprove that the compensation is reasonable.[24]

The presumption applies if the following three conditions are met: (1) the transaction is approved by an authorized body of the organization that is composed of individuals who do not have a conflict of interest concerning the transaction; (2) before making its determination, the authorized body obtained and relied on appropriate data for comparability;[25] and (3) the authorized body adequately documents the basis for its determination concurrently with making that determination.[26] The documentation should include (1) the terms of the approved transaction and the date it was approved, (2) the members of the authorized body who were present during debate on the transaction that was approved and those who voted on it, (3) the comparability data obtained and relied on by the authorized body and how the data was obtained, (4) any actions by a member of the authorized body having a conflict of interest, and (5) documentation of the basis for the determination within certain time limits.[27]

If an organization does not satisfy the requirements of the rebuttable presumption of reasonableness, a facts and circumstances test will be used based on established rules for determining the reasonableness of compensation and benefits for IRC 162 business expenses.[28] Accordingly, it would appear advantageous to meet the requirements of this presumption whenever possible where the size of the transaction justifies the burden of compliance.[29]

Avoid Automatic Excess Benefit Transactions

A trap for the unwary is the so-called automatic excess benefit transaction, which can lead to unintended penalties. In brief, the IRC provides that an economic benefit is not treated as consideration for the performance of services (and thus may be an excess benefit transaction) unless the organization clearly indicates its intent to so treat it.[30] The Treasury Regulations require that compensatory intent be established by "written substantiation that is contemporaneous with the transfer of the economic benefit at issue."[31]

There are several ways to establish this intention: One method is by reporting the benefit as compensation on federal tax returns regarding the payment (Form W-2 or Form 1099), the organization (Form 990), or the disqualified person (Form 1040).[32] Also, an organization may establish its intention by other written documentation, including an approved written employment contract, approval of the benefit as required in invoking the rebuttable presumption, or written evidence in existence before the filing of the return at issue that the organization had a reasonable belief that the benefit was a nontaxable benefit within the meaning of the Treasury Regulations.[33]

It should be noted that nontaxable benefits for this purpose include only those benefits specifically excluded from gross income under chapter 1 of subtitle A of the IRC (e.g., employer-provided health benefits and contributions to qualified plans) or from the operation of IRC 4958 (e.g., nontaxable fringe benefits and expense reimbursement payments made pursuant to an accountable plan).[34] Thus, any other economic benefit, *whether taxable or not*, must be included in a contract or approved as required above under the rebuttable presumption procedure or reported in a tax return to avoid automatic excess benefit transaction status.

One example of a benefit that is typically not reported as taxable income is a guarantee. The IRS has indicated that it considers guarantees as economic benefits that must be included as part of an employment contract or otherwise documented as compensation.[35] Similarly, the same concerns will exist for benefits that do not comply with the existing rules for excluding items from gross income, such as nonaccountable expense reimbursement plans and nontaxable fringe benefits under IRC 132. Accordingly, to avoid unintended penalties, all economic benefits to disqualified persons must be ascertained and either (1) reported in an appropriate tax return, (2) determined to be

A trap for the unwary is the so-called automatic excess benefit transaction, which can lead to unintended penalties.

properly excluded from the operation of the excess benefit transaction rules, or (3) otherwise documented in writing as being compensation to avoid automatic excess benefit transaction status.

Consider the Exception for Fixed Payments Made Pursuant to an Initial Contract

The Treasury Regulations contain a potentially useful exception to the intermediate sanctions rules for fixed payments made pursuant to an initial contract with the organization. That is, the Treasury Regulations provide that IRC 4958 does not apply to any "fixed payment" made to a person pursuant to an "initial contract."[36]

An "initial contract" is a binding written contract between the tax-exempt organization and a person who was not a disqualified person immediately before entering into the contract. A "fixed payment" is an amount of cash or other property specified in the contract, or determined by a fixed formula that is specified in the contract, that is to be paid or transferred in exchange for the provision of specified services or property. A "fixed formula" may, in general, incorporate an amount that depends on future specified events or contingencies, as long as no one has discretion when calculating the amount of a payment or deciding whether to make a payment (e.g., a bonus). A specified event or contingency may include the amount of revenues generated by one or more activities of the organization. In addition, payments made under qualified pension, profit sharing, or stock bonus plans, as well as employment benefit programs that satisfy the IRC's nondiscrimination rules, are generally treated as fixed payments.[37]

Given the IRS's compliance initiative regarding intermediate sanctions, these rules are likely to receive increasing attention.

While an initial contract is exempt from the intermediate sanction rules, it is not exempt from the traditional private inurement or private benefit rules. Moreover, it virtually eliminates the use of any discretionary payments. In addition, care must be exercised where an executive takes office with an exempt organization before the formal written employment contract has been signed. Nevertheless, this exception may be helpful in situations where compliance with the general rules is difficult, such as where comparable compensation data is not available or such amounts are exceeded.

File an Accurate and Complete Tax Return

The IRS has stated publicly in connection with its announcement of its excess benefit compliance initiative that a failure to file a tax return that complies with the reporting rules may result in questions from the IRS and possible subsequent examination.[38] Cited failures include not responding to the questions regarding whether the organization has engaged in an excess benefit transaction or marking the questions not applicable. Further, the IRS has stated that other reporting deficiencies, such as failures to answer questions regarding transactions with insiders, failure to explain those transactions where disclosed, failures to provide requested schedules to the return, and other similar reporting failures may lead to inquiries that may lead to examinations. Thus, filing a complete and accurate return may prevent further IRS inquiries.

Other Steps

In addition to the foregoing steps, other steps may be appropriate in particular circumstances. For example, educating key managers about the issues involved under the intermediate sanction rules may be helpful in identifying and preventing problems such as negotiating or providing employment arrangements that do not meet the rules. Also, those drafting, negotiating, and approving employment contracts should be familiar with the potential issues and the steps that can be taken to prevent them. Further, the organization may require that all contracts meeting certain criteria be subject to review for intermediate sanction compliance, including a procedure for approval. In addition, payments based on revenues should receive particular caution since the Treasury has yet to develop regulations in this area[39] and these contracts will typically be subject to scrutiny in an examination.

Conclusion

Given the IRS's compliance initiative regarding intermediate sanctions, these rules are likely to receive increasing attention and organizations may be subject to inquiries and possible examinations regarding their compliance with these rules. Given the nature of the rules and the potential penalties involved, nonprofit organizations should be advised to review their current compliance program with legal counsel specializing in this area and take steps to develop guidelines and procedures to ensure

that the organization is adequately protected from possible penalties.

NOTES

1. *E.g.*, Stokeld, *IRS to Begin Compliance Initiative on EO Excess Benefit Transactions*, 2004 TNT 53-3 (Mar 17, 2004).
2. IRC 4962. The IRS has also provided certain safe harbors for abatement of the first-tier tax, including correction within 30 days of discovery before the commencement of an IRS examination. Brauer & Henzke, Intermediate Sanctions (IRC 4958J Update), CPE for FY 2003, E-49.
3. IRC 4958(f)(6). *See generally* Treas Reg 53.4958-7.
4. IRC 4958(b).
5. IRC 4958(f)(5).
6. IRC 4961, 4963(e).
7. *See generally* Treas Reg 4958-1(d).
8. *Id*. The presumption of reasonableness is discussed in more detail below. See the text accompanying footnotes 23–29.
9. IRC 4958(d)
10. IRC 4958(c).
11. *See generally* Treas Reg 53.4958-4(b).
12. Treas Reg 53.4958-4(a)(1).
13. For this reason, it generally is not possible to secure a private letter ruling from the IRS regarding an excess benefit transaction where the issue turns on valuation or factual matters. However, a ruling on legal issues is generally available.
14. IRC 4958(e).
15. Treas Reg 53.4958-2.
16. IRC 4958(f)(1).
17. *See generally* Treas Reg 53.4958-3.
18. Treas Reg 53.4958-3(c).
19. *IRS Announces Pension Plan Limitations for 2004* (IR-2003-122), 2003 TNT 201-9 (Oct 16, 2003).
20. Treas Reg 53.4958-3(c)(3).
21. *See generally* Treas Reg 53.4958-3(e).
22. *Id*.
23. Treas Reg 53.4958-1(d)(4)(iv).
24. Treas Reg 53.4958-6(b).
25. This data may include published salary surveys, compensation reported by other organizations in their Form 990, compensation surveys compiled by independent firms, and similar information. Treas Reg 53.4958-6(c)(2). The IRS has warned that it will scrutinize reports prepared by the organization's regular accounting firm. Henzke, Remarks of Leonard J. Henzke Jr, *IRS Exempt Organizations Reviewer, Before the ALI-ABA Conference on Tax-Exempt Organizations*, 2004 TNT 25-25 (Feb 6, 2004).
26. Treas Reg 53.4958-6(a).
27. Treas Reg 53.4958-6(c)(3).
28. Treas Reg 53.4958-4(b)(1)(ii)(A).
29. Further, if the presumption is not available, the management may still be protected by a written opinion. *See* Treas Reg 53.4958-1(d)(4)(iii).
30. IRC 4958(c)(1)(A).
31. Treas Reg 53.4958-4(c)(1).
32. Treas Reg 53.4958-4(c)(3)(i)(A).
33. Treas Reg 53.4958-4(c)(3)(ii).
34. Treas Reg 53.4958-4(c)(2).
35. Henzke, 2004 TNT 25-25.
36. Treas Reg 53.4958-4(a)(3).
37. *Id*.
38. *See* n1.
39. Treas Reg 53.4958-5.

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The Doctrine of Culpa in Contrahendo *(Fault in Contractual Negotiations) and Its Applicability to International Transactions*

By Alexis J. Brink

Introduction

Culpa in contrahendo, or fault in contractual negotiation, is a legal term describing the imposition of liability on parties during negotiations. Some highly regulated jurisdictions, such as Germany and other European countries, embrace this doctrine. Therefore, international business executives and lawyers should be aware of its effect. This article analyzes *culpa in contrahendo* from the German Civil Code perspective. In addition, it compares the liability imposed because of *culpa in contrahendo* with U.S. precontractual liability, European Union conflict laws, and other international trade agreements such as the United Nations Convention on Contracts for the International Sale of Goods (CISG).

Legal philosophy

The term *culpa in contrahendo* implies a general good-faith obligation during precontractual negotiations. Conversely, the formalistic approach (also known as the aleatory view) restricts precontractual negotiations to offer, acceptance, and consideration, thus excluding the need for precontractual good-faith obligation. While most civil law countries, such as Germany, codify general good-faith standards,[1] most common-law countries, such as the United States, do not.[2]

Culpa in contrahendo, as opposed to the formal approach, may affect negotiating parties by creating contractual liability before a final agreement. Even under *culpa in contrahendo*, "[w]hile a promise made in the belief that it will not be taken seriously is still void, and a promise affected by unilateral mistake may still be voidable, the party injured by invalidity or disaffirmance of a contract will be entitled to recover his reliance interest" during negotiations.[3] *Culpa in contrahendo* breaks with the formal approach by offering a compromise solution before a final agreement.[4]

Culpa in contrahendo imposes precontractual liability where no formal agreement is found. "A party is liable for negligently creating the expectation that a contract would be forthcoming although he knows or should know that the expectation cannot be realized."[5] Furthermore, parties are necessarily bound to take precautionary measures protecting one another's person or property.[6]

> Of particular importance are the duties of disclosure imposed on negotiating parties in the interest of fair dealing and the security of transactions. Each party is bound to disclose such matters as are clearly of importance for the other party's decisions, provided the [other party] is unable to procure the information himself and the nondisclosing party is aware of the fact. . . . The [ignorant or unknowing party] is restored to the position he would have occupied had there been no violation of the duty of disclosure. The expectation interest can only be recovered if it can be shown that without *culpa in contrahendo* the contract would have been concluded on the terms anticipated by the innocent party.[7]

The aleatory view of contracts is unlike *culpa in contrahendo*. *Culpa in contrahendo* focuses on precontractual good faith. The

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aleatory view focuses on contractual form. According to Farnsworth, under the aleatory view "a party . . . enter[ing] negotiations in the hope of gain . . . result[ing] from ultimate agreement bears the risk of whatever loss results if the other party breaks off the negotiations. . . . All is hazarded on a successful outcome . . . ; all is lost on failure."[8] Goderre continues, "no protection against damages resulting from broken-off negotiations is afforded to a party who has entered into negotiations with the hope of achieving the gain that would result from ultimate agreement."[9] In other words, formalism "permits negotiating parties to deal with one another at arm's length."[10]

As a general rule, common-law countries embrace the aleatory view and reject *culpa in contrahendo*, or vice versa. The basic philosophical differences between the two approaches create debate on the international level. Civil-law countries support explicit precontractual good-faith standards, and common-law countries adamantly oppose their codification. Civil-law countries support universal adherence to *culpa in contrahendo*, noting the presence of good-faith standards in current international treaties and the need to establish internationally unified case law.[11] Common-law countries point out the subjective nature of the good-faith standard creating the possibility of multiple interpretations. Common-law advocates also note that good-faith standards are necessarily implied in the law of contracts, and uniformity through codification is impossible where remedies are left to national law.[12]

Many international treaties fail to mention *culpa in contrahendo* and thereby avoid the philosophical differences. One example is the CISG.[13] The CISG merely notes an internationally recognized trade good-faith standard.[14] The treaty does not explicitly codify *culpa in contrahendo*. Another example is the European Union, whose Court of Justice bypasses the debate by deferring to national and conflict law where possible.

German Contract Law

Freedom of contract underlies German contract law, which affects basic contract formation and the precontractual rights and duties of negotiating parties. According to Article 2, paragraph 1 of the Constitution of the Federal Republic of Germany, the Basic Law (Grundgesetz/GG), freedom of contract is a twofold concept limited by statute and case law.[15] The first is freedom to conclude a contract.[16] The second is freedom to determine the substance of the contract.[17] Both concepts presuppose unequal bargaining power. Consequently, freedom to contract enables the weaker party to compel another to contract. Ultimately then, negotiation is a mere byproduct.

German courts liberally interpret contract and precontractual language using evidence that in the United States would be omitted under the parol evidence rule. Therefore, a contracting party may be subjected to liability where it is otherwise protected by the four corners of the document.

German jurists examine the totality of the circumstances.[18]

> German jurists look to give effect to the purpose of the instruments and not . . . a literal interpretation to the language used . . . . German courts favor the so-called teleological method of interpretation: rather than restricting themselves to a literal interpretation of the wording of a provision, they tend to consider the purpose of the [instrument] and to interpret it in the way best suited to meet that purpose . . . .[19]

Therefore, a contractual declaration can literally say one thing but, in light of the economic or actual circumstances, have an entirely different meaning. Formalism is thus secondary to the realist interpretation.[20]

German courts use explanatory or supplemental interpretation to interpret not only contractual duties but precontractual duties as well. Under explanatory interpretation, the court searches for the "actual (real) intent of the parties and the objective meaning of the parties' declarations."[21] Under supplementary interpretation the court seeks to "resolve questions about whether certain conduct of the parties is to be understood as of contractual quality and about what content such conduct, certain declarations of intent and the contract itself have."[22] The courts fill the gaps in an agreement.

Finally, the German civil code explicitly imposes tort-like liability on contractual relations. "[T]he German civil code directly imposes a general good faith and fairness standard into its contractual relations as

The term culpa in contrahendo *implies a general good-faith obligation during precontractual negotiations.*

opposed to a general fault concept found in tort claims in the United States."[23] For example, the German legal system imposes a good-faith obligation on all precontractual negotiations *culpa in contrahendo.*

German Precontractual Liability: Culpa in Contrahendo

Culpa in contrahendo means "fault in contractual negotiations."[24] *Culpa in contrahendo* imposes a precontractual good-faith duty during negotiations.[25] The duty is not a primary obligation but a duty of mutual consideration, care, and loyalty.[26]

Culpa in contrahendo presumes good faith where one party creates reliance in another through implied readiness to negotiate and conclude a contract.[27] However, the mere entering of negotiations does not create liability, nor does the cutting off of negotiations.[28] Rather, breach results when one party awakes confidence in an imminent "coming into existence" of a contract coupled with incurred expenses.[29] In other words, a party may not refuse to contract without appropriate grounds after a party has created reliance, the relying party justifiably counts on the contract, and the negotiated content comes into existence.[30] An occasion of breach results in reliance damages.[31]

While most civil law countries, such as Germany, codify general good-faith standards, most common-law countries, such as the United States, do not.

Four different situations may result in breach because of a violation of *culpa in contrahendo* between the original parties. The first is a breach in reliance on the ultimate conclusion of a contract. *Culpa in contrahendo* permits remedies where the breaking off of negotiations has intentionally or negligently caused the other party to rely on the contract's ultimate conclusion.[32] For example, a nonformal substantive agreement could lead a party to believe that the contract is certain, with the ultimate conclusion viewed as a mere formality.[33] Such a belief would lead to a breach. The second situation is a breach for the unreasonable closure of negotiations. Liability may arise where there is no fault present but where the party breaking off negotiations had no sound reason to do so.[34] The third situation is a breach for failure to disclose, warn, or inform a party during the negotiation period. Primarily, a party must disclose objective, contractual details that go to the essence of the other party's decision.[35] *Culpa in contrahendo* may invalidate a valid contract where during negotiations a party fails to do so.[36] Note too that a duty to disclose and inform is broad and expanding. The fourth situation is a breach for negligent disregard for the safety of another's person or property.[37]

Third-party assistants of the original party may incur liability for their role in violating *culpa in contrahendo.* A third party assisting the original party will be held liable when the third party has a personal interest in the contract or where he or she takes advantage of special confidences that result in damages to the injured party.[38] Under such circumstances the third party incurs liability for negligence and willful conduct.[39] Examples of third-party liability are investment partnership promoters, investment brokers, or parent companies negotiating for their subsidiaries.[40]

A number of general consequences result when a party breaches its duty under *culpa in contrahendo*. Section 249 of the German Commercial Code (BGB) states that a "party at fault is liable for damages."[41] Performance interest damages are available where contract conclusion would have happened except for the misconduct.[42] Recent decisions permit adjusting the contract itself where the misconduct resulted in contractual formation on unfavorable terms.[43] Finally, courts permit cancellation of a concluded contract where the breaching party displays disloyal conduct.[44]

U.S. Precontractual Liability: Unjust Enrichment, Misrepresentation, and Specific Promises

U.S. courts acknowledge three types of precontractual liability during negotiation: (1) unjust enrichment, (2) misrepresentation, and (3) specific promises.[45] U.S. courts do not acknowledge a general precontractual good-faith obligation.[46] In other words, the United States does not acknowledge *culpa in contrahendo.* Accordingly, a party may break off negotiations even when success is likely.[47]

Unjust Enrichment. Under unjust enrichment, "a negotiating party may not with impunity unjustly appropriate benefits to its own use."[48] The benefit received can be characterized in one of two ways: (1) the "enhancement of the breaching party's property" or (2) "the reasonable value of the serv-

ices the breaching party received."[49] A "party in the wrong is required to disgorge the benefit it has received, putting [the other] party back in the position in which it would have been had there been no wrong."[50] In other words, recovery is measured by restitution.[51] Note that the injured party must prove that its services resulted in an actual benefit to the breaching party.[52]

Unjust enrichment claims are brought when misappropriation occurs.[53] A claim arises when ideas are disclosed or services rendered during negotiation.[54] The claim usually revolves around a misappropriation of the idea or, in limited circumstances, of the services rendered. An example of misappropriation that could occur is where an owner of a business discloses an idea in confidence to a potential buyer for appraisal purposes, the negotiations fall through, and the potential buyer proceeds to capitalize on the revealed confidences. The buyer may be liable for misappropriation, and the seller may receive restitution damages.[55]

Misrepresentation. Under misrepresentation, "a negotiating party may not with impunity fraudulently misrepresent its intention to come to terms."[56] Fraud is proved by showing that a promise was made without care or concern for whether the promise would be kept.[57] To recover costs the injured party must prove the breaching party's "state of mind," and to recover for lost opportunity the injured party must show substantial loss.[58]

Claims usually arise because of one party's mistaken belief about facts surrounding the agreement. "[I]n [the] absence of explicit representation, a party entering negotiations without serious intention to reach agreement" may be found liable;[59] for example, where a party continues with negotiations without the intent to negotiate in good faith, the breaching party may be held liable.[60] In addition, it seems that in spite of failed negotiations, a party may have a claim where the breaching party failed to disclose information that on discovery would have caused failed negotiations.[61] However, courts rarely apply the law of misrepresentation to failed negotiations.[62]

Specific promises. A specific promise occurs when "one party makes [a specific promise] to the other party in order to interest the other party [to negotiate]."[63] "[A] negotiating party may not with impunity break a promise made during negotiations if the other party has relied upon it."[64] In other words, specific promises create conduct, a breach of which is similar to promissory estoppel. The reason courts allow recovery is that "the promise necessary to sustain a cause of action for promissory estoppel 'does not have to embrace all essential details of a proposed transaction . . . so as to be the equivalent of an offer.'"[65] Therefore, in equity, the courts protect reliance. Accordingly, the injured party may recover costs incurred and lost opportunity damages. The burden of proof is always on the injured party to show loss.[66]

International Law and Transnational Law

Transactions between the United States and Germany occur across borders, thereby invoking international and transnational law. Therefore, lawyers, businessmen, and commercial parties should be aware of the effect of these laws on applying *culpa in contrahendo.*

There are three sources of potentially applicable international law: the CISG, UNIDROIT, and the European Principles.[67] The CISG is the default law for most international sale of goods transactions unless the parties expressly agree otherwise.[68] The UNIDROIT Principles and European Principles[69] carry weight in the European Union and are generally referred to as soft law having no express grounds of jurisdiction.[70] "All three documents are optional in application, but the parties are free to make any of the documents the law of their contract through an expressed choice of law clause."[71]

The CISG[72] contains no precontractual good-faith provision. Rather, the CISG calls for general good faith in international trade.[73] Explicitly, the CISG directs signatories to national good-faith standards according to contractually agreed-on terms.[74] Therefore, depending on a contract's conflict of law provision, either *culpa in contrahendo* or U.S. precontractual law will apply.[75]

Under the CISG, parties may form an implied contract through oral agreement.[76] This permits evidentiary flexibility when proving precontractual liability by allowing parties to apply national substantive law. Assuming German substantive law applies,

Culpa in contrahendo *imposes a precontractual good-faith duty . . . of mutual consideration, care, and loyalty.*

proving precontractual liability is made easier because the German civil code does not apply the parol evidence rule.

The CISG recognizes custom and usage in determining contractual rights and duties. Under the CISG, "[t]he enforceability of a commercial instrument or letter will be affected by the general customs of international business transactions, the usage of a particular business or trade, and the usage of the locality in which it is to be performed."[77] Consequently, assuming that German substantive law applies and that under the CISG,[78] "[p]rior dealings between the parties [are] used to bolster the enforceability claim of the receiver of a promise or of a business letter,"[79] a party may be found liable under *culpa in contrahendo.*

[C]ourts rarely apply the law of misrepresentation to failed negotiations.

The CISG also recognizes the use of business and professional standards to determine contractual rights and duties. Consequently, "particular groups of business persons and professionals have developed guidelines for the contents of their business instruments. . . . The development of business and professional standards provide added sources to assist a plaintiff in reaching the evidentiary threshold."[80] Assuming German substantive law applies, these standards, without the parol evidence rule, make it easier to find precontractual liability.

The Court of Justice of the European Communities is a binding court of the European Union that applies *culpa in contrahendo* if it is a part of a member state's substantive law. The court has held that *culpa in contrahendo* does not pose a threat to international or transnational contractual relations. The Court of Justice categorizes *culpa in contrahendo* as a rule of the trade of which contracting parties should be aware.[81]

Conflict of Laws

Germany is a signatory to the Brussels Convention and therefore subject to the Court of Justice of the European Communities. As a general rule the Court of Justice reserves for itself only those legal issues affecting the economic stability of the European Union as a whole. In other words, the Court of Justice applies the substantive law of a contracting state unless explicitly stated otherwise.[82]

The Court of Justice conflict law is fairly straightforward. In the commercial context, the place of performance of the contract determines the applicable law. Where parties designate more than one place of performance, the Court applies the substantive law of the place having the closest connection to the dispute. In the consumer context, a consumer plaintiff may bring suit in the jurisdiction of the state in which the plaintiff is domiciled, which in turn determines the applicable conflict law. In other words, if the consumer plaintiff is not domiciled in an EU member state and brings suit where he or she is domiciled, the Court of Justice defers to the conflict law of the jurisdiction where the suit is brought.[83]

Under the German civil code, the law governing a contract determines a breach of that contract.[84] C*ulpa in contrahendo* applies depending on the law of the prospective contract or where the parties entered the contract. Some jurisdictions also apply the *lex loci delicti,*[85] which may affect certain precontractual liability.

Preliminary Agreements

A preliminary agreement is "any agreement, whether or not legally enforceable, that is made during negotiations in anticipation of some later agreement."[86] Many types of preliminary agreements exist, such as a letter of intent, commitment letters, binders, agreements in principle, memoranda of understanding, and heads of agreement.[87] Preliminary agreements are used to establish predictability in spite of the doctrine of *culpa in contrahendo*.[88]

Preliminary agreements can be categorized in two analytical classifications: (1) agreements with open terms and (2) agreements to negotiate.[89] These two classifications "alter the regime under which the parties negotiate by imposing regimes intermediate between those of negotiation and ultimate agreement."[90] In other words, preliminary agreements formalize negotiations, creating predictability within the contacting process.[91]

Two other types of preliminary agreements exist. The legal implications of these agreements are straightforward. The first is an agreement to engage in a transaction, which is a "commitment by one or both parties to do something . . . in the future," e.g., buy, sell, lend, or leave no terms to be negotiated.[92] The agreement binds parties but delays fees associated with the agreement—

in essence the agreement is ultimate. The second is a stop gap agreement, which is a "temporary expedient to govern the parties' relationship during further negotiations"; for example "while . . . negotiating a[n] . . . acquisition, [a party] may agree [to] conduct its business in the ordinary course and use its best efforts to preserve its value."[93] Here the agreement is ultimate but postponed.

In spite of a preliminary agreement, the German courts have latitude in applying *culpa in contrahendo*. This is based on the assumption that policy considerations may outweigh the party's freedom to contract.

Conclusion

Culpa in contrahendo provides good-faith standards during negotiations. Therefore, German courts, unlike U.S. courts, are more likely to find a contract, supply missing terms, or rule breach of contract under *culpa in contrahendo*. Ultimately then, international businessmen and lawyers should be aware of its effect.

Preliminary agreements are used to establish predictability in spite of the doctrine of culpa in contrahendo.

NOTES

1. The universality of good faith in contract formation and performance is evident when reviewing the legal regimes of planned or socialist economies. [This was the case with Germany after the fall of the Nazi regime.] Private contract law is generally not associated with countries characterized by state ownership of property and planned economies prior to the fall of communism in the former Soviet Union and Eastern Europe. At that time, contracts of sale, however, were used to facilitate transactions between state-owned agencies. Implicit in the notion of such contractual interchange was the duty to cooperate in concluding contracts and 'perform their obligations with due care.' These duties to cooperate and to act in good faith were required because all agencies were obligated to work toward goals stated in national economic plans. [This was also the case with Germany after the fall of the Nazi regime, and is also true of the European Union.] Thus, failure to act in good faith was viewed as not only harming the other contracting party but the state itself. Failure to perform or providing defective goods resulted in the assessment of penalties not necessarily related to actual damages.

Larry A. DiMatteo, *An International Contract Law Formula: The Informality of International Business Transactions Plus the Internationalization of Contract Law Equals Unexpected Contractual Liability*; 23 Syracuse J Intl L & Com 67, 86–87 (1997) (hereinafter *DiMatteo International Contract Law*).

2. Some believe the U.S. courts have not pushed to impose such obligations because a society that accepts the aleatory view cannot "create an open market," so to speak, if it has an interest in the outcome of negotiations. E. Allan Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 Colum L Rev 217, 242, (Mar 1987) (hereinafter *Farnsworth Precontractual Liability*). In other words, in a capitalist society active participants see themselves as individual contractors, motivated by the free exchange of ideas and association, and not as collective bargainers. The active participants thus view particular contracts as "private" and not a public issue. "There is no reason to believe that imposition of a general obligation of fair dealing would improve the regime under which such negotiations take place." *Id.* at 242. Freedom, creative problem solving, and risk necessary to push a thriving market would be stifled and burdened by those who, for whatever reason, should not be in the market or their specific trade industry in the first place. Note also that other areas of the law such as warranty, fraud, and consumer protection protect the ultimate consumer without imposing a general obligation of fair dealing on those who enter transactions with heightened expertise.

However, it does seem that the United States courts have not resolved at what point in negotiations the duty of fair dealing arises. Many scholars believe that the question creates unnecessary uncertainty, pointing out that precontractual liability regarding negotiations may discourage parties from entering negotiations and may put pressure on parties to come to a hasty conclusion. *Id.* at 243.

3. Friedrich Kessler and Edith Fine, *Culpa in Contrahendo, Bargaining in Good Faith, and Freedom of Contract: A Comparative Study*, 77 Harv L Rev 401, 403 (1964) (hereinafter *Kessler Culpa in Contrahendo*).

4. *Id.* at 403.

5. *Id.* at 404.

6. *Id.*

7. *Id.* at 404–405.

8. *Farnsworth Precontractual Liability*, *supra* note 2, at 221.

9. Diane Madeline Goderre, *Tenth Annual Corporate Law Symposium: Intellectual Property Law for the Twenty-First Century: Comment: International Negotiations Gone Sour: Precontractual Liability Under the United Nations Sales Convention*, 66 U Cin L Rev 257, 268 (Fall 1997) (hereinafter *Goderre International Negotiations*).

10. *Kessler Culpa in Contrahendo*, *supra* note 1, at 407.

11. *Goderre International Negotiations*, *supra* note 2, at 262.

12. *Id.*

13. This treaty applies to a number of international commercial transactions. Amongst its signatories, the CISG is one of the most important commercial documents used in international commercial trade.

14. *Id.*

15. 2 Matthew Bender & Co, Inc., *Part II General Private and Commercial Law* §10.01(1)(d)(2) (2002) (hereinafter *Bender Contracts*).

16. Freedom to conclude a contract is limited to cases "where, due to a monopoly- or quasi-monopoly-position of one party, there is no guarantee of general access to such party's products or services." *Bender Contracts*, *supra* note 15, at §10.01(1)(d)(2)(a). A party under these circumstances has the right to compulsory contracting. Compulsory contracting may take form, for example, through a "mandatory conclusion of a contract upon unilateral request by one party." *Id.*

17. Freedom to determine the substance of the contract accounts for three distinct considerations. First, freedom to determine the substance of a contract is limited to cases where the "public interest is at stake," therefore, the "law restricts the freedom of contract to certain types of contracts with a more or less standardized form;" for example, family, inheritance, property, and corporate contracts. *Id.* at §10.01(1)(d)(2)(b). Second, freedom to determine the substance of the contract is limited to cases "where the bargaining position of the parties tend to be extremely unequal." Where the bargaining positions tend to be extremely unequal the law provides parties with either (1) mandatory rules that parties cannot amend or

exclude and thus necessarily determine the parties' rights and obligations under contract or (2) general procedures a court uses to verify the general reasonableness of the terms of the contract. *Id.*; *see* The Standard Contracts Act of 1976 (the English translation of the German document entitled (Gesetz uber die allgemeinen Geschaftsbedingungen). Third, freedom to determine the substance of the contract notes section 138, paragraph 1 BGB by testing the validity of a contract, stating that "[a] legal transaction which is against public morals is void." *Id.*

Before classifying the types of German contract law, it is wise to note that German contract law only applies fully to private law contracts. *Id.* at §10.01(1)(d)(3). In addition, just because one party is a public entity does not make the contract public in and of itself. *Id.* at §10.01(1)(d)(3).

As a precaution, lawyers should be aware that private law contracts relating to family or inheritance law vary somewhat from regular contract rules. *Id.* at §10.01(1)(d)(2)(b). In addition, private law contracts in which parties "do not intend to create obligations but to transfer, release, encumber or alter existing rights" vary slightly from regular contract rules. *Id.* at §10.01(3). Regarding an obligation contract, the contract "contains within itself the legal basis for the rights and duties generated by the agreement." *Id.* Regarding a disposition contract, the "transfer or encumbrance is effective even though the underlying obligation . . . is invalid." *Id.* In other words, the "transfer or disposition may be reclaimed by application of the doctrines governing unjust enrichment." *Id.*; *see* Medicus, *National Reports*, 1 International Encyclopedia of Comparative Law F-9.

German law also recognizes unilateral contracts such as gifts or guarantees, perfectly bilateral contracts such as mutual contracts, and imperfectly bilateral contracts such as gratuitous loan of a chattel or a mandate. *Bender Contracts*, *supra* note 15, at §10.01(1)(d)(2)(b).

18. *DiMatteo International Contract Law*, *supra* note 1, at 73.

19. *Id.* at 70–71; *see* footnote 14, Christophe von Teichman and Dennis Campbell ed., *Germany, Federal Republic,* 1 Legal Aspects of Doing Business in Western Europe 206 (1983).

20. Specifically, section 133 BGB states that "[i]n interpreting a declaration of intent the real intention is to be sought without adhering to the literal meaning of the expression." *Bender Contracts*, *supra* note 15, at §10.01(1)(d)(4). And section 157 BGB states, "[c]ontracts shall be interpreted in accordance with good faith taking into account common usage." *Id.* Further, "Article 133 of the German civil code states that 'in interpreting a declaration of intention the true intention shall be sought without regard to the declaration's literal meaning." *DiMatteo International Contract Law*, *supra* note 1, at 71; *see* Naglar Nassar, *Sanctity of Contracts Revisited: A Study in the Theory and Practice of Long-Term International Commercial Transactions* 44 (1995) (citing German Civil Code Book I §133).

21. *Bender Contracts*, *supra* note 15, at §10.01(1)(d)(4)(a). The German courts use a three-part analysis to uncover an explanatory interpretation. First, they look to the literal wording of the contract. Note that the literal meaning lacks relevance compared to grammatical, logical, systematic, and historic context. *Id.* at §10.01(1)(d)(4)(a)(i). Second, the courts look to the surrounding circumstances, and only those circumstances of which the parties knew or should have been aware. *Id.* at §10.01(1)(d)(4)(a)(ii). Examples of surrounding circumstances include past performance on similar contracts between the parties, conduct of parties after the conclusion of the contract, and details about preliminary negotiations. (Note: there is no parol evidence rule in German contract law.) Finally, the courts look to good-faith standards and standards of common usage. Good faith requires a search for a construction that reflects the justified concerns of the parties and that is in accordance with honest business practices. *Id.* at §10.01(1)(d)(4)(a)(iii). "Common usage [consists of] usage actually in practice at the time of contracting by the group or business community to which the parties belong." *Id.* In addition to the three-part analysis, German law provides a special rule for standard contract terms. According to section 5 AGBG, "[d]oubts in construing standard business conditions are to be resolved against the party applying such conditions." *Id.* at §10.01(1)(d)(4)(a)(iv).

22. *Id.* at §10.01(1)(d)(4)(b). The courts will consider three aspects of a contract to which they will apply supplemental interpretations. First, the court considers contractual gaps. These gaps may be deliberately left to be resolved later or may arise after the contract is concluded or result from later legal or economic circumstances or the contract terms are no longer ascertainable. *Id.* at §10.01(1)(d)(4)(b)(i). The second consideration is whether to apply contract law or supplementary interpretation. If contract law provides a solution, the parties may not rely on supplementary interpretation; thus supplementary interpretation is allowed only when (1) application of codified law openly contradicts the express or implied terms or (2) codified law does not speak to the specific problem. *Id.* at §10.01(1)(d)(4)(b)(ii). The third consideration is whether the courts should fill the gap. Courts use the "hypothetical intent" doctrine: What would the parties have reasonably agreed to had the parties considered the gap? *Id.* at §10.01(1)(d)(4)(b)(iii). (Note: filling the gaps cannot "contradict the parties' intent," the "content of the contract," or "change or extend the subject of the contract or the rights and obligations of the parties." *Id.*

23. *Kessler Culpa in Contrahendo*, *supra* note 3, at 401–405.

24. *Farnsworth Precontractual Liability*, *supra* note 2, at 240 (citing Jhering; *Culpa in Contrahendo, oder Schadensersatz bei nichtigen oder nicht zur Perfektion gelangten Vertragen*, 4 Jahrbucher fur die Dogmatik des heutigen romischen und deutschen Privatrechts 1 (1861)).

25. *Bender Contracts*, *supra* note 15, at §10.04(6)(a).

26. *Id.* at §10.04(6)(b)(i).

27. *Id.*

28. *Farnsworth Precontractual Liability*, *supra* note 2, at 240.

29. *Id.* (*citing* Judgment of July 14, 1967, *Bundesgerichtshof, W Ger, Lindenmaier-Mohring, Nachschlagewerk des Bundesgerichtshofs*, BGB §276 (Fa) no23 (1968)).

30. *Id.* at 241 (citing Judgment of Feb 6, 1969, *Bundesgerichtshof, W Ge., Lindenmaier-Mohring, Nachschlagewerk des Bundesgerichtshofs*, BGB §276 (Fa) no28 (1969)). However, subsequent decisions have cast some doubt on this ruling.

31. *Farnsworth Precontractual Liability*, *supra* note 2, at 240.

32. *Bender Contracts*, *supra* note 15, at §10.04(6)(b)(iii).

33. *Id.* at §10.04(6)(b)(iii).

34. *Id.*

35. *Id.*

36. *Id.* at §10.04(6)(b)(ii).

37. *Id.* at §10.04(6)(b)(iii).

38. *Id.* at §10.04(6)(b)(i).

39. *Id.*

40. *Id.*

41. *Id.* at §10.04(6)(b)(ii).

42. *Id.*

43. *Id.*

44. *Id.*

45. *Farnsworth Precontractual Liability*, *supra* note 2, at 221.

46. *Id.* at 222.

47. By negative implication, the Uniform Commercial Code does not impose a duty of good faith and fair dealing to precontractual negotiations. *Id.* at 221; *see* UCC 1-203, 1-103, 2-721 (1978); Restatement (Second) of Contracts §205 and comment C (1981).

48. *Farnsworth Precontractual Liability, supra* note 2, at 229.
49. *Id*. at 223.
50. *Id*.
51. *Id*. at 229.
52. *Id*. at 223.
53. *Id*. at 231.
54. *Id*. at 229.
55. *Id*.
56. *Id*. at 233.
57. *Id*. at 234; *Markov v ABC Transfer & Storage Co*, 76 Wash 2d 388, 396, 457 P2d 535.
58. *Farnsworth Precontractual Liability, supra* note 2, at 226.
59. *Id*. at 234.
60. *Id*.
61. *Id*. at 235.
62. *Id*.
63. *Id*. at 236.
64. *Id*.
65. *Id*.
66. *Id*. at 226.
67. UNIDROIT is the international Institute for the Unification of Private Law. It is an independent intergovernmental organization whose purpose is "to study the needs and methods for modernizing, harmonizing, and co-ordinating private and in particular commercial laws as between States and groups of States." www.unidroit.org/english/presentation/main.htm (last checked Aug 10, 2004).

There are three main metaprinciples of universal contract law: (1) good faith, (2) fairness in exchange, and (3) the duty to inform. *DiMatteo International Contract Law, supra* note 1, at 83.

For further comparison of these three documents, see Larry A. DiMatteo, President and Fellows of Harvard College, *Contract Talk: Reviewing the Historical and Practical Significance of the Principles of European Contract Law*, 43 Harv Int'l LJ 569, 574–576 (2002) (hereinafter *DiMatteo Contract Talk*); *see id*. at 574 (figure 2 shows the comparison between the coverage of contract principles in the CISG versus UNIDROIT versus European Principles).

68. The CISG can be compared to the UCC.
69. The UNIDROIT Principles and European Principles are analogous to the U.S. model law and the Restatement of Contracts.
70. *DiMatteo Contract Talk, supra* note 68, at 572, 578.
71. *Id*. at 575. Most international treaties attempt to recognize the general principles of law found in all civilized societies. *DiMatteo International Contract Law, supra* note 1, at 82.

However, the treaties are often worded to embrace the substantive law of each contracting party simultaneously enforcing the agreed-on international rules.

72. Signatory states to the CISG, such as the United States and Germany, are subject to the *lex mercatoria* or international commercial law of the CISG. *Id.* at 78–82. The result is that "national stare decisis is . . . transplanted by an informal supranational stare decisis." *Id*. at 78–79. The more recognition given to the *lex mercatoria* the more universalized and formalized the principles and concepts become in both the civil and common-law systems. Both the United States and Germany are signatories to the CISG. For example, the European Union's Court of International Justice imposes the *lex mercatoria* on all signatories to the CISG. *Id.* at 82.

The CISG is the most unified international law, but "idiosyncrasies found in . . . national legal systems makes . . . foreign council . . . a necessity," *Id*. at 75, because the CISG does not cover every aspect of international trade and contacting. Regarding foreign contract law, something that may look meaningless to the U.S. businessman may have legal implications elsewhere, so it behooves one to investigate all communications for their legal consequences. For example, the German courts as well as the CISG embrace *nachfrist* notice, which "allows a buyer or seller to fix an additional time for performance beyond that which is specified in the contract." *Id.* at 77. "The buyer may give notice to the seller that she will accept delivery beyond the time prescribed. The buyer is then enjoined from taking legal action during the *nachfrist* period and must accept any proper tender of performance during that period." *Id.* If the seller seeks a *nachfrist* extension, then the buyer must give notice that he or she does not accept; failure to respond is an automatic grant of the seller's request. *Id.*

73. *Id*. at 83. Article 9(2) of the CISG implies a good-faith obligation through acceptable trade usage and ordinary custom. *Id*. at 84. In addition, Article 77 adopts the duty to mitigate, which is a counterpart to the duty of good faith. *Id.*
74. *Id*. at 84.

> Common and civil law jurisdictions recognize a principle of good faith requiring "fair dealing, affirmative disclosure of material facts and assistance to others in achieving the free benefit of contractual relationships." The good faith concept is in accordance with the code of fair play of everyday ethics, is written into the civil codes in almost all civil-law systems and is thoroughly established in Anglo-American equity. [Furthermore, it can be found as] an equitable element in the Jewish, Roman, English medieval, Muslim, English modern, Scottish, American, French, German, Swiss, Belgian, Dutch, Italian, ... Soviet, Polish, Swedish, Japanese, and Greek legal systems.

Id.

75. Under the German law, the BGB states that "[t]he German Commercial Code (BGB) voids any agreements or contractual terms that are considered . . . contrary to the public policy of good faith." *Id.* at 85. According to the German Law on General Business Conditions or AGB-Gesetz (AGBG), "as a general rule a contract provision is void if it 'works to the disadvantage of a party in a way irreconcilable with good faith.'" *Id.*

The AGBG also provides specific techniques for making a good-faith detection. First, any fundamental deviation from the "default rules of the BGB . . . may be considered to have been made in bad faith." *Id*. The consequence of a good-faith violation under this technique is *not* per se invalidity but *is* striking the violation. *Id.* Second, as a result of *culpa in contrahendo*, if the contract is not freely negotiated, then the courts will apply a literal and restrictive interpretation. *Id.* Third, the courts are free to consider parol evidence to detect a violation. *Id.* Finally, the BGB uses a "basis of the bargain" concept to excuse performance of a frustrated contract resulting in an equitable reformation or a rescission of contract. *Id*. In general, the courts will rewrite the contract to fit the parties' real intentions or, if that fails, void the contract. *Id.*

Under U.S. law, the Restatement (Second) of Contracts and the UCC establish a contract standard of good faith, not a precontractual standard of good faith. However, some expansive readings of the UCC impose a duty of good faith in negotiations, Nicola W. Palmieri, *Good Faith Disclosures Required During Precontractual Negotiations*, 24 Seton Hall L Rev 70 (1993); in the duty to cooperate, Jill Pride Anderson, Comment, *Lender Liability for Breach of the Obligation of Good Faith Performance*, 36 Emory LJ 917 (1987); in the duty to adjust from the express terms of the contract, 2 JL & Com 193 fn 102 (1982); and in the termination of contract relations, Robert A. Hillman, *An Analysis of the Cessation of Contractual Relations*, 68 Cornell L Rev 617 (1983).

76. *DiMatteo International Contract Law, supra* note 1, at 74–75; *see generally* Charles Knapp, *Reliance in the Revised Restatement: The Proliferation of Promissory Estoppel*, 81 Colum L Rev 52 (1981); *cf.* P. Pham, *The Waning of Promissory Estoppel*, 79 Cornell L Rev 1263

(1994). The CISG does not require a written document for a contract to be binding. *DiMatteo International Contract Law*, *supra* note 1, at 73.

77. *Id.* at 74. "[An] applicable usage of trade in the place where any part of [the] performance is to occur [as an aide] in interpreting the agreement." *Id.* at 109.

78. *Id.* at 75.

79. *Id.* at 73.

80. *Id.* at 75.

81. Case C-93/92, CMC Motorradcenter GmbH v Pelin Baskiciogullari, 1993 ECR I-5009, 1993 ECJ CELEX LEXIS 7377 (1993) (hereinafter *CMC I*). This case dealt with Article 30 of the Brussels Convention regarding competition and imports. The issue revolved around *culpa in contrahendo*, the duty of negotiating parties to provide information before the conclusion of a contract. Specifically, Article 30 of the ECC Treaty does not preclude a rule established in the courts of a member state from imposing an obligation to provide information before the conclusion of a contract. *See* Case C-93/92, CMC Motorradcenter GmbH v Pelin Baskiciogullari, 1993 ECR I-5009, 1993 ECJ CELEX LEXIS 7495 (1993).

Recapping the theory of *culpa in contrahendo*,

> From the beginning of negotiations for a contract there arises between the parties, according to that theory, a fiduciary relationship comparable to that of a contract. From that relationship of trust it follows that one party must take account of the interests of the other and must in particular inform him of circumstances known to the first party alone, which he knows to be of decisive importance for the other party in concluding the contract. A failure so to inform him is regarded as constituting a pre-contractual wrong (culpa in contrahendo). This duty . . . applies also in the case of a contract of purchase and sale . . . the crucial point with regard to the duty to provide information is that a given circumstance is clearly determinative for a party's decision as to whether or not to enter into a contract.

CMC I, at *6.

With the respect given Article 30, according to the rules of trade, "consistent case-law of the supreme court of a Member State with jurisdiction in civil matters has undoubtedly the character of 'rules' in a sphere such as contract law. . . . In relationships between traders, or between traders and individuals, such case-law does in fact constitute 'trading rules.'" *Id.* at *7. Therefore, the court held that a duty such as *culpa in contrahendo* does not "hinder intra-Community trade," and thus *culpa in contrahendo* standards are compatible with Article 30 of the ECC Treaty. *Id.* at *8.

82. According to the ECC Treaty, in reference to the subsidiary principle of Article 3, "in areas which do not fall within [Member States'] exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, *only if* and so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States.'" *DiMatteo Contract Talk*, *supra* note 68, at 580; Treaty of Amsterdam Amending the Treaty on European Union, the Treaties Establishing the European Communities, and Certain Related Acts, Oct 2, 1997, OJ (C 340) 3 (1997).

83. In Case C-318/93, *Brenner and Noller v Dean Witter Reynolds*, 1994 ECR I-4275, 1994 ECJ CELEX LEXIS 7295 (1994), a consumer contract case, the court reasoned that

> where a consumer enters into a contract with a party who is not domiciled in a Contracting State but has a branch, agency or other establishment in one of the Contracting States, that party shall, in disputes arising out of the operations of the branch, agency or establishment, be deemed to be domiciled in that State.

(Quoting Article 13 of Brussels Convention on Jurisdiction and the Enforcement of Judgments in Civil and Commercial Matters (Sept 27, 1968) (hereinafter the Brussels Convention). Article 13 of the Brussels Convention defines a consumer as one who proceeds "concerning a contract concluded by a person for a purpose which can be regarded as being *outside his trade or profession*." Article 13 applies to three different types of contracts:

> 1. a contract for the sale of goods on installment credit terms; or 2. a contract for a loan repayable by installments, or for any other form of credit, made to finance the sale of goods; or 3. any other contract for the supply of goods or a contract for the supply of services, and (a) in the State of the consumer's domicile the conclusion of the contract was preceded by a specific invitation addressed to him or by advertising; and (b) the consumer took in that State the steps necessary for the conclusion of the contract.

Id.

Further, Article 14 of the Brussels Convention states that "[a] consumer may bring proceedings against the other party to a contract either in the courts of the Contracting State in which that party is domiciled or in the courts of the Contracting State in which he is himself domiciled." The first paragraph of Article 4 of Brussels Convention states that "[i]f the defendant is not domiciled in a Contracting State, the jurisdiction of the courts of each contracting State shall, subject to the provisions of Article 16 [which lays down rules for exclusive jurisdiction], be determined by the law of that State." In its final decision, the court reasoned that, "subject to those cases of exclusive jurisdiction, the jurisdiction of courts in proceedings where the defendant is not domiciled in a Contracting State is governed not by the Brussels Convention but by the law of the Contracting State of the court in which proceedings are brought." Case C-318/93, *Brenner and Noller v Dean Witter Reynolds*, at *12.

For the most part, the law of the contracting state will take precedence, but only by virtue of the authority given the contracting state by the Economic Community (European Union).

Case C-89/91, *Shearson Lehmann Hutton, Inc v Trenhandgesellschaft etc.*, 1993 ECR I-139, 1993 ECJ CELEX LEXIS 7198 (1993), dealt with the issue of whether a company plaintiff that brings suit on behalf of a private individual may be regarded as a consumer within the meaning of the Brussels Convention and therefore benefit from the special rules laid down by the Convention. In this case, before applying Article 14, the court principally noted that except for the exception found in Article 14, courts are hostile to allowing the jurisdiction of the courts of the plaintiff's domicile. To recap, Article 14 provides for the courts of the contracting state in which the consumer is domiciled to have jurisdiction to hear and determine the '"proceedings against the other party to a contract." Further, Article 13 defines a consumer as a person acting "for a purpose which can be regarded as being outside his trade or profession" and provides that the various types of contracts listed in that article, and to which the provisions of Section 4 of Title II of the Convention apply, must have been concluded by the consumer. It thus follows from these provisions that the exception found in Article 14 "affects only a private final consumer, not engaged in trade or professional activities, who is bound by one of the contacts listed in Article 13 and who is a party to the action, in accordance with Article 14." The Brussels Convention protects the consumer only as much as he personally is the plaintiff or defendant in the proceeding.

According to German law, parties choose which body of law applies to the contract, and if the contract is silent on the issue, then general conflict rules apply. Note, however, that parties may not contract in a way that violates public policy.

84. *Bender Contracts*, *supra* note 15, at §10.04(6)(d).

85. *Id.*

86. *Farnsworth Precontractual Liability*, *supra* note 2, at 249 fn126 ("Strictly speaking, this includes an agreement to sign an ultimate agreement all terms of which have already been fixed. E.g., Morton v. Morton, [1942] 1 All. E.R. 273 (P.)")

87. *Farnsworth Precontractual Liability*, *supra* note 2, at 250.

88. Preliminary agreements are commonly used where the investment of one party becomes substantial to the entire deal and can not be spread over other deals and the parties can not escape negotiations by moving to ultimate agreement. *Id.* at 250. Preliminary agreements seek to avoid the issues of intent to be bound, unenforceability because of indefiniteness, authority of the negotiators, application of the statute of frauds, and interpretation of the language. Rarely do preliminary agreements address issues of offer and acceptance. *Id.*

89. *Id.*

90. *Id.*

91. Three elements make up an agreement with open terms. First, an agreement with open terms sets out most of the terms, and parties agree to be bound by the terms, but negotiating continues on the open terms, which are ultimately part of the entire agreement. *Id.* If the agreement with open terms is enforceable, a party breaches his obligation to negotiate if that party fails to agree upon the open terms. *Id.* If despite failure to agree on the open terms, and there is thus no ultimate agreement, parties are still bound to the original agreement and courts will supply the open terms. *Id.* An agreement with open terms is often used in mergers and acquisitions where a letter of intent is signed by the acquiring and target entities. *Id.*

Two elements make up an agreement to negotiate. An agreement to negotiate may "set out . . . substantive terms of the deal, but . . . the parties do not agree to be bound [by them]." *Id.* at 251. If the agreement is enforceable in spite of the agreement to not be bound by the open terms, the party may breach his or her obligation to negotiate for failure to agree on the open terms. *Id.* However, if the parties fail to agree on the open terms and no ultimate agreement is found, the parties are not bound to the original agreement. Therefore, and to exemplify the point, in mergers and acquisitions a letter of intent is only an agreement to negotiate—not to be bound as in an agreement with open terms. *Id.*

92. *Id.*

93. *Id.* at 252.

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Case Digests

*Prepared by Alayna L. Tolbert**

Taxation—"Incidental to Service" Test

In *Catalina Mktg Sales Corp v Department of Treasury*, Nos 121673, 121674, 2004 Mich LEXIS 969 (May 5, 2004), the petitioner, the developer of the Checkout Coupon program, submitted a check for $38,002 to the respondent to constitute full payment of its Michigan use tax liability for the specified tax audit period. The respondent, however, claimed that the petitioner owed $388,856 because the petitioner sold coupons to manufacturer-clients and these sales were taxable at retail. The petitioner maintained that it was selling services, not goods, and that the coupons were only one part of its "targeted marketing distribution" services.

The issue on appeal was whether the Michigan Tax Tribunal (MTT) and the court of appeals erred in holding that the petitioners' coupon program, which involved both the transfer of tangible personal property and the provision of services, constituted a sale at retail subject to sales tax. The supreme court adopted the "incidental to service" test for categorizing a business relationship that involves both the provision of services and the transfer of tangible personal property as either a service or a tangible property transaction. The court then remanded the case to the MTT for application of the "incidental to service" test.

Arbitration—Magnuson-Moss Warranty Act

In *Abela v GMC*, 677 NW2d 325 (Mich 2004), plaintiff purchased a 1999 Chevrolet truck from a General Motors (GM) dealership under defendant's employee purchase plan. As part of the plan, plaintiff was required to sign an agreement where any warranty dispute was to be settled by binding arbitration. The truck subsequently developed several problems, necessitating expensive repairs. Plaintiff sued defendant under the Magnuson-Moss Warranty–Federal Trade Commission Improvement Act (MMWA). However, defendant claimed that all parties had agreed to arbitration of any warranty dispute.

The court found that the text, legislative history, and purpose of the federal MMWA did not evidence a congressional intent under the Federal Arbitration Act to bar agreements for binding arbitration of claims covered by the MMWA. Thus, plaintiff's agreement with GM to address a warranty claim through GM's dispute resolution process, including mandatory arbitration, was enforceable.

Arbitration—Motor Vehicle Lease

In *Lexus Fin Servs, Inc v Trombly Tindall, PC*, No 243472, 2004 Mich App LEXIS 834 (Mar 30, 2004), defendant's law firm signed a lease for a motor vehicle that included an agreement to arbitrate. Defendant defaulted on the payments, and plaintiff repossessed the vehicle. When plaintiff sued to recover the payments, defendant personally counter-sued, alleging violations of his constitutional rights. Defendant then moved the court to send plaintiff's claims to arbitration pursuant to the lease but refused to arbitrate his counterclaims. When the trial court gave him the choice of having all of the claims either tried or arbitrated, defendant agreed to arbitration. Defendant also accepted the car in return for his firm placing in escrow overdue payments and future payments as they became due.

The issue before the appellate court was whether defendant must arbitrate his personal claims together with his firm's claims. Because the court did not find a binding arbitration agreement between the lessor and defendant, defendant's personal claims remained in the trial court while his firm's claims, as well as the lessor's, would be arbitrated.

Contracts—Fraud

In *Echelon Homes, LLC v Carter Lumber Co*, Nos 243112, 243180, 2004 Mich App LEXIS 832 (Mar 30, 2004), builder Echelon hired Carmella Wood as a secretary/bookkeeper/administrative assistant. It was later discovered that Wood had engaged in a scheme with several of her family members to embezzle from Echelon. The scheme included fraudulently obtaining credit accounts with several of Echelon's vendors, including respondent Carter, and then using those accounts for their own personal use. Echelon reported Wood's actions to the Michigan State Police and terminated her employment. In addition, Wood pled guilty to embezzlement and publishing a forged instrument.

Echelon subsequently sued Carter for aiding and abetting Wood in the conversion of its assets and committing fraud. Carter filed a counterclaim alleging that Echelon still owed for goods purchased on credit during Wood's tenure.

The court found that where an agent did not have the authority to act on the principal/builder's behalf in setting up a credit account, no binding agreement existed between the builder and a supplier. There could be no account stated because the builder never assented to the creation of the account. Therefore, Echelon was not liable for the outstanding balance, and the trial court did not err in denying Carter's motion for summary disposition. Moreover, Carter failed to show that Echelon had sufficient knowledge of the material facts for its actions to constitute an assent to Wood's conduct.

Contracts—Molder's Lien Statute

In *Gateplex Molded Prods, Inc v Collins & Aikman Plastics, Inc*, No 23945, 2004 Mich App LEXIS 617 (Feb 26, 2004),

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General Motors (GM) contracted with defendant to produce certain plastic parts for its automobiles. GM owned the molds and allowed defendant to possess, use, or assign the molds to third parties to produce the plastic parts. Defendant assigned the molds to Mexican Industries (Mexican) to do the production. Mexican then assigned the molds to plaintiff, a tier III subcontractor. Plaintiff produced the parts, but before plaintiff was paid in full by Mexican, Mexican filed for bankruptcy. Before filing for bankruptcy, Mexican was paid in full by defendant (a tier I subcontractor) for the plastic parts produced by plaintiff. As a result, plaintiff filed a molder's lien against defendant's assignee, Mexican, and refused to return the molds when asked to do so by defendant.

The court of appeals affirmed the trial court's rulings that plaintiff did not state a valid cause of action because it did not have a valid lien on the molds. Under MCL 445.618, the molds did not "belong to" the assignee that had declared bankruptcy, but instead belonged to the manufacturer, who both parties acknowledged was the owner of the molds. Further, plaintiff should immediately return the molds to defendant. The case was decided under the molder's lien statute prior to its 2002 amendments, but the court noted that these amendments would not have changed the outcome of the case.

Labor and Employment—Unemployment Tax Liability

In *Great Lakes Plumbing & Heating of N Michigan, Inc v WDLS, Inc*, No 240970, 2004 Mich App LEXIS 482 (Feb 17, 2004), Proctor's Heating and Air Conditioning entered into an exclusive listing agreement with defendant realty broker, granting defendant the right to sell the Proctors' listed property. The president and secretary of plaintiff corporation, the Musselmans, purchased the Proctors' listed property in their individual capacity. After the closing, the Musselmans leased the real property to the plaintiff corporation. The Michigan Employment Security Commission subsequently made a determination that the plaintiff was a successor to the Proctors' company and that the Musselmans' lease of the real property to plaintiff was a so-called "straw man" transaction. Therefore, plaintiff had acquired all of the Proctors' company assets. Plaintiff sued defendant realty corporation, alleging that it failed to disclose the existence of the unemployment tax liability as required by MCL 421.15(g).

The court held that, pursuant to MCL 421.15(g), defendant real estate broker was obligated to disclose the seller's outstanding unemployment tax liability to the buyer, plaintiff Great Lakes, but not to Great Lakes' president and secretary as individuals. The broker's duty to Great Lakes was triggered at the start of negotiations for the purchase of real property and business assets; it is irrelevant that the broker no longer acted as the seller's agent at the transaction's conclusion. The broker was not excused from the disclosure requirement merely because its representation of the seller was limited to the real estate, which constituted less than 75 percent of the ultimate transaction. The good-faith provision of MCL 421.15(g) applies to an agent who disclosed information in good faith, but does not protect the broker from liability for its good-faith misunderstanding of its statutory disclosure responsibilities. Because Great Lakes' president and secretary did not personally acquire "the organization, trade, business, or 75% or more of the assets from an employing unit," they had no remedy under MCL 421.15(g).

Contracts—Agency Agreements

In *Uniprop, Inc v Morganroth*, 260 Mich App 442 (2004), defendant attorney, Morganroth, represented his client, Yaker, in a legal proceeding. During those proceedings, plaintiff corporation asserted that Yaker owed a debt to it in the amount of $333,000. In lieu of taking other actions to secure its debt, plaintiff creditor entered into a contract in which Yaker assigned to plaintiff creditor part of the amount held under a writ of attachment in another lawsuit. Yaker thereby directed Morganroth to pay plaintiff creditor from the attached funds.

The court held that defendant law firm was not a party to an agreement between the firm's principal and plaintiff to pay plaintiff but that instead the firm agreed to act as the principal's agent for his promise to pay the debt from the proceeds of the lawsuit. Because the firm neither undertook nor owed a contractual duty to ensure plaintiff was paid, the court of appeals affirmed the trial court's grant of summary disposition for defendant law firm, holding that agency agreements do not create rights in third parties.

Trademarks—Anti–Cyber Squatting Consumer Protection Act

In *Lucas Nursery & Landscaping, Inc v Grosse*, 359 F3d 806 (6th Cir 2004), plaintiff nursery performed work on a swale in defendant Grosse's front yard. After allegedly contacting plaintiff on numerous occasions to express her displeasure with the work and to seek some repair, Grosse filed a complaint with the Better Business Bureau (BBB). After the BBB ended its investigation without making a recommendation, Grosse registered the domain name "lucasnursery.com" and posted a Web page for the sole purpose of relaying her displeasure with plaintiff to the public. The Web page was titled, "My Lucas Landscaping Experience," and included all of defendant's complaints about plaintiff's service. Plaintiff nursery subsequently sent defendant Grosse a letter demanding that she cease operating the Web site. Grosse removed the Web site's content. However, after learning that that no trademark registration existed for Lucas Nursery and Landscaping, defendant Grosse concluded that plaintiff could not prevent her from retaining the Web site.

The court held that, in order for liability to attach under the Anti–Cyber Squatting Consumer Protection Act (ACPA), defendant's action must constitute bad faith. This

bad-faith analysis begins with the consideration of several factors, nine of which are listed in the ACPA. Although defendant's actions would arguably satisfy several of the factors, she did not fall within the factor that the court considers central to the finding of bad faith: she did not register multiple Web sites. Further, it is not clear to the court that the presence of simply one factor that indicates bad-faith intent to profit, without more, can satisfy an imposition of liability within the meaning of the ACPA. Defendant's actions, which seem to have been undertaken in the spirit of informing fellow consumers about the practices of a landscaping company that she believed had performed inferior work on her yard, falls squarely on one of the ACPA's main objectives, which is the protection of consumers from slick internet peddlers who trade on the names and reputations of established brands. The court found that informing fellow consumers of one's experience with a particular service provider is not inconsistent with the ACPA's ideals.

Labor and Employment—Race, Age, and Disability Discrimination

In *DiCarlo v Potter,* 358 F3d 408 (6th Cir 2004), the 46-year-old plaintiff was hired as a part-time mail processor by the U.S. Postal Service. However, DiCarlo's employment was contingent upon passing a drug screening and a medical evaluation. As part of the medical evaluation, DiCarlo signed a document outlining the functional requirements of the job, which included walking for two hours, standing for eight hours, and repeated bending that required both legs. Even though DiCarlo suffered from a debilitating leg injury, he indicated that he had no medical condition throughout the evaluation. Near the end of his 90-day probationary period, DiCarlo was terminated for "unsatisfactory work performance." As a result, DiCarlo filed a discrimination complaint alleging race, age, and disability discrimination. He also alleged that his termination was retaliation for filing a complaint.

The court found that DiCarlo presented direct evidence of national origin discrimination because he showed that the supervisor who made the termination decision made derogatory age-related remarks and derogatory remarks about Italian-Americans. Thus, the evidence demonstrated a genuine issue of material fact about whether the supervisor terminated the employee based upon a predisposition to discriminate. The court also found that the temporal proximity between the employee's complaint and the discharge constituted indirect evidence of a causal connection to create an inference of retaliatory motive. However, given that DiCarlo did not establish a disability, the court affirmed the judgment on the disability discrimination claim.

Labor and Employment—Fair Labor Standards Act

In *Schaefer v Indiana Michigan Power Co,* 358 F3d 394 (6th Cir 2004), plaintiff sued defendant power company, doing business as American Electric Power (AEP), because of an overtime payment dispute. Plaintiff began his employment at AEP as a "radiation protection technician, junior," and, through promotion and company reorganization, subsequently held several other positions as well. Plaintiff most recently worked as a "qualified shipping specialist" under Department of Transportation regulations. Although plaintiff was paid a yearly salary, he worked in positions classified as exempt from Fair Labor Standards Act (FLSA) overtime requirements by AEP since 1988. Nonetheless, he received time-and-a-half overtime pay for hours in excess of 40 hours in a given workweek until 1997. Beginning in 1997, AEP began to pay only straight overtime under its exempt-overtime plan, and in 1999, the plan was changed so that overtime generally did not begin until after 45 hours were worked in a given workweek.

The court held that where the employer bears the burden of proving an exemption that is to be construed narrowly against the employer, AEP had not demonstrated that no reasonable trier of fact could find that plaintiff 's primary duty did not consist of work "directly related to management policies or general business operations of his employer" or that plaintiff did not exercise sufficient discretion and independent judgment to meet the exemption when the facts were viewed in the light most favorable to plaintiff. Issues of material fact persisted, and it must be left to a trier of fact to weigh the credibility of plaintiff's characterization of his day-to-day duties with that of AEP. The court reversed the decision of the district court granting summary judgment to AEP and remanded for further proceedings.

Insurance—Defense Obligations

In *Century Indemnity Co v Aero-Motive Co,* No 1:02-CV-108, 2003 US Dist LEXIS 24565 (WD Mich Dec 17, 2003) defendants William Becker and Roger Becker (the Beckers) owned and operated the Aero-Motive Company (Aero I) between 1960 and 1972. In 1972, Aero I sold its assets to Kalaco, Inc. Kalaco later changed its name to Aero-Motive Manufacturing Company (Aero II). Pursuant to the asset purchase agreement between Aero I and Aero II, Aero I assigned various contracts to Aero II, including various insurance policies issued by Century, Continental, and One Beacon. In the early 1990s, Aero II discovered contamination at the site of the Aero I manufacturing plant, which Aero II had operated since 1972. Subsequent investigation revealed that contamination had migrated from this property to an area one mile downgradient. As a result, Aero II was required to take remedial action in response to claims by the Michigan Department of Environmental Quality (MDEQ) and incurred costs to clean up the contamination.

In 1999, Aero II filed suit against the Beckers, alleging that they were liable to Aero II for cleanup costs (the Becker suit). The Beckers notified plaintiff insurers of the

lawsuit. The plaintiffs agreed to fund 40 percent of the Beckers' defense costs, subject to a reservation of rights. In 2001, Aero II filed suit against Aero I (the Aero I suit) for recovery of cleanup costs. Century agreed to fund all of Aero I's defense costs in that suit, subject to a reservation of rights.

The court held that plaintiff insurers had no duty to defend Aero II but that they did have a duty to defend the Beckers. The Beckers were entitled to recover defense costs incurred after the date of tender of the defense to Continental and One Beacon. Defense costs would be allocated among the insurers on a time-on-the-risk basis. The court also denied Aero's motion to dismiss Century's claim for recovery of excess defense costs. Finally, the court denied plaintiffs' Rule 56(f) motions.

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Saturday	5/21/05	8:30 a.m. – 5:30 p.m.
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