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

MISSION STATEMENT

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

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

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Business Law Section

August 2005

Dear Business Law Section Members:

It is with great pride that we share with you another issue of the *Michigan Business Law Journal*. This issue features informative articles written and solicited by the Business Law Section's Corporate Laws Committee, including: Proposed Amendments to the Michigan Business Corporation Act, Franchino v Franchino, Death of Minority Shareholder Suits in Michigan, What's Happening in Michigan Early Stage Venture Markets, Developments in Delaware Corporate Case Law, Choice of Entity, and Frequently Asked Questions About Traditional Business Factors. Our columns, Tax Matters, Did You Know and Technology Corner, provide substantive information regarding issues of interest to business law practitioners. We are grateful to our authors and our Section's Director of Publications, Robert Wilson, for their efforts in making the *Journal* a success.

The Section's Second Annual Scholarship Award was presented in May. This year's winner is Damien Weiss of the University of Michigan Law School. Damien captured the award with his article entitled Analyzing Disney in the Context of the Business Judgment Rule, which is published in this issue. The scholarship award will run again next year, and details will be posted at Michigan law schools and on the Section's website at the end of this year.

The Section's Annual Meeting is scheduled for September 15, 2005 at 5:00 p.m. at the Westin Hotel in Southfield. A cocktail and hors d'oeuvres reception will immediately follow the meeting. We hope you will take this opportunity to socialize with both old and new acquaintances and mingle with other Section members.

If you are a Section member but have not yet become involved in Section activities, we encourage you to contact any of the Section's officers to discuss how you can meaningfully participate. Thank you for your continued interest and support of the Business Law Section.

Sincerely,

David Foltyn
Chairperson, Business Law Section

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DID YOU KNOW? By G. Ann Baker

Finding the Proper Agency

Finding information and contact details for state agencies in Michigan and other jurisdictions can be frustrating. When an agency changes its name or merges with another agency, it can further complicate efforts to locate the appropriate agency.

Different jurisdictions locate services and programs in various agencies. For example, in Michigan, business entities file with the Corporation Division, Bureau of Commercial Services in the Department of Labor and Economic Growth, but in many other jurisdictions, business entities file with the secretary of state. Outside the United States, the filing offices have a variety of names. In the United Kingdom, it is Companies House; in Switzerland, the Federal Office of Justice; and in New Brunswick, Canada, the Service New Brunswick.

A new feature was recently added to the State of Michigan's Web site to make it easier to find state offices and information. On the right hand side of the opening page, near the top, are three buttons for State Departments, State Sponsored Sites, and Statewide Online Services. These three buttons, which also appear on the department, office, or agency pages of the state's Web site, allow you to more quickly locate the appropriate department, Web site, or online service. The information is presented alphabetically and organized by category. For example, under Business Entity Search (Statewide Online Services link), you can quickly find the location for filing online, looking up a business entity, or verifying a license. Under State Sponsored Sites, you can find the Michigan Timely Application and Permit Service, MiTaps, which provides a one-stop shop online for businesses to determine and obtain the permits needed to do business in Michigan, http://michigan.gov/mitaps. Businesses can find out what information and documentation is required for various permits, apply online, pay fees online, and track the progress of their application.

On July 27, 2005, Governor Jennifer Granholm announced the launch of a new Web site to encourage entrepreneurship. The Web site, "Be Your Own Boss," can be found at http//:www.michigan.gov/beyourownboss. The Web site makes it easier for prospective and current business owners to find good information for all stages of business development from a start-up to finding skilled workers and sources of financing. In addition, the Web site provides information about government regulations and licenses that may be required.

Some assistance available for locating the filing office in another jurisdiction may also help reduce frustration and save time. The International Association of Commercial Administrators (IACA) is an organization for the administrators of entity statutes and Uniform Commercial Code or personal property registries in the United States, Canada, and several other countries. IACA includes on its Web site, http://www.iaca.org, links to many jurisdictions and a directory of its member jurisdictions. There is also a link to IACA from the Bureau of Commercial Services, Corporation Division, Web site.

> *A new feature was recently added to the State of Michigan's Web site to make it easier to find state offices and information.*

On the IACA Web site, select Jurisdictions from the Members drop-down menu to view the list of links to Web sites of jurisdictions. Click on United States for links to some state Web sites, on International for links to some jurisdictions outside the United States, or just scroll down the page. Jurisdictions in the United States are listed first and international jurisdictions are at the bottom of the page.

When assistance is needed in another jurisdiction with filing entity documents or financing statements, it is helpful to know both the agency and the contact person's name. The IACA directory can help you locate the appropriate agency; contact person; and his or her phone number, fax number, or e-mail address. In addition to the 50 states and the District of Columbia, the directory includes Guam, Puerto Rico, and the Virgin Islands; The Navajo Nation; Canada–Federal Government; the Canadian provinces of Alberta, British Columbia, Manitoba, New Brunswick, Newfoundland and Labrador, Northwest Territories, Nova Scotia, Nunavut, Ontario, Prince Edward Island, Quebec, Saskatchewan, and Yukon Territory; and England, Scotland, and Wales.

To view the directory, on the drop-down menu for Documents, select 2005 IACA Directory or go to http://www.iaca.org/doc/2005_iaca_directory.pdf. Jurisdictions are listed in alphabetical order. Australia and New Zealand are not listed in the directory, but there is a link to the appropriate agencies under Members, Jurisdictions, and International. Bermuda and Spain do not appear on either list. The URL for the Spain Central Mercantile Register is http://www.rmc.es. The URL for the Bermuda Registrar of Companies is https://www.roc.gov.bm/roc/rocweb.nsf/roc?OpenFrameSet.

Several jurisdictions have online access to information and online filing service. To find out about the information and services available in each jurisdiction, you can visit the Web site of the specific jurisdiction. Information regarding the services in many jurisdictions, however, is also included in the Annual Report of Jurisdictions, which is posted on the IACA Web site. On the Documents drop-down menu, select Report of Jurisdictions. The most recent IACA

Report of Jurisdictions was compiled for the organization's meeting in Fredericton, New Brunswick, on May 22–26, 2005, and will be available on the Web site soon. The report is over 400 pages in length, but it is divided into United States and Canada, and the jurisdictions in each section are in alphabetical order, which allows you to easily page forward to the appropriate jurisdiction.

Utah and Hawaii, for example, have implemented one-stop registration services that allow businesses to register with multiple agencies at one location. In addition, they have links to the Internal Revenue Service that permit the business to obtain a federal employer identification number at the same time that it is registering with the state. New Brunswick has implemented a system that permits the agency to forward filed name changes to other agencies rather than requiring the business to notify multiple agencies when it changes its name. In British Columbia, the file number assigned when articles are filed becomes the last six digits of all other identification or licensing numbers assigned by other agencies in the province.

European Union (EU) countries are actively taking steps to attract new business. France has adopted a new entrepreneur law, reduced the number of steps in processing documents, and increased the number of new business filings. Poland has made dramatic improvements in its processes and has reduced turnaround time from 35 to 5 days. However, in exchange for limitations on personal liability, disclosure of financial information is required in the EU, and information about directors is frequently required. The costs vary within the EU. They may be low if the company is a one-person company and more if it is a publicly traded company. In some instances the fees are based on capital. As online filing is implemented, fees may be reduced.

European Commerce Register's Forum (ECRF) is similar to IACA for company registration offices in Europe, http://www.ecrforum.org. Information about the organization is included on its Web site at http://www.ecrforum.org/previous/aboutus.htm. In addition, information is available on the EU Web site, http://europa.eu.int/geninfo/info-en.htm. The EU Web site includes direct links to specific countries at http://europa.eu.int/youreurope/nav/en/ business/links/index.html. For example, the United Kingdom link has a direct link to Companies House, the corporation registrar. The EU Web site also includes a link to SOLVIT for assistance if obstacles are encountered within a member state (http://europa.eu.int/solvit/site/index_en.htm).

Countries in the Pacific are also moving to attract business and improve service by offering more services online. The Web site for the Philippines Securities and Exchange Commission (http://www.sec.gov.ph), includes links to a variety on online services. The Web site for the Hong Kong Companies Registry, http://www.info.gov.hk/cr/, includes contact phone numbers and provides for e-mail inquiries.

As various jurisdictions add or expand the information and services available online, the other jurisdictions will take steps to improve their services. With more and increasingly efficient technology, the ability to quickly locate information and file documents will continue to improve.

G. Ann Baker is an attorney with the Corporate Division of the Michigan Bureau of Commercial Services in Lansing. Ms. Baker is a member of the International Association of Commercial Administrators. She is a member of the State Bar of Michigan Committee on Libraries, Legal Research, and Legal Publications and is a past chairperson of the Business Law Section Council. She served as the director of the Office of Franchise and Agent Licensing from 1981 to 1984, administering the Michigan Franchise Investment Law and the broker, dealer, agent, and investment advisor portion of the Michigan Uniform Securities Act. She is a member of the Corporate Law Committee and the Unincorporated Enterprises Subcommittee on the LLC 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

Why Do These E-Mails and Letters Have a "You Cannot Depend on This" Tax Disclaimer?

Introduction

As attorneys, we are also licensed to practice before the Department of Treasury under Circular 230.[1] These rules govern practice before the Department of Treasury, including the Internal Revenue Service (IRS). As you are probably aware, there has been considerable activity under the guise of licensure to combat tax shelters. Unfortunately, the regulatory scope now encompasses the vast majority of written tax advice. Circular 230 is available online at www.irs.gov/pub/irs-pdf/pcirc230.pdf. There is also an excellent American Bar Association members only Web site, with model policies and a forum for questions, at www.abanet.org.

The Problem

How did this regulatory overkill arise? It is a response to the well-documented reprehensible behavior of America's largest tax shelter peddlers, including several of the nation's largest professional firms. In the tax-shelter travesties of recent years, brand-name promoters would cement the marketing effort by seeing that a recognized firm would give an opinion letter. The promoters intended the six-figure opinion letters to reassure taxpayers that the transactions represented "legal loopholes" that were legitimate and were bullet-proof from IRS penalties. That second characterization was a gross overstatement of the law. However, a taxpayer's reasonable reliance on professional advice may act as a shield to the 40 percent penalties that are commonly asserted by the IRS under IRC 6662. To combat that widespread abuse, Treasury proposed sweeping amendments to govern the regulation of written tax advice that have a scope of coverage many times broader than the intended target of tax shelters. However, last year's Jobs Act included a specific provision, 31 USC 330(b), granting Treasury carte blanche to regulate "written advice relating to a tax matter that is identified as having the potential for tax avoidance or evasion." The regulations released last December, with modifications through this June, took effect June 20, 2005.[1] That is why you have, no doubt, seen "you cannot rely on this" type disclaimers in letters and e-mails from national and some local firms.

Structural Issues

Under Circular 230, unless written tax advice rises to the level of a "covered opinion," it must include an express disclaimer that it cannot be relied on for penalty avoidance purposes. This disclaimer must be set out in a special section in the text of the letter and be set in the same typeface as the rest of the letter. The practical problem is that this disclaimer has to be in any written tax advice that is either a shelter (a very minuscule fraction of 1 percent) or any written advice that has a "significant purpose" of "tax avoidance." "Tax avoidance" is tax parlance for legal steps that reduce tax liability. For example, if a client e-mails you that he or she will sell greatly appreciated publicly traded securities purchased just days short of a year ago and you advise your client to wait until a year and a day before selling to obtain long-term capital gain treatment, the purpose of that advice is clearly tax avoidance.

There are exceptions for, *inter alia,* "preliminary advice," "oral advice," post–tax return filing advice (such as in an audit or appeal), in-house counsel, a "negative opinion," and statutorily contemplated transactions.[2] A meaningful discussion of exemptions is well beyond the scope of this brief article.

Action Steps

Each and every firm must essentially select one of three paths:

1. Legend the disclaimer in every e-mail, memo, and letter from all practitioners (and educate your clients about it).
2. Legend the disclaimer in every written communication from a particular department, such as tax (however, transactional and other practitioners also dispense tax advice and forward e-mails and memos from others containing tax advice).
3. Selectively legend tax advice with the disclaimer in non–"covered opinion" written communications that have a significant purpose of tax avoidance.

Every firm must also adopt, communicate, and implement policies consistent with Circular 230's new regulatory regime. It must be stressed that while adoption of proper policies is a start, such policies must also be followed. See the ABA Web site for a model policy.

The downside of noncompliance is not merely a tax-practice ethical violation but also potential tax malpractice. Tax malpractice pleadings now routinely allege that the failure to comply with federal standards of tax practice under Circular 230 is actionable.

There is also the client educational component. You do not want your client to receive a written communication with the nonreliance disclaimer without either a prior warning or explanation.

Many informed practitioners complain that these new rules represent regulatory overkill long after the proverbial horse (here the reprehensible tax shelter peddling of the late 1990s and early part of this decade) has left the barn. However, we all give sound advice when we tell clients to deal with the legal structure as it is rather than how they might like it to be. We must follow our own advice.

NOTES

1. 31 CFR 10.1 et seq.
2. 69 Fed Reg 75839 (2004), with later amendments at 70 Fed Reg 28824 (2005).
3. *See* 31 CFR 10.35(b)(2).

Paul L.B. McKenney, of Raymond & Prokop PC, Southfield, Michigan, practices in the areas of tax and business planning. He is a member of the Taxation Committee of the Oakland County Bar Association; the Sales, Exchanges and Basis Committee of the Taxation Section of the American Bar Association; and the Taxation Section of the State Bar of Michigan. He has also served as co-chairperson of the Taxation Committee of the Detroit Bar Association, as chairperson of the Oakland County Bar Association's Taxation Committee, and as a member of the Taxation Section Council of the State Bar of Michigan. Mr. McKenney was an adjunct professor in the graduate taxation program at Walsh College. He has published numerous articles and is a frequent lecturer on tax topics before various organizations. Mr. McKenney is a contributor to Torts: Michigan Law and Practice *(ICLE 2d ed & Cum Supp).*

By Michael S. Khoury

Open Source: What Does It Mean to You?

Open-source software is one of the buzzwords that you have been hearing over the last few years from the technology sector. Many businesses have used open-source software to reduce their reliance on software from Microsoft Corporation or to control technology budgets. This article explores some of the issues that businesses need to consider when adopting open-source software for their own development projects and when acquiring software that includes open-source components.

What is Open Source?

The basic idea behind open-source software is that the underlying technology should be publicly available in both human and computer readable forms (i.e., source and object code). With its genesis in academia, members of the open-source community want to make their works freely available to others who will improve and redistribute the modified software. Standard forms of open-source licenses have been developed to ensure that these works remain public, not proprietary. One goal of these agreements is to ensure that the public can use, modify, and redistribute the software without restriction, except to the extent that the license under which the software was published imposes a restriction.

There are a number of organizations that promote the concepts behind open source, including The Free Software Foundation (www.fsf.org) and the Open Source Initiative (www.opensource.org). This promotion is coupled with an inherent agreement by developers and users to follow guidelines adopted by the initial developer. Open-source software is, therefore, distributed under the terms of a public license.

Although the concept of open source may give you the impression that it can be freely used without restriction, this impression is far from the truth. Each public license is a little different, although most developers will use one of the standard agreements. You will hear such terms as the Mozilla Public License or the General Public License (GPL) for specific open-source licenses attributed to companies or organizations. For example, a developer may say, "I publish open source under the Mozilla v1.1 Public License." The names of the licenses range from the descriptive (the Academic Free License), the specific (the IBM Public License), or the whimsical (the GNU GPL). Each of these agreements restricts in different ways the manner in which the software code can be used.

Although many of the concepts of open source are consistent among the members of the open-source community, the specific provisions under which members will seek to distribute open-source software vary widely. Under some circumstances, publicly available open-source software allows this software code to be used for commercial purposes without limitation. Other open-source software will require a licensing fee if the intended use is for commercial purposes. At the other end of the spectrum, some open source is available only if the user also commits to freely distribute all updates and derivative works to the public.

Impact on the Use of Open Source by Your Organization

In the last few years, company executives have become surprised at the extent to which development partners and employees of their own organizations have begun using open-source software and integrating that code within business applications. This is sometimes done without knowledge of the organization's management and often without consideration of the underlying licensing requirements. Some companies have found, to their surprise, that they have integrated software that requires their proprietary business applications to become public. Others have found that they have used open-source software for commercial purposes in violation of the underlying public license and without payment of the required fees.

The prevalence of open-source software and the continued use by developers requires companies to assess the impact of the phenomenon on their businesses and business applications. More important, each organization must establish policies to control, or at least manage, the intellectual property ramifications of open source.

Five Steps to Protect Your Company

IP agreements with employees. Although not directly related to open source, each company should have an agreement with its employees under which the intellectual property rights to inventions or other works are assigned to the company. This assignment is often included in an employee manual that the employee acknowledges receiving at the outset of employment. The better practice is to also have a separate agreement that includes the intellectual property assignment, confidentiality restrictions, and any noncompete provisions or restrictions.

Development policies. If employees within your organization are developing software, a clear policy should be in place about the use of open-source software and the incorporation of open-source software into business applications. To the extent that the use is allowed, make sure that you understand the license agreements under which the use is permitted and that you comply with the terms. If a commercial license is required, this should be considered a cost of doing business, because the potential ramifications for violating the commercial use restrictions in a public license might be the obligation to release

your proprietary business software into the public domain.

Make sure your open-source disclosure is accurate. Most licenses under which open-source software is distributed require that you disclose the incorporation of the open-source software to the public. You must include information about the nature of the licenses obtained. Compliance with the attribution requirements is important; you don't want the ownership of your business applications challenged because of your disregard of a requirement of the public license.

Development partners. The use of open-source software is not limited to employees but includes development work sourced to individuals and third-party providers. To ensure that software developed by third parties does not include open-source software that would limit your ability to keep the work product confidential, you must require that all third parties providing development services adhere to your policies on the use of open-source software. If open source is incorporated with your consent, your agreement should indicate who is responsible for any commercial license fees, and the underlying licenses should be reviewed to ensure that the work product can be kept confidential.

Quality assurance. Open-source advocates try to make the case that open source is more reliable than proprietary software because it is peer reviewed and the subject of continuous improvement. However, that does not provide the validation necessary to an organization that the software meets the necessary quality and internal control requirements. In this era of Sarbanes-Oxley, quality assurance and testing remain important components for all business applications, including open-source applications.

Conclusions

The use of open-source software can provide cost savings to a company and a reasonable alternative to proprietary software. However, the licensing models for open-source software should be carefully examined and considered when using open source for your business applications. Organizational policies should be clear and consistently enforced so that unpleasant surprises can be kept to a minimum.

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Proposed Amendments to the Michigan Business Corporation Act

By Justin G. Klimko

The Michigan Business Corporation Act (BCA) first became effective in 1973, replacing the General Corporation Act. The BCA has been amended numerous times since its inception to keep abreast of developments in other jurisdictions and in the Model Business Corporation Act to reflect general trends in corporate governance and regulation and to address matters that may have resulted from judicial holdings. Significant comprehensive amendments were made in 1989 and 1993. The BCA typically is amended on a three- to four-year cycle.[1]

The Business Corporation Act Subcommittee of the Corporate Laws Committee of the State Bar of Michigan Business Law Section has developed additional proposed amendments to the BCA. These have been submitted to State Representative Bill Huizenga for introduction as legislation. As of this writing, introduction of the legislation is expected soon. The proposed amendments would make the changes to the BCA discussed in this article.

Shareholder Oppression

Section 489[2] of the BCA permits shareholders to bring actions "to establish that the acts of the directors or those in control of the corporation are illegal, fraudulent, or willfully unfair and oppressive to the corporation or to the shareholder." In 2001, Section 489 was amended to provide, among other things, that "willfully unfair and oppressive" conduct means a continuing course of conduct, action, or series of actions that substantially interfere with the interests of the shareholder as a shareholder." In *Franchino v Franchino*,[3] the court of appeals held that this language prevented a shareholder from maintaining a Section 489 action based on the termination of his employment by a majority shareholder. Although plaintiff's employment compensation had been substantial and had been the only source of meaningful income from his interest in the corporation, the court held that it did not implicate his interest as a shareholder.

The subcommittee believes that the Section 489 definition has been too narrowly construed. It was meant to exclude ordinary employment claims but not de facto freeze-outs accomplished through employment actions. In closely held corporations, where shareholders and management are often identical, employment compensation frequently is the primary benefit that shareholders receive. In drafting the 2001 amendments, the committee did not want to turn every employment action involving close corporations into a Section 489 oppression claim. However, the committee did not intend to forbid courts from considering employment-related actions as the basis for the claim.

To address this issue, the amendments would expand the definition in Section 489 to provide that willfully unfair and oppressive conduct may include termination of employment or limitations on employment benefits to the extent that the actions interfere with distributions or other shareholder interests disproportionately to the affected shareholder. The revised definition would permit a court in a Section 489 action to consider actions affecting employment that disproportionately affect shareholder interests. Examples might be a denial of shareholder distributions or the threat of a termination of employment to force a shareholder to take a certain action with respect to his or her shares.

Effective Date of Filed Document

Section 131[4] would provide that, once the Department of Labor and Economic Growth endorses a filed document, it becomes effective as of the date it was received, even though it may not have been reviewed and endorsed until a later date. Under current law, a document is not effective until it is endorsed, which occurs after the department has reviewed the document for compliance with the provisions of the BCA. This can cause problems for filers who need a specific effective date, particularly for year-end filings. Under the current statute, if filings are

submitted immediately prior to year-end but not reviewed and endorsed until after December 31, the tax and regulatory planning for a transaction may be adversely affected. The amendment seeks to avoid this problem by treating the document as effective on its submission date even though it is not endorsed until a later date.

This change could raise certain issues. One is whether a document that was submitted with defects and had to be corrected before endorsement would be effective on the original submission date. A second issue concerns the status of department certifications issued between the submission date and the endorsement date. For instance, suppose a merger certificate was submitted on the first of the month but not endorsed until the fifth, and in the meantime the department issued a good-standing certificate for the nonsurviving corporation on the third. The good-standing certificate would become incorrect after the fact, because the endorsement on the fifth would result in the retroactive termination of the corporation's existence as of the first of the month.

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The Department of Labor and Economic Growth had previously expressed its opposition to the amendment to Section 131 due to these issues. However, the department asked that language be submitted to which it could react, rather than forwarding an alternate proposal. Rather than attempt to modify the initial proposal, the subcommittee determined to submit its original language and then work with the department to come to a mutually agreeable amendment. The subcommittee anticipates that additional discussions with the department and the bill's sponsor will be held on the language of Section 131.

Other alternatives might also address the effective-date issue. An accelerated filing process could be created to guarantee an effective date for an additional fee (Delaware has such a process), or a provision could be added requiring the department to accept filings without reviewing content. The problem concerning certificates of good standing issued while a filing is pending could be addressed in one of two ways: either by prohibiting the issuance of good-standing certificates while a filing is pending that would implicate good standing or by requiring that certificates issued during that period bear a notation that such a filing is pending.

Notices

Subsection 143(1)[5] currently requires that notices and communications be sent to shareholders by first-class mail. This section would be amended to exempt corporations with a class of securities registered under the Securities Exchange Act of 1934. This change would permit the use of bulk mailing, thus lowering the sometimes considerable cost to public companies of shareholder mailings.

Section 143(2)[6] would permit a corporation to "household" written notices of shareholder meetings as well as any other written notices, reports, or statements. This would permit corporations to deliver a single notice, report, or statement to shareholders sharing a common address, rather than being required to deliver separate notices to each holder. An "address" for this purpose would include a street address, post office box, e-mail address, or fax number.

Householding would be permitted only for shareholders who consented to it, but consent would be presumed for shareholders who fail to object in writing within 60 days of written notice by the corporation of its intention to engage in the practice. The consent would be revocable.

Federal securities laws already permit householding of certain documents required to be delivered under those laws.[7] The amendment to Section 143(2), while not restricted to publicly held corporations, would integrate with those provisions by allowing public corporations, for instance, to deliver a single notice of a shareholders meeting as part of a proxy statement delivered under the Securities Exchange Act of 1934. Corporations would still have to ensure that they deliver sufficient copies of other documents, such as forms of proxies, to enable each shareholder at the common address to take requested action.

Guaranties of Related Party Obligations

Section 261[8] of the Act enumerates the powers of a corporation incorporated under the BCA. Included among these powers, in subsection (i), is the power to give guaranties that are necessary or convenient to the conduct, promotion, or attainment of the business of (1) the guarantor's wholly owned subsidiary corporations, (2) the guarantor's parent corporation if the parent owns all of the guarantor's shares, and (3) a so-called sister corporation if all of the outstanding shares of the

sister are owned, directly or indirectly, by a corporation that owns, directly or indirectly, all of the outstanding shares of the guarantor.

The provisions of Section 261(i) overrode common-law doctrines that found a guaranty given by a corporation for the benefit of a shareholder or other related party to be ultra vires and therefore void.[9] The safe harbor in Section 261 provides a basis for counsel to offer legal opinions as to the enforceability of these types of guaranties. Practitioners should note, however, that the Section 261 provisions do not affect the analysis of whether a guaranty is permissible under the Uniform Fraudulent Transfer Act.[10]

The current wording of Section 261(i) applies only to affiliated entities in a wholly owned relationship and only if they are corporations. The proposed amendment to subsection (i) would add limited liability companies (LLCs) to the types of affiliated entities covered. Thus, the amendment would provide a safe harbor for a guaranty given by a Michigan corporation for the benefit of its wholly owned LLC subsidiary, a parent LLC that owns all of its shares, or a sister LLC that is wholly owned by the guarantor's parent if the parent also wholly owns the guarantor.[11]

The subcommittee considered whether other types of entities should also be specified and whether the provision should be extended to less than wholly owned entities. The subcommittee determined not to further extend the provision, since it is merely a safe harbor and does not preclude a finding in the proper circumstances that guaranties given for the benefit of other types of entities, or those with other ownership proportions, are within a corporation's powers.

Status of Abstentions

Sections 441(2)[12] and 442[13] would clarify that, unless otherwise provided in the articles of incorporation, abstentions and nonvotes do not count as votes cast or affect a shareholder vote. Section 441(2) provides that shareholder action is taken if authorized by "a majority of the votes cast." Some have questioned whether abstentions or broker nonvotes constitute the casting of votes for this purpose, and the amendment would provide that they do not, absent contrary provisions in the articles of incorporation. The amendment to Section 442 would extend this principle to class voting.

This amendment would have a practical effect on only certain matters submitted to a shareholder vote. Extraordinary transactions for which the BCA requires shareholder approval, such as merger, sale of substantially all assets, amendment of the articles of incorporation, and dissolution, generally require approval of a majority of the outstanding shares entitled to vote, not merely a majority of the votes cast. For these actions, abstentions and nonvotes, even if not considered cast, have the same effect as votes against. For other shareholder actions, however, including those required of public companies by stock exchange or NASDAQ regulations, the amendment would clarify the effect of abstentions and nonvotes.

Creation of Subcommittees

Section 528[14] would add a subsection (3) permitting a board committee to create subcommittees, unless the power to do so was restricted in the resolution appointing the committee or in the articles or bylaws. Each subcommittee would be required to consist of committee members and could be delegated any or all of the powers and authority of the committee.

Board Approval for Amendments to Articles

Section 611[15] would require amendments to the articles of incorporation to be initiated by the board of directors. At present the BCA is atypical in that it does not require amendments of the articles to be initiated or approved by the board. The Model Business Corporation Act and the vast majority of other state acts require board action on amendments.[16]

This amendment was originally proposed in 2003, during the takeover battle between Simon Property Group, Inc., and Taubman Centers, Inc. At that time the Simon interests alleged that the amendment was a defensive maneuver intended to help Taubman fend off Simon's offer, and the amendment was subsequently withdrawn.

The subcommittee debated whether the amendment should be made applicable only to publicly held companies. The rationale for the distinction would be that the BCA has historically emphasized shareholder rights and applied governance principles differently for privately held and publicly held companies.[17] However, the lack of such a

Sections 441(2) and 442 would clarify that, unless otherwise provided in the articles of incorporation, abstentions and nonvotes do not count as votes cast or affect a shareholder vote.

distinction in the charter amendment provisions of other states persuaded the subcommittee not to recommend it in the Section 611 amendment.

Under the amended language, the board would be permitted to condition its submission of an amendment to the shareholders on any basis.

Repeal of Control Share Act

Chapter 7B, the Michigan Control Share Act,[18] would be repealed in its entirety. Chapter 7B provides that certain acquisitions of "control shares" of Michigan corporations must be approved by the corporations' shareholders, failing which the acquired control shares lose their voting rights in the hands of the acquirer. The wording of this act has always been very dense and difficult to apply and understand, due no doubt to its original purpose as a roadblock to hostile acquisitions. As such, it has often served as a trap for the unwary in transactions that were never within the ambit of the statute's original intent.

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The usefulness of Chapter 7B was further brought into question in the Simon-Taubman contest. Though the chapter was designed to protect target companies, Simon was able to use it as an offensive weapon in its control bid. Only legislative intervention seems to have prevented that effort from succeeding: the chapter was amended in 2003 to provide that formation of a group does not constitute a control share acquisition.[19] The amendment overruled a U.S. district court ruling adverse to Taubman.[20]

The subcommittee reasoned that the Control Share Act seems to serve little purpose in light of these developments. Regardless of individual philosophies regarding the merits of the statute's original intent, the Simon-Taubman contest demonstrated that Chapter 7B serves this intent poorly, if at all. Since the statute is otherwise obtuse and has often resulted in unintended consequences, the subcommittee recommended repeal.

Corresponding amendments would also be made to other sections to remove references to the Control Share Act. For example, Section 762[21] would be amended to eliminate approval of a control share acquisition as an event triggering dissenters' rights.

Technical Amendments

Section 106[22] would be amended to name the Department of Labor and Economic Growth as the administering department of the BCA, following the latest round of government reorganization in Lansing.

Section 405[23] would be amended to reconcile subsections (1), (3), and (4). Subsection (1) has long permitted shareholders to participate in meetings by conference telephone call or other communications equipment so long as all participants could hear all others. The 2001 amendments added the phrase "remote communication" to subsection (1) and also added subsections (3) and (4) permitting meetings to be held entirely by remote communication, subject to certain ground rules. The amendment would make clear that the special rules of subsection (4) apply only to meetings held entirely by means of remote communication and do not apply to participation in regularly convened meetings by conference call or other remote communication.

Section 735(1)[24] would be amended by striking subsection (a)(iii) and moving that language to a new subsection (d). This would correct a drafting error in the 1997 BCA amendments. Section 735 deals with mergers or share exchanges involving foreign and domestic corporations. Current subsection (1)(a)(iii) requires foreign corporations involved in those transactions to amend or withdraw their applications for certificates of authority to transact business in Michigan. The current placement of subsection 1(a)(iii) suggests that it applies only to a foreign corporation that is a parent company involved in a short-form parent-subsidiary merger under Section 711.[25] Moving this language to a separate subsection (1)(d) would make clear that it applies to all foreign corporations involved in any of the transactions described in Section 735.

Section 823[26] would be amended to replace a leftover reference to Section 463 (which was repealed in 1997) with a reference to Section 488 (which deals with shareholder agreements)

NOTES

1. The most recent previous amendments were adopted in 2001.
2. MCL 450.1489.
3. 263 Mich App 172, 687 NW2d 620 (2004).
4. MCL 450.1131.
5. MCL 450.1143(l).
6. MCL 450.1143(2).
7. 17 CFR 240.14a-3(e).
8. MCL 450.1261.

9. *See, e.g., Pratt v Valliquette*, 338 Mich 397, 61 NW2d 648 (1953). The theory of such doctrines was that a corporation had no power to provide a guaranty for the benefit of a person or an entity in which it had no equity interest, because it received no benefit for the guaranty.

10. MCL 566.31 et seq.

11. An interesting question, which is beyond the scope of this article, is what effect this amendment will have on Michigan LLCs. MCL 450.4210 provides that "a limited liability company has all powers necessary or convenient to effect any purpose for which the company is formed, including all powers granted to corporations in the business corporation act." Will the amendment to the BCA constitute express authorization to Michigan LLCs to provide guaranties for parent, subsidiary, and sister LLCs in wholly owned relationships? Note OAG 6592 (July 10, 1989), in which the attorney general held that the Professional Service Corporation Act's (PSCA's) incorporation of the BCA referred only to the provisions of the BCA in existence when the PSCA was adopted or subsequently amended.

12. MCL 450.1441(2).

13. MCL 450.1442.

14. MCL 450.1528.

15. MCL 450.1611.

16. *See,* e.g., 8 Del C § 251.

17. For instance, in MCL 450.1488 and MCL 450.1489.

18. MCL 450.1790–1799.

19. MCL 450.1791(6).

20. *See Simon Prop Group, Inc, v Taubman Ctrs, Inc,* 261 F Supp 2d 919 (ED Mich 2003), *vacated and remanded sub nom Glancy v Taubman Ctrs, Inc,* 373 F3d 656 (6th Cir. 2004).

21. MCL 450.1762.

22. MCL 450.1106.

23. MCL 450.1405.

24. MCL 450.1735(l).

25. MCL 450.1711.

26. MCL 450.1823

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Franchino v Franchino: *A Serious Blow to Minority Shareholder Oppression Lawsuits in Michigan*

By Mark E. Hauck and Stephen W. King

Introduction

On July 29, 2004, the Michigan Court of Appeals released its decision in *Franchino v Franchino.*[1] In a case of first impression, the court was called on to decide whether MCL 450.1489 of the Michigan Business Corporation Act (BCA) created a cause of action for a minority shareholder in a close corporation when the shareholder was removed from the corporation's board of directors and the shareholder's employment was terminated.[2] The court ruled that, in a minority shareholder oppression lawsuit, MCL 450.1489(3) only protects a shareholder's interest "as a shareholder" and therefore does not create a cause of action for a shareholder who was removed from the board of directors or whose employment was terminated.[3] The court reasoned that a decision to remove a shareholder from the board of directors and to terminate a shareholder's employment did not affect a shareholder's interest "as a shareholder" but merely affected that shareholder's interest in a board position and continued employment.[4]

Based, in part, on this ruling the *Franchino* court also declined to adopt the "reasonable expectations" test for defining the phrase "oppressive conduct." The court reasoned that this phrase did not include conduct that defeated the reasonable expectations of a minority shareholder because MCL 450.1489 did "not . . . place the focus upon the 'rights or interests' of the complaining shareholder but, rather, specifically place[d] the focus upon the actions of the majority."[5] In addition, the court reasoned that, even if a minority shareholder's reasonable expectations should factor into whether oppressive conduct occurred, the limiting nature of MCL 450.1489(3) prevented the reasonable expectations test from expanding the protections of MCL 450.1489 to interests other than "as a shareholder."[6]

The *Franchino* court's interpretation of the phrase "as a shareholder" is too restrictive, because it ultimately fails to acknowledge certain business realities that are inherent in the vast majority of closely held corporations. With this interpretation, the *Franchino* court has limited MCL 450.1489 from having any practical effect in future minority shareholder oppression lawsuits. The court's ruling is not consistent with the legislature's intent in promulgating MCL 450.1489(3), which was intended to protect the rights of minority shareholders. Further, it is clearly out of step with courts across the country, with various learned commentators, and, most important, with business reality. For these reasons, this article advocates the adoption of a more practical application of MCL 450.1489.

Franchino v Franchino

In *Franchino*, the pleadings revealed that, for many years, the majority shareholder (the father and defendant) and the minority shareholder (the son and plaintiff) were the only members of the board of directors and the only shareholders in a closely held corporation. Plaintiff's employment contract provided that his employment could only be terminated by the unanimous agreement of the board of directors. Various disputes arose over the years, and defendant finally terminated plaintiff's employment. Defendant then removed plaintiff from the board of directors and amended the corporation's bylaws so that he would be the only director. Plaintiff responded by immediately filing suit.

In 2002, the Michigan Court of Appeals convened a special panel to resolve a split of authority.[7] The main issue in dispute was whether MCL 450.1489 of the BCA created a direct cause of action. In *Estes v Idea Eng'g & Fabrication, Inc*, the special panel concluded that MCL 450.1489 provided a "separate, independent, and statutory basis for a caus of action."[8]

Based on the special panel's opinion, plaintiff in *Franchino* amended his pending

complaint to include a sole claim for minority shareholder oppression based on MCL 450.1489, which provides in pertinent part:

> (1) A shareholder may bring an action in the circuit court of the county in which the principal place of business or registered office of the corporation is located to establish that the acts of the directors or those in control of the corporation are illegal, fraudulent, or *willfully unfair and oppressive* to the corporation or to the shareholder. If the shareholder establishes grounds for relief, the circuit court may make an order or grant relief as it considers appropriate, including, without limitation, an order providing for any of the following:
>
> . . . .
>
> (3) As used in this section, *"willfully unfair and oppressive conduct" means a continuing course of conduct or a significant action or series of actions that substantially interferes with the interests of the shareholder as a shareholder*. The term does not include conduct or actions that are permitted by an agreement, the articles of incorporation, the bylaws, or a consistently applied written corporate policy or procedure.[9]

(Emphasis added.) At the trial court level and on appeal, plaintiff argued that his "removal from the board of directors and from his employment at Franchino Mold and Engineering Company (FMEC) constituted oppression of his rights as a shareholder because he received the bulk of his share of the corporate profits through his salary and expected to participate in FMEC's management."[10] Before directly addressing the central issue (i.e., whether a shareholder's employment with a close corporation and membership on the board of directors are shareholder interests pursuant to MCL 450.1489), the *Franchino* court discussed the traditional role of a shareholder in a close corporation. The court noted that "[i]t is generally acknowledged that, in close corporations, shareholders often work for the corporation, and corporate dividends are often paid in the form of salary."[11] It is well-known that shareholders in a close corporation generally receive a return on their investment not through stock dividends, which are rarely paid, but through a share of the profits, which are paid through annual salaries and bonuses. In *Franchino*, for example, plaintiff earned an annual salary averaing approximately $500,000 a year but only received $3,100 a year in dividends.[12]

Other courts have expanded on what expectations a shareholder may have when investing time and capital into a close corporation. For example, the *Estes* court noted:

> [T]he shareholders of a closely held corporation participate in the management of the corporation, whereas the management of a publicly held corporation represents the shareholders . . . .
>
> In contrast, because the shareholders participate in the management of the corporation, the relationship among those in control of a closely held corporation requires a higher standard of fiduciary responsibility, a standard more akin to partnership law. Henn & Alexander, § 268; O'Neal's, §§ 1.02, 1.08.[13]

In *Exadaktilos v Cinnaminson Realty Co*, the Superior Court of New Jersey discussed the expectations of minority shareholders in a close corporation:

> Unlike their counterparts in large corporations, [shareholders in a close corporation] may expect to participate in management or to influence operations, directly or indirectly, formally or informally. See Tinney, "Oppressive Conduct by Majority Shareholders, Directors, or Those in Control of Corporation," [5 Proof of Fact 2d 645 (1975)]. Furthermore, there generally is an expectation on the part of some participants that their interest is to be recognized in the form of a salary derived from employment with the corporation. See Note, "Relief to Oppressed Minorities in Close Corporations: Partnership Precepts and Related Considerations," [1974 Ariz St LJ 409, 412].[14]

[T]he Franchino *court's overly restrictive reading of the statute eviscerated the minority shareholder protections intended by the legislature.*

Various learned commentators have also provided input on this issue. Robert B. Thompson noted that shareholders in close corporations "expect employment and a meaningful role in management, as well as a return on the money paid for [their] shares."[15] Another leading commentator on close corporations, F. Hodge O'Neal, noted that shareholders in close corporations have certain reasonable expectations, such as the expectation that they will participate in the management of the business and enjoy continued employment.[16]

Generally, shareholders of close corporations have different expectations and face different financial realities than shareholders in publicly traded corporations. For example, shareholders of Wal-Mart stock look on their ownership of that stock as an investment. They have no expectation of employment as a result of that investment, and they know that they will not play a role in managing the corporation. Moreover, because their stock is publicly traded, they may easily sell it on any given day if the corporation does not perform as expected. Such freedom to cash out one's investment does not exist in a close corporation, so majority shareholders can essentially hold the minority shareholders' investment hostage indefinitely. For these reasons, a minority shareholder's interest in a close corporation is of little value unless that minority shareholder is employed by or allowed to somehow share in the profits of the corporation. As a practical matter, minority shareholders who are deprived of employment with the company or of a decision-making role as a member of the board have no means to direct or enjoy the fruits of their investment. MCL 450.1489 was adopted by the legislature to address such potential abuses by majority shareholders. However, the *Franchino* court's overly restrictive reading of the statute eviscerated the minority shareholder protections intended by the legislature.

. . . because the shareholders participate in the management of the corporation, the relationship among those in control of a closely held corporation requires a higher standard of fiduciary responsibility . . . .

Despite the overwhelming support for the protection of the reasonable expectations of minority shareholders, the *Franchino* court, relying on *Fletcher Cyclopedia Corporations*, stated that "employment and board membership are not generally listed among the rights that automatically accrue to shareholders" and that therefore, "employment and board membership are not considered shareholder rights" in a close corporation.[17] The court's strange leap in logic and singular reliance on *Fletcher Cyclopedia Corporations* is troubling. Not only is it inconsistent with the trend in courts across the country to protect minority shareholder rights, it is at odds with numerous experts on close corporations, and it flies in the face of business reality.

Proposed Amendment to BCA: the "Reasonable Expectations" Test

The Michigan Business Corporation Act Subcommittee has agreed, in part, that the *Franchino* court improperly limited the definition of *as a shareholder* to exclude a minority shareholder's expectation of continued employment. To wit, the subcommittee recently submitted the following proposed amendment and comment regarding MCL 450.1489(3) to the legislature:

> (3) As used in this section, "willfully unfair and oppressive" conduct" means a continuing course of conduct or a significant action of series of actions that substantially interferes with the interests of the shareholder as a shareholder. WILLFULLY UNFAIR AND OPPRESSIVE CONDUCT MAY INCLUDE THE TERMINATION OF EMPLOYMENT OR LIMITATIONS ON EMPLOYMENT BENEFITS TO THE EXTENT THAT THE ACTIONS INTERFERE WITH DISTRIBUTIONS OF PROFITS OR OTHER SHAREHOLDER INTERESTS DISPROPORTIONATELY TO THE AFFECTED SHAREHOLDER. The term does not include conduct or actions that are permitted by an agreement, the articles of incorporation, the bylaws, or a consistently applied written corporate policy or procedure.
>
> COMMENT: The definition added in 2001 was read narrowly by the Court of Appeals in *Franchino v Franchino Mold and Engineering Co.* to prevent consideration of termination of employment as relating to shareholder oppression. The revised definition authorizes consideration of employment actions if the actions disproportionately affect shareholder interests, such as through denial of shareholder profit distributions made through employee bonuses or

> a termination of employment for the purpose of coercing a sale of shares.

The comment clarifies that the proposed amendment does not provide that termination of a shareholder's employment automatically constitutes oppression. It does, however, allow a court to consider a termination if the action disproportionately affects a shareholder's interests.

In defining oppression or oppressive conduct, state courts have used differing methods. Some state courts define oppression as "burdensome, harsh and wrongful conduct . . . a visible departure from the standards of fair dealing and a violation of fair play on which every shareholder who entrusts his money to a corporation is entitled to rely."[18] Other state courts have tied the term oppression to a breach of fiduciary duty between shareholders.[19] Finally, some state courts have adopted the "disappointment of reasonable expectations" test as the best method of defining oppression. Plaintiff in *Franchino* urged the court to adopt this final method.

The *Franchino* court declined to adopt the "reasonable expectations" test for three stated reasons. First, there was no controlling precedent in Michigan.[20] Second, the phrase "oppressive conduct" did not include conduct that defeated the reasonable expectations of a minority shareholder because MCL 450.1489 did not place the focus on the rights of the minority shareholder but on the actions of the majority shareholders.[21] Third, even if the minority shareholder's reasonable expectations should factor into whether oppressive conduct occurred, the limiting nature of the MCL 450.1489(3) prevented the reasonable expectations test from expanding the protections of MCL 450.1489 to interests other than shareholder interests.

With regard to the second reason for declining to adopt the reasonable expectations test, the *Franchino* court stated in pertinent part:

> Courts in other jurisdictions have generally refused to adopt the reasonable expectations test for oppression if the applicable state statute defines oppression in terms of the majority's conduct rather than the effect of that conduct on the minority. For example, in *Kiriakides v Atlas Food Systems & Services, Inc.*, plaintiff sued under a statutory provision permitting dissolution if "the directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, fraudulent, oppressive, or unfairly prejudicial either to the corporation or to any shareholder (whether in his capacity as a shareholder, director, or officer of the corporation)." SC Code Ann Sec 33-14-300(2)(ii). . . .

Noting that "section 33-14-300 does not place the focus upon the 'rights or interests' of the complaining shareholder but, rather, specifically places the focus upon the actions of the majority," the court concluded that "a 'reasonable expectations' approach is simply inconsistent with our statute." *Id* at 265-266. Accordingly, the court "declined to adopt such an expansive approach to oppressive conduct in the absence of a legislative mandate." *Id* at 602.[22]

The *Franchino* court then noted that the Supreme Court of South Carolina did not adopt the reasonable expectations test in *Kiriakides*. This is technically accurate; however, the *Kiriakides* court did note that a minority shareholder's reasonable expectations may be considered as a factor in defining oppression:

> We agree with Professor Miller's suggestion that the best approach to the statutory definition of oppressive conduct may well be a case-by-case analysis, augmented by factors or typical patterns of majority conduct which tend to be indicative of oppression, such as exclusion from management, withholding of dividends, paying excessive salaries to majority shareholders, and analogous activities. Sandra K. Miller, *How Should U.K. and U.S. Minority Shareholder Remedies for Unfairly Prejudicial or Oppressive Conduct Be Reformed?*, 36 Am Bus LJ 579, 585 (Summer 1999). In this regard, we note that we do not hold that a court may never consider the parties' reasonable expectations, or the other items enumerated by the Court of Appeals, as **factors** in assessing oppressive conduct; such factors, however, are not to be utilized as the sole test of oppression under South Carolina law.[23]

Some state courts define oppression as "burdensome, harsh and wrongful conduct . . . a visible departure from the standards of fair dealing and a violation of fair play on which every shareholder who entrusts his money to a corporation is entitled to rely."

Furthermore, a number of state courts have adopted the reasonable expectations test even though the applicable statute placed the focus upon the actions of the majority and not on the rights of the minority shareholder.[24] For example, in *Mueller v Cedar Shore Resort, Inc,* the Supreme Court of South Dakota concluded:

> South Dakota has adopted the Model Business Corporations Act, which provides equitable relief for minority shareholders who have been oppressed, particularly in the context of a close corporation. *See* SDCL 47-7-34. The Code, however, does not define what constitutes oppression. We have resolved the question "by considering oppressive actions to refer to conduct that substantially defeats the 'reasonable expectations' held by minority shareholders in committing their capital to the particular enterprise."[25]

The South Dakota statute that governs the grounds for judicial dissolution provides in pertinent part:

> The circuit court shall have full power to liquidate the assets and business of a corporation in an action by a shareholder when it is established:
>
> . . . .
>
> (2) That the acts of the directors or those in control of the corporation are illegal, oppressive or fraudulent.[26]

Supporters of *Franchino* will undoubtedly be quick to point out that the *Mueller* Court stated, "[t]he Code, however, does not define what constitutes oppression,"[27] whereas in Michigan, oppression is defined in MCL 450.1489(3). This merely highlights the importance of rectifying the *Franchino* court's overly restrictive interpretation of "as a shareholder." If *Franchino*, perhaps the model case of minority shareholder oppression, stands, it will serve to deny relief in the very situation in which it is most needed since termination of a minority shareholder's status as an employee is a much more common means of oppression in a close corporation than is infringement of a minority shareholder's status as a shareholder.[28]

If Franchino, *perhaps the model case of minority shareholder oppression, stands, it will serve to deny relief in the very situation in which it is most needed . . . .*

Conclusion

Has the *Franchino* court's interpretation of the phrase "as a shareholder" and its refusal to adopt the "reasonable expectations" test signaled the demise of lawsuits aimed at protecting minority shareholder rights in Michigan? At this point, it is unclear. However, unless *Franchino* is overruled or the Michigan Business Corporation Act Subcommittee's proposed amendment is adopted, the *Franchino* court's restrictive interpretation will continue to curtail the ability of minority shareholders to pursue legal remedies in Michigan court.

NOTES

1. *Franchino v Franchino*, 263 Mich App 172, 687 NW2d 620 (2004).
2. *Id.* at 173.
3. *Id.*
4. *Id.* at 173–174.
5. *Id.* at 188 (citing *Kiriakides v Atlas Food Sys & Serv, Inc,* 343 SC 587 600, 541 SE2d 257 (2001)); *see also* 9 *Michigan Law and Practice,* ch 11, § 322.
6. 263 Mich App at 188.
7. *Estes v Idea Eng'g & Fabrication, Inc,* 245 Mich App 328, 631 NW2d 89 (2001), *vacated in part*, 245 Mich App 328, 631 NW2d 89 (2001); *Baks v Moroun*, 227 Mich App 472, 576 NW2d 413 (1998).
8. 245 Mich App at 278.
9. MCL 450.1489 was amended by 2001 PA 57.
10. *Franchino,* 263 Mich App at 183.
11. *Id.* at 184 (citing 1 O'Neal & Thompson, *O'Neal's Close Corporations*, § 6.02 (3d ed 1971 & supps); *see also Exadaktilos v Cinnaminson Realty Co,* 167 NJ Super 141, 153–154, 400 A2d 554 (1979).
12. 263 Mich App at 182.
13. *Estes,* 250 Mich App at 281.
14. *Exadaktilos,* 167 NJ Super at 153-154.
15. Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 Bus Law 699, 702 (1993); *see* 1 F. Hodge O'Neal & Robert B. Thompson, *O'Neal's Close Corporations* 1.08, at 31–32 (3d ed 1996).
16. F. Hodge O'Neal, *Close Corporations: Existing Legislation and Recommended Reform*, 33 Bus Law 873, 885 (1978).
17. *Franchino*, 263 Mich App at 184.
18. *2 O'Neal & Thompson*, § 7:13 (citing *Skierka v Skierka Bros*, 192 Mont 505, 519, 629 P2d 214 (1981)).
19. *2 O'Neal & Thompson*, § 7:13.
20. While accurate, it is interesting to note that in 1994 the same court, in an unpublished opinion, applied the reasonable expectations test in determining whether oppressive conduct had occured in *Lardner v Port Huron Golf Club*, Nos 138038, 139092 (Mich Ct App 1994).
21. *Franchino*, 203 Mich App at 188 (citing *Kiriakides*, 343 SC at 600). 22. 203 Mich App at 187–188.
23. 343 SC at 603 n25.
24. *Colt v Mount Princeton Trout Club, Inc*, 78 P3d 1115 (Colo Ct App 2003); *Taylor v Hinkle*, No 04-471, 2004 Ark LEXIS 808 (Dec 16, 2004); *Del Borrello v Del Borrello*, 62 Pa D & C 4th 417 (2001); *Schaefer v Ulinski*, 253 Wis2d 845, 644 NW2d 293 (2002); *Gunderson*

v Alliance of Computer Prof'ls, Inc, 628 NW2d 173 (Minn Ct App 2001).

25. 2002 SD 38, ¶13, 643 NW2d 56 (2002) (citations omitted).

26. SD Codified Laws § 47-7-34.

27. 2002 SD 38, at ¶13.

28. 263 Mich App at 185.

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Applying the Business Judgment Rule in In re The Walt Disney Co *Derivative Litigation*

By Damien M. Weiss

Editor's note: On August 9, 2005, the Delaware Court of Chancery submitted its ruling in In re The Walt Disney Company. *Ending eight years of litigation, Chancellor Chandler concluded that the Disney board did not violate its fiduciary duty to its shareholders. This article analyzes an earlier decision denying a motion to dismiss.*

Introduction

Historically, the business judgment rule has shielded directors from personal liability from claims that they breached the duty of care in making a corporate decision. Provided that certain criteria are met, courts typically refuse to question the substantive wisdom of any business judgment made by directors.

The Michigan Supreme Court's decision in *Dodge v Ford Motor Co* articulates this principle of abstention: "The discretion of the directors will not be interfered with by the courts, unless there has been bad faith, willful neglect, or abuse of discretion."[1] The court in *Dodge* justified its refusal to exercise substantive review of director decisions by stating that such decisions are not within the court's expertise, remarking that "judges are not business experts."[2] Thus, even a disastrous decision would not, by itself, be sufficient to prevent application of the business judgment rule. Rather, in most circumstances, a plaintiff must allege that the process of decision making—not the outcome—was flawed to prevent a court's application of the business judgment rule.

In the context of a board's decision to commence or refrain from commencing litigation, the Delaware Supreme Court's decision in *Aronson v Lewis* clarified the pleading standard for excusing a plaintiff from demanding that the board commence litigation.[3] To establish demand futility, a plaintiff must allege facts creating a reasonable doubt (1) that the directors were disinterested and independent or (2) that the decision at issue was the product of a valid exercise of business judgment.[4] This article addresses the second prong of the *Aronson* test, which requires that a plaintiff allege facts that rebut the presumption that the board made a decision "on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company."[5]

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The *Disney* Case

The Hiring and Firing of Michael Ovitz

In 1995, Disney CEO Michael Eisner sought to fill the vacancy of president and COO of the company—a position left vacant by Frank Wells after he died in a plane crash the year before.[6] Eisner approached his friend, Michael Ovitz, to become Eisner's second in command at Disney.[7] Ovitz headed the Creative Artists Agency (CAA), where he received more than $30 million in compensation each year.[8] Ovitz agreed to leave CAA after he negotiated several terms that were included in his contract with Disney. Among these terms was an agreement that if Disney terminated him without cause or if the company consented to his resignation, Ovitz would receive a severance package valued at over $120 million, with additional possible bonuses.[9]

As he settled into his new job at Disney, it became apparent that Ovitz could not coexist with Eisner.[10] Amid reports of a growing feud between the two, Ovitz was fired after only 14 months on the job.[11] Disney termed his departure as a no-fault termination, and Ovitz received his severance, valued at a total of $140 million, for just over one year of work.[12]

The Case

Plaintiff shareholders filed derivative actions against both Ovitz, for violation of his fiduciary duties as president, and the Disney board, for violation of its duty of care. This

article will analyze the action filed against the Disney board. Three appellate decisions mark the progress of the litigation initiated against the board, and the last of these before the directors' ultimate victory is the focus of this article.

In *Disney III*,[13] plaintiffs pled particularized facts suggesting that the Disney board intentionally abandoned its duty to inform itself about the severance package and its non-fault termination term.[14] Plaintiffs alleged that the board blindly granted all negotiating authority to Eisner, that no board members asked to meet with Eisner regarding the term, and that the board never sought to negotiate with Ovitz regarding his departure.

The chancery court ruled that these facts, if true, would support an inference that the board neither informed itself nor acted in good faith. Each finding, if made in plaintiffs' favor, would mandate that the directors did not receive business judgment rule protection.

The *Aronson* Test Versus the Irrational Decision Exception

As discussed in this article, there are two ways of squaring the *Disney* decision with traditional doctrinal understanding of the business judgment rule. The first is by analyzing it as an application of the second prong of the *Aronson* test (that directors made an informed decision, in good faith, and with the honest belief that the company would benefit[15]) directly and inferring that the *Disney* court found that plaintiff had adequately alleged that the board did not adequately inform itself with respect to Ovitz's contract. The second is to infer that the *Disney* court classified the board's decision as completely irrational. Ultimately, however, a court would return to the *Aronson* test to infer bad faith from the irrational nature of the decision.

Applying Aronson

In its dismissal of the original *Disney* complaint, the chancery court wrote that the size of the payout to Ovitz alone would not be enough to rebut the presumption of good faith.[16] Courts may not infer bad faith based on the outcome of a board's decision alone; there must be some allegation of procedural misconduct to preclude application of the business judgment rule.[17] This left plaintiffs to allege that the board's decision was not the product of a valid exercise of business judgment.

With regard to Ovitz's hiring, plaintiffs alleged that the board did not weigh the merits of hiring Ovitz but rather left the entire negotiation process of Ovitz's contract to Eisner and failed to review the final drafts of the contract.[18] With regard to Ovitz's firing, plaintiffs alleged that the board did not seek to negotiate the terms of his departure, nor did it seek an at-fault termination that would have prevented Ovitz from receiving the lucrative severance package.[19] In determining whether the board's decision was informed, the court concluded that on the facts alleged, no real deliberative decision was made at all. "[T]he facts belie any assertion that the New or Old Boards exercised *any* business judgment."[20]

The opinion in *Disney III* may not stand for the proposition that merely pleading facts suggesting that the board did not inform itself would alone satisfy the *Aronson* test:

> These facts, if true, do more than portray directors who, in a negligent or grossly negligent manner, merely failed to inform themselves or to deliberate adequately about an issue of material importance to their corporation. Instead, the facts alleged in the new complaint suggest that the defendant *directors consciously and intentionally disregarded their* responsibilities, adopting a "we don't care about the risks" attitude concerning a material corporate decision.[21]

Thus, the court seems to be assigning high value to an inference of conscious intent in determining whether plaintiffs meet the *Aronson* test. This seems to suggest a subjective analysis. However, courts generally find good faith based on the *absence* of an intent or scheme to defraud or of self-conflicting interest, as well as on evidence of the sincerity of the directors' beliefs underlying their actions.[22]

Applying a Rationality Standard

The focus thus far has been on judicial review of the procedural aspects of a board's decision, in particular, facts showing whether a board informed itself with respect to a decision that they are called on to make. Occasionally, however, courts have used the decision itself—apart from allegations of the

"The discretion of the directors will not be interfered with by the courts, unless there has been bad faith, willful neglect, or abuse of discretion."

decision-making process—as evidence of whether the *Aronson* test has been met.[23] For example, a business decision that is irrational on its face might be evidence from which a court infers that the board could not honestly have believed that the company would benefit from the decision.

Commentators disagree about the wisdom of evaluating the rationality of business decisions. On the one hand, some courts have refused to go beyond the doctrine of abstention, arguing against any assessment of the merits of a decision.[24] Implicit in this approach is the belief that judges are not in the business of business administration, an argument similar to the one made in *Dodge*. In the famous *RJR Nabisco* case, the chancery court best framed the argument against assessing the rationality of the challenged decision: "[t]o recognize in courts a residual power to review the substance of business decisions for 'fairness' or 'reasonableness' or 'rationality' where those decisions are made by truly disinterested directors in good faith and with appropriate care is to make courts super-directors."[25]

. . . another way to analyze Disney is to infer that the court was disturbed by the lack of process . . . in agreeing to the severance package and then the irrationality in not attempting to dismiss Ovitz.

On the other hand, other decisions have implied that, absent some legitimate justification underlying the board's decision, the business judgment rule may not apply. In *Sinclair Oil Corp v Levien*, the Delaware Supreme Court held that the business judgment rule applied to a board's decision because the decision had a "rational business purpose."[26] The focus on the decision and its purpose would seem at odds with the analysis of *RJR Nabisco*. Many commentators agree, however, that when the focus is on a rational business purpose for the challenged decisions, courts do not require evidence of a board actually contemplating this purpose.[27] Rather, if a court itself can conceive of any possible business purpose, the standard is met.[28]

Regardless of whether it is easily met, this irrationality standard seems to be an exception to the general rule that a court will only review the procedural aspects of a board's decision. However, in very rare circumstances, courts will use evidence of an irrational decision as a backdoor way of finding the *Aronson* reasonable doubt test has been met. A decision that serves no plausible legitimate purpose suggests procedural misconduct or bad faith. The decision by the chancery court in *In re JP Stevens & Co Shareholders Litig* serves as an example of a court using an irrational decision itself to infer the bad-faith element in the *Aronson* test.[29] In that case, the court stated that the business judgment rule does not apply when the decision at issue is "so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith."[30] As Chancellor Allen wrote in *RJR Nabisco*, "such limited substantive review as the rule contemplates (i.e., is the judgment under review 'egregious' or 'irrational' or clause, would certainly be 'so beyond reason,' etc.) really is a way of inferring bad faith."

Professor Stephen Bainbridge of UCLA School of Law has theorized that the chancery court is doing exactly this in *Disney*: using evidence of an exorbitant severance obligation, which gave no conceivable benefit to shareholders, to infer bad faith on the part of directors. However, a true rationality standard, applied as contemplated in Levien, might not explain the court's decision to excuse demand. The court could easily have determined that the board's acquiescence to the $140 million severance obligation was related to some rational business purpose. First, Ovitz was making over $30 million each year at Creative Artists Agency, the business he had founded; thus, Disney had to make it worth his while to switch. To accomplish this, Disney had to offer security—in the form of immense collateral—to induce the transfer. Second, Ovitz presumably wished to build in a very strong disincentive for the board to dismiss him without cause, and the board, at the front end, should have been legitimately motivated to give him strong assurances that he would not be whimsically dismissed without cause. Without knowing how it all played out, a board decision to give a $140 million severance in the event of dismissal without cause might not have seemed irrational. It was not as if the board saddled the company with such a severance in the event of dismissal with cause.

Accepted at face value, the reasoning in *Disney III* suggests that the facts alleging procedural flaws of the Disney board decision (the directors' lack of attempt to inform themselves) are what led to demand excusal. However, another way to analyze *Disney* is to infer that the court was disturbed by the lack of process the board showed in agreeing to the severance package and then the irrationality in not attempting to dismiss Ovitz for cause once the company decided to fire him. In truth, neither the court nor commentators

have explicitly devoted analysis to the differences between the board's conduct when Disney hired Ovitz and its conduct when Disney fired him.

There are two separate business judgments that the Disney board made—resulting in different outcomes under a rationality test. The first judgment, involving the approval of the severance package and its non-fault termination clause, would certainly be upheld under a traditional rationality standard. The second judgment, the classification of Ovitz's firing as a non-fault termination, might not survive the rationality standard. According to Eisner and several other Disney executives, Ovitz was a truly incompetent and wasteful employee. Ovitz threw lavish parties, tried to secretly negotiate a deal to leave Disney for a competitor, and frequently deceived his co-workers and Disney's business partners. The classification of Ovitz's termination as non-fault—especially without any further examination or attempt to negotiate—may have led the court to decide that the board's decision was simply irrational.

In all likelihood, the court likely considered a combination of procedural and substantive factors in making its determination. In the end, the size of the package and the possibility of an irrational business decision likely represented a red flag that led the chancery court to exercise closer scrutiny of the procedural aspects of the board's decision.

Application of the Business Judgment Rule

What do the *Disney* rulings mean for the application of the business judgment rule? First, courts may be increasingly willing to evaluate the substantive merits of a business decision to infer bad faith. However, a trend of more stringent judicial review may be emerging in a more specific arena of compensation committees. As Chancellor Chandler noted with candor, "the sheer size of the payout to Ovitz, as alleged, pushes the envelope of judicial respect for the business judgment of directors in making compensation decisions."[36]

Disney demonstrates the role of courts in protecting expectancy and predictability for investors and directors. This is a common theme in corporate law generally.[37] On the one hand, courts want to ensure that directors have the utmost confidence that when they make a business decision, as long as their conduct meets a set of minimum criteria, they will not be questioned and will not risk personal liability. Shareholders do expect that directors will sometimes make poor business decisions. However, shareholders do not expect directors to ignore their duties completely, and neither should directors.

. . . courts may be increasingly willing to evaluate the substantive merits of a business decision to infer bad faith.

NOTES

1. 204 Mich 459, 500, 170 NW668 (1919).
2. *Id.* at 508.
3. 473 A2d 805 (Del 1984), *overruled in part by Brehm v Eisner,* 746 A2d 244 (Del 2000).
4. 473 A2d at 810. The language in *Aronson* seems to require that both prongs be met. However, the Delaware Supreme Court has established that the "and" in *Aronson* actually requires that only one prong be met. *See Levine v Smith*, 591 A2d 194, 205 (Del 1991), *overruled in part on other grounds by Brehm*.
5. 473 A2d at 812.
6. *See Brehm*, 746 A2d at 249.
7. *Id*. at 250.
8. *See* Joseph Bachelder, *"Disney": Severance and the Business Judgment Rule*, NYLJ Jan 29, 1998.
9. *See* Kim Masters, *Deposed: The Strange Hiring and Firing of Michael Ovitz*, *at* slate.msn.com/id/2105223 (posted Aug. 16, 2004). The severance package included the vesting of options to three million shares, a $10 million special bonus (which Ovitz would receive with a termination before September 30, 2000), and $7.5 million multiplied by the number of years remaining on his contract.
10. *Id.*
11. *Id.*
12. *Id.*
13. *In re Walt Disney Co Derivative Litig*, 825 A2d 275 (Del Ch 2003).
14. *Id*. at 289.
15. See note 4.
16. *In re Walt Disney Co Derivative Litig*, 731 A2d 342, 350 (Del Ch 1998), *aff'd in part and rev'd in part, remanded sub nom Brehm*.
17. *See Williams v Geier*, 671 A2d 1368, 1337 (Del 1996). The court noted that, when there is no coercive action on the part of a director, courts will not analyze the reasonableness of a business decision.
18. 825 AD at 288–289.
19. *Id.* at 289.
20. *Id.* at 287.
21. *Id.* at 289.
22. *See Chesapeake Corp v Shore*, 771 A2d 293, 330 (Del Ch 2000).
23. *See Litwin v Allen*, 25 NYS2d 667, 699 (Sup Ct 1940). The court held a bank's directors liable even with no evidence of procedural misconduct. "[T]he entire arrangement was so improvident, so risky, so unusual and unnecessary as to be contrary to fundamental conceptions of prudent banking practice." *Id.*
24. *See Pollitz v Wabas RR Co*, 207 NY113.120, 100 NE 721 (1912). The court articulates an inflexible prohibition of evaluation of business decisions but does not explicitly contemplate a highly irrational decision. "Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to their honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be ques-

tioned, although the results show that what they did was unwise or inexpedient." *Id.*

25. *See, e.g., In re RJR Nabisco, Inc Shareholders Litig*, 1989 Del Ch LEXIS 9, at *41 n13, Fed Sec L Rep (CCH), 94,194 (Del Ch Jan 31, 1989); *see also In re Caremark Int'l,* 698 A2d 959, 967 (Del Ch 1996) ("Whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational', provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests. To employ a different rule—one that permitted an 'objective' evaluation of the decision—would expose directors to substantive second guessing by ill equipped judges or juries, which would, in the long-run, be injurious to investor interests")(emphasis omitted).

26. 280 A2d 717, 720 (De1 1971).

27. *See* Michael P. Dooley, *Two Models of Corporate Governance*, 47 Bus Law 461,478–479 n58 (1992).

28. *Id.*

29. 542 A2d 770, 780 n81 (Del Ch), *later proceeding*, 540 A2d 1089 (Del 1988).

30. 542 A2d at 780 m81; *see also Parnes v Ball Entm't Corp*, 722 A2d 1243, 1246 (De1 1999).

31. *See RJR Nabisco*, 1989 Del Ch LEXIS 9 at 41 n13.

32. Stephen Bainbridge, *Substantive Due Care and the Business Judgment Rule* in *Corporate Fiduciary Duty Law, at* http://www.professorbainbridge.com/2003/11/substantive_due.htm(Nov29, 2003).

33. Masters, *supra* note 9.

34. "The depositions amplify what was obvious from the start: In terms of temperament and experience, Ovitz could not have been more ill-suited to the job. He had no idea what it meant to act as a director of a publicly held company or how to function within the confines of one." Masters, *supra* note 11.

35. *Id.*

36. *See Brehm*, 746 A2d at 249.

37. The expectations of the parties play an important role in general joint venture and partnership law (see *Meinhard v Salmon*, 249 NY 458 (1928), where courts analyzed whether parties could reasonably expect to be made privy to opportunities arising from a partnership), partnership dissolution law (see *Page v Page*, 55 Cal 2d 192, 10 Cal Rptr 643, 359 P2d 41 (1961), where the expectation of the parties, in the absence of contractual terms, determines the nature of the partnership's duration), and corporate opportunity doctrine (see *Broz v Cellular Info Sys*, 673 A2d 148 (Del 1996), where courts analyze whether a company has a reasonable expectancy to a new opportunity), among others.

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Choice of Entity: Frequently Asked Questions

by Aaron J. Veldheer

It's been said in the split second before a perilous experience, "My life flashed before my eyes." To help your client choose the right business entity, you will need the entire life of the business venture to "flash before your eyes." This is difficult because, although the business idea is conceived, the entity hasn't been born yet. Still, you must address the countless paths a business venture can take before choosing the type of entity suited to that venture.

To choose the right entity, you'll have to ask your client the right questions. And you'll need to answer his or her questions. This article compares corporations, limited liability companies (LLCs), partnerships, and the various forms of those entities in a "frequently asked questions" format. Your client may ask you some of these questions, but those that aren't asked should also be addressed with your client.

What are "traditional business factors" in choosing an entity? Traditional business factors are the nontax reasons to choose one entity over another.

Limiting Liability

Is any one traditional business factor more important than the others? Yes, in most cases limiting liability is the most important business factor used to determine the right entity.

Okay, but what liabilities does a limited liability entity limit? A limited liability entity generally protects its owner's personal assets from the creditors of the entity.

So why discuss the traditional business factors as they apply to full and partial liability entities? Because many businesses are currently full or partial liability entities, and you may need to explain to the owners the need to convert to a limited liability entity. Or because full liability entities have a longstanding tradition, and your client has already determined a general partnership is the right choice. In these situations, you will need to explain to him or her the liability associated with a general partnership. Finally, to understand the advantages of a limited liability entity, you should have a general understanding of how a full liability entity works.

Corporations (C corporations and S corporations) and LLCs (member-managed and manager-managed) are limited liability entities. Their owners are generally not personally liable to creditors for the debts and obligations of the entity. In other words, the owners are only liable to the extent of their investment.[1] It makes sense, then, that shareholders may be liable to creditors for (1) unpaid capital contributions that they have agreed to make and (2) for wrongful distributions if the corporation fails to pay its creditors. A shareholder may also be liable to creditors personally if the corporation was not properly formed or the veil of limited liability is pierced. Michigan courts may *pierce the corporate veil* (disregard the corporate entity) when shareholders have used the corporation to commit fraudulent or illegal acts or when the corporate formalities are not complied with.[2]

Likewise, LLC members are typically only liable to the extent of their investment. However, greater member liability to company creditors can be created in the operating agreement. Further, while Michigan courts have not yet pierced the limited liability veil of an LLC, it is likely that corporate veil-piercing principles will apply. In addition, since the LLC has become an option in Michigan, many partnerships have converted to LLCs. Under MCL 450.4707 and MCL 450.4705, all liabilities of the converting general or limited partnership continue as liabilities of the LLC and its owners.

On the other end of the owner's liability spectrum is the general partner. General partners in a general or limited partnership are jointly and severally liable for all obligations arising out of a partner's wrongful acts or breach of trust. For all other obligations of the general or limited partnership, general partners are jointly liable.

A limited partner's liability falls somewhere in the middle. It is generally restricted to the limited partner's capital contribution.

This rule does not apply, though, if (1) a limited partner is also a general partner; (2) the limited partner's name is used in the name of the partnership; or (3) the limited partner participates in the management of the partnership in a substantially similar manner as a general partner.

Limited liability seems like a no-brainer, so what's the catch? In practice, a limited liability entity may not limit an owner's liability at all. In small businesses, creditors may require shareholders, members, and partners to personally guarantee the entity's obligations. This personal contract liability increases the owner's financial exposure. Further, individual owners remain responsible for their own negligence, even if acting on behalf of the entity. Realistically, a limited liability entity may not provide much protection from tort liability to an active owner participating in high-risk activities.

In practice, a limited liability entity may not limit an owner's liability at all. In small businesses, creditors may require shareholders, members, and partners to personally guarantee the entity's obligations.

What if an owner's concern does not involve protecting personal assets from entity liabilities but instead involves protecting the entity assets from the owner's unrelated liabilities? In other words, can an owner protect an asset from creditors by owning it through an entity? In LLCs and partnerships, after obtaining a judgment against a member or partner, the creditor may not force a liquidation of the interest, exercise voting rights of the debtor, control management of the entity, or force distributions. A creditor may generally only receive distributions that would have otherwise gone to the owner.

If a creditor attaches an LLC membership interest, the creditor is generally not allowed to vote the membership interest. However, a creditor may force a liquidation of the membership interest if the LLC operating agreement allows liquidation of a membership interest by withdrawal. Even if no operating agreement exists, specific sections of the LLC and partnership statutes limit the creditor's rights to a "charge order," giving the creditor only whatever distributions would otherwise have gone to the owner.[3]

In corporations, however, after attaching corporate shares, the creditor may also vote the shares. This may be significant depending on the corporate voting structure and percentage of votes acquired.

Management and Ownership Issues

What are the other business factors? The other business considerations that factor into a choice of entity decision can be very important, depending on the venture. In any case, before forming an entity, an owner should know the rules that apply to obligations among owners, entity decision-making authority and ability to bind the entity, voting, capital and equity, changes in owners, and the number and types of owners.

Obligations Among Owners

If limited liability means protection from personal liability to the entity's creditors, does that mean an owner may still be liable to other parties as a result of entity ownership? Yes. The first section of this article discusses how limited liability entities protect owners from an entity's obligations to third parties. But owners and managers have certain duties and obligations that can create liability to the entity and to other owners, regardless of the protection afforded from creditors.

An owner's duties will depend, in some respects, on the type of entity. Yet duties to the entity and other owners cross over entity lines. Specifically, corporate shareholders, members in a manager-managed LLC, and limited partners will only be liable to the entity for payment of the price of their investment and for wrongful distributions paid to them when they knew the distribution was wrongful. Further, these owners generally owe no fiduciary duties to each other.

This changes if those owners have enough votes to control decisions. For example, controlling shareholders owe a duty to the entity and the minority shareholders. A controlling shareholder may be liable for minority shareholder oppression if those duties are not upheld.[4] The same goes for members in a manager-managed LLC. Another exception applies to limited partnerships. In a limited partnership, limited partners will be liable to the partnership and the other partners if they have participated in management and are deemed to be general partners.

In contrast, members in a member-managed LLC and general partners in a general or limited partnership generally have a fiduciary duty to the entity and to each other. Similarly, corporate directors and LLC managers, regardless of whether they are also

owners, owe fiduciary duties of care and loyalty to the entity and owners.

May the owners limit the liability of directors and managers to the entity and other owners? Yes. The owners of the corporation or LLC may agree to limit the liability of the directors and managers. But owners may not eliminate liability for certain wrongful actions.[5] Further, limitations on liability will not apply retroactively for conduct that occurs before liability is limited by amendments to the articles of incorporation or articles of organization.

Management

If director liability to the entity and owners is not contingent on ownership, what is it related to? Management and decision making. Corporations are generally managed by a board of directors who are elected by the shareholders. After being elected, the directors select the officers who are in charge of corporate operations.

Being a shareholder is not a prerequisite to sitting on the board. A closely held corporation's board, however, typically consists of those shareholders who are active in the everyday business of the corporation.

Shareholders may, however, eliminate the board of directors and participate directly in the management if certain Section 488 requirements are observed.[6] If the shareholders do not enter into a Section 488 agreement, the shareholders will retain some decision-making authority. By statute, certain actions can only be taken by shareholders, including dissolution, certain amendments to the articles, director elections, mergers, and sale of substantially all the corporation's assets.[7]

Who manages an LLC? A partnership? An LLC is managed by its members (member-managed) unless the articles of organization provide that the LLC is managed by managers (manager-managed).[8] In a member-managed LLC, all members have the authority to make management decisions and to act as agents for the LLC. Unlike partners, members are allowed to participate in management without losing their limited liability protection.

In a manager-managed LLC, however, members are not agents of the entity and vote on only specified major decisions, dissolution, merger, and amendments to the articles of organization.[9] Instead, managers make the ordinary business decisions and have the authority to act as agents of the LLC. Still, the following actions may be authorized only by members and not by the managers, unless the operating agreement provides otherwise: (1) the transfer of substantially all the assets of the LLC other than in the ordinary course of business and (2) transactions involving conflicts of interest with managers.[10] Conflict of interest transactions must be authorized in the operating agreement in advance.

In a general partnership, a majority of partners may make most decisions. Some decisions require unanimous consent unless a written agreement provides otherwise.[11] In a limited partnership, certain specific actions may be taken by limited partners without losing their protection from personal liability.[12]

Voting

These major decisions that only the owners may make, how do the owners make them? How are votes distributed among owners, and what percentage of the votes is necessary to take action? In a corporation, voting is generally based on the number of shares owned by a shareholder. The default rule entitles each shareholder to one vote per share.[13] The default rule may be altered. For example, shares may be classed as nonvoting, voting, or voting preferred. In addition, a corporation may elect to have a cumulative voting system, giving minority shareholders a greater impact on the election of directors and officers.[14] And just as a Section 488 agreement can provide greater flexibility in management structure, it can provide flexibility in voting distribution. For instance, a Section 488 agreement can provide for weighted voting.

In contrast, under the LLC statute, each member has one vote regardless of his or her capital contribution and ownership interest.[15] Voting rights may be, and normally are, modified in the operating agreement to reflect the percentage of sharing interest of the members' capital contributions. While LLC action is normally approved by majority vote, operating agreements may provide that certain major decisions require supermajority or unanimous vote.

Capital Structure

Regarding the other (nonvoting) rights and privileges of owners, may certain owners get preferential treatment over others? Yes, in some cases more than others. In a C corporation, the

By statute, certain actions can only be taken by shareholders, including dissolution, certain amendments to the articles, director elections, mergers, and sale of substantially all the corporation's assets.

shareholders may create different classes of stock that provide preferential treatment to certain shareholders over the rights of other shareholders. Just as classes of stock may grant unequal voting rights, stock may be separated into classes for dividends or preferences on dissolution or sale. Again, a Section 488 agreement can provide even more options to corporate shareholders structuring their equity investment.

All the options of a Section 488 agreement are not available to S corporation shareholders. Under the Internal Revenue Code, S corporations may have only one class of shares.[16] This limits the flexibility of profit allocations and other corporate arrangement and ownership decisions.

LLCs, on the other hand, may have more than one class of membership interest. The operating agreement may provide for different classes of membership interest that grant disproportionate distributions and preferred returns.

In a general or limited partnership, all partners share in partnership profits and losses equally, unless provided for in an agreement. Like an LLC operating agreement, the certificate of partnership or partnership agreement may provide for disproportionate distributions and preferred returns.

[T]o ensure the entity will have the right to expel an owner, expulsion rights must be provided for in an agreement that is enforceable against each of the owners.

Changes in Owners

Once an owner is in, how does the owner get out? An owner could be expelled, retire, withdraw, or transfer his or her ownership interests.

The Michigan statutes do not specifically address the expulsion of owners.[17] Therefore, to ensure the entity will have the right to expel an owner, expulsion rights must be provided for in an agreement that is enforceable against each of the owners.

Withdrawal, however, is specifically addressed by Michigan statutes. Under Michigan law, general partnerships are dissolved by any partner ceasing to be associated with the carrying on of the partnership business.[18] Unless the remaining owners decide to continue the business, the entity's business must also be liquidated. In the same way, a general partner's withdrawal from a limited partnership causes dissolution, unless there is another general partner.[19]

A limited partner, however, may not withdraw until the time or on the happening of events specified in the certificate of limited partnership. If the certificate does not specify a time or an event, a limited partner may withdraw six months after written notice to each general partner.[20] On withdrawal, a limited partner is only entitled to receive any distribution to which he or she is entitled under the partnership agreement.[21] In corporations, shareholders have no inherent right to withdraw from their ownership by forcing the corporation or other shareholders to buy them out. These matters are handled by shareholder agreement or article provisions.

In LLCs, before the July 1997 amendments, a member's death, withdrawal, etc., caused dissolution. The 1997 amendments deleted this provision. Operating agreements drafted before the 1997 amendments may still provide for dissolution on the occurrence of these events. Like limited partners, a member may withdraw only as provided in the operating agreement.[22]

But I can always voluntarily transfer my ownership interest, right? No. Although the default rules provide that owners may transfer their interests, transfers are often restricted by agreement. And even when transfer is allowed, the transferee may not receive all the rights associated with the ownership interest of the transferor.

A corporation is the only entity in Michigan that allows a shareholder to transfer all of his or her rights as a shareholder without consent of the owners. In cases in which a venture's success depends on the ability of all owners to work closely together, owners will want to put restrictions on the transfer of shares. A shareholders agreement, or buy-sell agreement, is a private agreement used to impose transfer restrictions.

The LLC provides the owners with a few options. First, the owners may restrict a member's voluntary transfer in the operating agreement. Common restrictions include granting rights of first refusal to the company or the remaining owners on good faith offers to buy membership interests. If the operating agreement does not restrict transfer rights, the second option and default rule is that an LLC member may freely assign his or her ownership interest.[23] However, the assignment transfers only the right to receive distributions and profits. The other members entitled to vote must unanimously approve a transferee's participation in management or other member rights. Regardless of whether the other members do so, a transferor mem-

ber ceases to be a member on assignment of all his or her membership interest.[24] A third option is to provide free transfer of membership interests in the operating agreement, which, like the default rule for shareholders, allows a transferee to step into the shoes of the former member.

Like the LLC default rule, the transfer of ownership default rule in partnerships is that, unless the other partners unanimously admit an assignee as a general or limited partner, an assignee may only share in the partnership's profits. The default rule restricts transferability in a general partnership because each partner may bind the partnership and subject the other partners to personal liability. These restrictions on a limited partner assignee are less important because a limited partner may not participate in management.

Is transferring an owner's interest the only way to admit a new member? No. In a corporation, the board of directors may decide to sell shares to add a new owner without permission from existing shareholders absent agreement to the contrary.[25]

In contrast to the corporate rules, no person may become a member of a partnership without the unanimous consent of the existing partners, absent an agreement to the contrary. Likewise, a person may acquire a membership interest from an LLC only with unanimous consent of the members, unless the operating agreement provides otherwise.

Number and Types of Owners

Is it possible to admit too many owners? Is there a minimum number of owners requirement? Are there restrictions on the qualifications of owners? C corporations and LLCs have no minimum or maximum number of shareholders or owners. Partnerships must have two partners, and in the case of a limited partnership, one of the partners must be a general partner and one of the partners must be a limited partner. S corporations have strict limitations on the type and number of owners. For taxable years after December 31, 2004, S corporations may have no more than 100 shareholders. In addition, each shareholder must meet specific requirements. For example, neither an LLC nor certain types of corporations may be an owner of an S corporation. So if an LLC is admitted as an S corporation owner, the S corporation will lose its S status and by default become a C corporation.

Note that effective January 1, 2005, for purposes of determining the number of S corporation shareholders, all "members of the family" will be treated as one shareholder. *Members of the family* means any common ancestor, lineal descendants of the common ancestor, and the spouses (or former spouses) of lineal descendants or common ancestors.[26] Therefore, the number of actual shareholders of an S-corporation may exceed 100, as long as certain shareholders are members of the (same) family.

Formalities and Flexibility

Do the rules have rules? The corporate laws are specific about a variety of issues surrounding actions by shareholders and directors. Timing, location, waiver, and notice of both shareholder and director meetings are addressed in the Michigan Business Corporation Act (BCA). The BCA requires many other corporate formalities that make this choice of entity the least flexible.

As mentioned, however, Section 488 provides that an agreement among the shareholders may limit and even eliminate many of the corporate formalities. Section 488 agreements provide for director proxies, elimination of the board of directors, shareholder management and authority, disproportionate distributions, and any other matters relating to corporate powers or management that are not contrary to public policy. The terms of a valid Section 488 agreement will govern, even if they are inconsistent with the default provisions of the BCA. A Section 488 agreement may only be amended by all persons who are shareholders at the time of the amendment, unless the agreement itself provides otherwise. Further, the flexibility provided corporations under Section 488 may be restricted by tax considerations under the Internal Revenue Code. This is particularly true for S corporations.

In contrast to the corporate default rules, partnership and LLC statutes include few specific rules. While this makes partnerships and LLCs attractive choices, the flexibility of these entities can create problems for their owners. The owners should keep certain formalities, such as separate accounts for the LLC or partnership. If creditors of the LLC and partnership can find evidence of commingled funds, the owners may be liable to the creditors under a *piercing the veil* claim.

Note that effective January 1, 2005, for purposes of determining the number of S corporation shareholders, all "members of the family" will be treated as one shareholder.

In addition, for owners who form a business with a view to being acquired or making a public offering, the LLC's flexibility might not be a good thing. Instead, investors, whether involved in an Initial Public Offering or acquisition, may believe that buying corporate shares is a less risky investment because of corporate formalities.

Mechanics of Creation

Now that I've chosen an entity, how do I set it up? Corporation (C and S) incorporators must file articles of incorporation that include certain information about the company and its incorporators, such as

- the corporate name;
- the purposes for which the corporation is formed;
- the number of authorized shares;
- information about share classes or series, if the shares are to be divided into classes or series;
- the name of the resident agent and address of the registered office;
- the name and address of each incorporator; and
- the duration of the corporation if other than perpetual.[27]

The incorporators can then adopt bylaws and appoint the first directors, who in turn may admit the initial shareholders of the corporation. Failure to comply with the legal formalities of incorporation can result in the failure to recognize the existence of the corporation as a legal entity (and loss of limited liability for its owners).

To form an S corporation, the shareholders must elect S corporation status. Assuming the eligibility requirements are met and all the owners consent to the election, the election will be effective as of the beginning of the taxable year if it is made during the preceding taxable year or if it is made on or before the 15th day of the third month of the current taxable year.[28]

To form an LLC, one or more persons must sign the original articles of organization as organizer(s).[29] To be filed, the articles of organization must include

- the name of the LLC;
- the purpose for which the LLC is formed (it may engage in any activity for which LLCs may be formed under the Michigan Limited Liability Company Act);
- the address of its registered agent;
- the maximum duration of the LLC, if other than perpetual; and
- a statement that the LLC is to be managed by managers, if the owners intend it to be manager-managed.[30]

The members may also enter into an operating agreement that sets forth the members' rights and duties. In Michigan, when a provision of the articles of organization conflicts with a provision in the operating agreement, the articles control.

Formation of a general partnership requires no filing with the state. A certificate must be filed with the county where the partnership does business, but this is not a prerequisite to the creation of a partnership. In fact, a partnership may be created without any writing whatsoever. As long as two or more individuals consent to the formation of a partnership, a partnership is created. Notwithstanding the absence of an agreement, the owners will have unlimited liability for the debts of the partnership.[31] A general partnership can also be formed when two or more individuals execute a written partnership agreement. The agreement governs the relationship of the partners, including managerial rights, distribution rights, interests in profits and losses, and rights on dissolution of the partnership.

As long as two or more individuals consent to the formation of a partnership, a partnership is created. Notwithstanding the absence of an agreement, the owners will have unlimited liability for the debts of the partnership.

Formation of a limited partnership requires filing a certificate with the state that sets forth the rights and duties of the partners and identifies the general partners. Typically, the general and limited partners also execute a written partnership agreement. If new general partners are added, amended filings are required.

Conclusion: The Birth of a Business

Because the form of the entity will impact many issues arising throughout the life of the entity, choosing the right entity is critical to the success of the business venture. While it may seem irrelevant at such an early stage, even how your client will one day sell his or her ownership interest depends on the choice of entity. By addressing the traditional business factors, in combination with the important tax factors, your client can create the entity best suited to the business venture. And while this will not prevent every pitfall during the entity's life, it will put your client

in a position to deal with problems that arise along the way.

NOTES

1. MCL 450.1317, .4501.
2. *Gottlieb v Arrow Door Co*, 364 Mich 450, 110 NW2d 767 (1961); *Bernard F Hoste v Kortz*, 117 Mich App 448, 324 NW2d 46 (1981).
3. *See* MCL 450.4507.
4. MCL 450.1489.
5. MCL 450.1209.
6. MCL 450.1488.
7. MCL 450.1505, .1611, .1703, .1736, .1751, .1753, and .1804.
8. MCL 450.4401.
9. MCL 450.4502(3).
10. MCL 450.4502(4)–(5).
11. MCL 449.9, 10, 18.
12. *See* MCL 449.1303(b).
13. MCL 450.1441.
14. MCL 450.1451.
15. MCL 450.4502.
16. IRC 1361(b)(1)(D).
17. But see MCL 450.4509(2), which states that an operating agreement "may provide" for expulsion.
18. MCL 449.29, .31.
19. MCL 449.1801.
20. MCL 449.1602.
21. MCL 449.1604.
22. MCL 450.4509.
23. MCL 450.4505.
24. MCL 450.4505, .4506(1).
25. MCL 450.1301, .1488.
26. IRC 1361(c)(1)(B)(i).
27. MCL 450.1202.
28. IRC 1362(b)(1).
29. MCL 450.4103(1).
30. MCL 450.4203(1)(d).
31. *Bush v Halle*, 197 Mich 85, 163 NW 875 (1917).

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By addressing the traditional business factors, in combination with the important tax factors, your client can create the entity best suited to the business venture.

What's Happening in Michigan Early-Stage Venture Capital Markets

By Timothy R. Damschroder

Introduction

In the broadest sense, venture capital transactions include a wide variety of corporate finance arrangements. This article discusses the state of fund-raising markets in Michigan for business start-ups and early-stage companies.[1] While a large number of such enterprises are based on information technology,[2] the financing arrangements discussed in this article apply across the board to all types of business endeavors. This article focuses on the scope and nature of the start-up and early-stage Michigan capital markets, including the typical terms under which transactions are financed, segregated into four distinguishing types: (1) funding sourced from a venture capital fund, (2) funding sourced from one or more angel investors, (3) equity-based transactions, and (4) debt-based transactions. These four different approaches are often intertwined over the life of the enterprise or, at times, combined into the same financing transaction or series of transactions.

Venture capital funds, are, for the most part, limited partnerships (some funds have begun using limited liability companies) managed by a general partner experienced in the venture capital industry and owned by one or more limited partner investors. Angel investors are simply individuals with an appetite for investment in start-up and early-stage companies.

Equity-based transactions involve the sale and purchase of common or preferred stock of the issuing entity. Debt-based transactions generally consist of a secured loan with a warrant to purchase shares in the debtor.

The venture capital industry is full of colloquialisms such as *full ratchet*, *archangel*, *down round*, *follow-on investment*, *clawback*, and *premoney* and *postmoney* valuations. A few of these terms are identified and described in this article.[3]

Venture Capital Funds

Venture capital funds are limited partnerships or limited liability companies that have been established by one or more persons with some level of experience in the venture capital industry. The governing documents for the fund usually limit the type of portfolio companies into which the fund may invest to those in specified industries or, at times, a specified group of companies. A venture capitalist may also work with a group of investors in setting up a series of special purpose funds with the sole purpose of investing into one stated company. Accordingly, behind the operating name of each venture capital fund usually lie a series of limited partnerships or limited liability companies through which the investments are actually made.

Exhibit 1 sets forth a list of Michigan-based venture capital funds. Michigan start-ups and early-stage companies also often receive funding from venture capital funds located outside the state. Exhibit 2 is a list of Michigan-based venture capital funded transactions that were reported during calendar year 2004 and the second calendar quarter of 2005.

Exhibit 3 includes graphs showing total venture capital dollars invested into portfolio companies in the United States and in Michigan by year. These charts show that the total venture capital market in Michigan is fairly small compared to that of the entire United States (especially when analyzed against Michigan's annual gross state product figures).

Participants in Michigan venture capital markets have worked long and hard to increase the state's available venture capital. Several recent efforts have been initiated to assist with this growth. One such effort is the creation of the Venture Michigan Fund in January 2004 by the Michigan Legislature as a nonprofit, tax-exempt organization that will act as a "fund of funds." This means that the Venture Michigan Fund will invest in other venture capital funds that have a substantial presence in Michigan. The hope is to create new funds with a Michigan presence or increase the size of current funds.

The Venture Michigan Fund's stated goal is to promote at least two dollars of investment in Michigan businesses for every one dollar of investment into the fund. On April 18, 2005, the Venture Michigan Fund announced that Credit Suisse First Boston

will act as the manager of the fund. Capital is to be raised for the Venture Michigan Fund by providing tax credits that will guarantee investments made into the fund in case the fund is not able to return the amount invested. So as to not limit their own capital-raising efforts, venture capital funds receiving investments from the Venture Michigan Fund are not required to invest those funds in portfolio companies located in Michigan. However, the Venture Michigan Fund will require each venture fund to use its best efforts to invest in Michigan-based companies.

Angel Investors

As noted above, angel investors are individuals who have a special interest or desire to invest in start-up and early-stage companies. There is a loose network of experienced angel investors in Michigan who will often work together to provide funding for an enterprise. Or an angel investor may be a friend, family member, or business acquaintance who has agreed to put funding into the enterprise. Many angels are experienced in the industry to which the enterprise relates (i.e., automotive executives investing in an automotive supply company, or a successful software entrepreneur looking to participate in other technology-sector opportunities).

A lead angel investor is often called an *archangel* or an *angel aggregator*. The angel aggregator performs the useful functions of identifying prospective early-stage companies, conducting due diligence, creating investor disclosure information (such as a private placement memorandum), bringing additional angel investors to the table, negotiating the terms of the investment, and working with a law firm to prepare the documents for the transaction and to negotiate those documents to a closing.

The terms of angel investments are varied and can consist of anything from simple unsecured debt or issuance of common stock to completing a preferred share issuance containing the same (or at times, even more favorable) terms as those found in a typical venture capital transaction.

Entrepreneurs seeking to obtain angel investment should concentrate their efforts on finding one or two lead investors, ideally experienced in their industry, who have connections to a network of other angel investors. Many angel investors will wait to see if a well-known angel has signed on to the round before agreeing to make an investment. Once one or more well-known angels have agreed to make an investment, more often than not, the round ends up being fully funded (and perhaps angels are turned away).

One successful Michigan entrepreneur, Dwight Carlson, has devised an innovative form of angel financing working with the Bank of Ann Arbor. Called a Michigan Innovation CD, an enterprise seeking funding will enter into a three-party arrangement with a bank and the investors. Under this arrangement, the bank will sell certificates of deposit (CDs) to the investors and the CDs will be used as collateral for a loan by the bank to the enterprise. The company pays interest only on the loan during the term of the loan (suggested to be five years). The investors receive:

- typical quarterly interest payments on the CDs from the bank over the life of the CDs,
- quarterly interest payments directly from the enterprise, and
- a warrant to purchase shares of the enterprise exercisable anytime up to termination of the Michigan Innovation CD at a fixed exercise price.

Thus, the investors will begin receiving a return on their investment immediately instead of waiting for a liquidation event (e.g., 4 percent from the bank CD plus 4 percent from the enterprise). If the company is unable to pay the loan at the end of the term, the investors will lose their CDs. However, the investors could obtain an assignment of the security interest from the bank on any foreclosure by the bank. Alternatively, while it may seem harsh, allowing the unsuccessful companies to collapse at the end of the initial term of the loan may prevent a situation in which the company continues to operate on a marginal basis year after year, without any return to the investors or any way for the investors to write off the investment.

Equity-Based Financing

In General

Equity-based venture transactions, whether completed by a venture capital fund or by angel investors, can consist of anything as simple as issuance of common stock to issu-

Entrepreneurs seeking to obtain angel investment should concentrate their efforts on finding one or two lead investors, ideally experienced in their industry . . .

ance of preferred shares with detailed and very proinvestor rights, preferences, and privileges. In any event, the issuing entity must comply with applicable federal and state securities laws, the analysis of which is beyond the scope of this article. Exhibit 4 is a basic term sheet for a private placement of series A preferred shares that outlines the basic rights, preferences, and privileges that are typically given to investors in a series A preferred round. Other than the preferred dividend and liquidation preference granted to the series A preferred shares, most of these terms can be included in a funding round involving an issuance of common shares. Equity investment rounds are usually completed under a stock purchase agreement that includes typical representations and warranties similar to those found in a merger or acquisition transaction.

If the issuing entity has already completed a series A round, typically a follow-on round will then involve either the issuance of additional series A shares (hopefully at a higher per share purchase price) or the issuance of series B shares, with rights, preferences, and privileges superior to those granted to the series A shareholders.

Discussed below are a few of the typical provisions in a series A round, each of which are included in the term sheet attached as exhibit 4.

Establishing the premoney valuation of the enterprise is often one of the most enlightening experiences that a founder will go through in obtaining early-stage funding.

Valuation

The first task in completing a financing round is to determine the amount that needs to be raised, the minimum investment required, and a premoney valuation of the enterprise. When determining the amount to be raised, conventional wisdom dictates that the parties involved should create a pro forma list of expenses that the enterprise is likely to incur to cause the enterprise to fully complete its next stage of growth. One of the worst things that can happen to an early-stage enterprise is not obtaining enough funding to complete its contemplated stage of growth or spending the raised funds too quickly, causing the enterprise to have to go back to the venture capital market too soon. Accordingly, accurately defining the current scope and stage of the company's growth is essential. The primary goal should be to ensure that the company's value is significantly increased during the period in question. This may mean completion of a prototype, proof of market acceptance by obtaining certain sales levels, reaching a gross revenue target, or, the ultimate goal, becoming profitable.

Establishing the premoney valuation of the enterprise is often one of the most enlightening experiences that a founder will go through in obtaining early-stage funding. Venture capital firms are driven to provide a specified return to their investors, which in turn causes the venture capital firm to analyze the company's business plan with an eye toward the likely return on investment. This likely return on investment is used to establish the premoney valuation (by subtracting the amount to be invested from the likely return). This process can lead to complicated and drawn-out negotiations between the venture capital firm and the entrepreneurs. Notwithstanding this process, in the end, the premoney valuation is most often established by the basic capitalistic tenet of what the willing buyer and the willing seller are able to agree to. Specifically, company founders are often not willing to sell their business idea for too high of an equity percentage given to investors. Based on this author's experience participating in dozens of early-stage funding rounds, founders tend to target a premoney valuation that will yield a 20–40 percent equity position to the investors as long as they are able to use the funds to move the company significantly forward. Founders are not always successful in this goal. Early-stage investors sometimes end up with over 40 percent of the equity of the enterprise and, in some cases, majority control. During the past two years in Michigan, many founders have had to settle for a minority position in the enterprise to obtain any seed funding to see their business idea developed.

Common Shares

Some preferred share rounds will also include common shares issued to the investors at a nominal per share price. This offers a way to increase the value of the round to the investors without the heavy price to the founders of selling the entire round in preferred stock.

Preferences—Dividends and Liquidation Payments

Most preferred rounds include a dividend accrual of between 6 and 15 percent that accumulates for the benefit of the preferred holders, but is not paid until a liquidation event (a merger, sale of substantially all assets, reor-

ganization, or another transaction in which control of the enterprise is transferred, and in some cases an initial public offering). The dividend accrual is generally seen as the first-level return on investment.

In addition to the dividend accrual, preferred holders are given a liquidation preference such that their original investment plus the accrued dividend is paid to them on liquidation before any payments to the common shareholders. In addition, the preferred shares may be given a liquidation multiplier such that they will receive two, three, or four times their original investment, plus the accrued dividend, before any liquidation payments to common shareholders.

Finally, preferred shares are either *participating preferred* or *nonparticipating preferred*. Participating preferred shares participate on a pro rata basis with common shareholders on all liquidation payments made after the preferred payments have been made to the preferred shareholders. Nonparticipating preferred shareholders will only receive their liquidation preference payments (the investor's original investment, any liquidation multiplier, plus accrued dividends). The common shareholders receive all remaining assets on liquidation.

Antidilution

There are two typical types of antidilution protections that are normally included in preferred rounds. The main goal of antidilution protection is to provide the preferred holders with protection against dilution if shares in the issuing company are sold at a later date for a price that is lower than that paid by the preferred holders. If that occurs, there are two methods to protect the preferred holders, both of which result in a lowering of the conversion price that is used to convert the preferred shares to common shares upon a liquidation event or if the company goes public. The first method is commonly referred to as the weighted average method, under which a formula is used to lower the conversion price based on the number of outstanding shares before the new share issuance at the lower price, the number of new shares sold under the lower-price round, and the per share price under the lower-price round. The second method is referred to as the full-ratchet method, in which the conversion price is lowered to the share price offered under the new lower-price round.

Affirmative and Negative Covenants

Preferred holders are normally provided with certain negative and affirmative covenants. The negative covenants usually take the form of voting rights that require a certain percentage of the preferred shareholders' approval for specified transactions, such as large capital expenditures, deviations from annual budgets approved by the board, the issuance of new securities, the issuance of securities having a preference to the preferred shares issued under the current round, and the like. The affirmative covenants usually include rights of inspection and receipt of financial statements and requirements that an audit be performed and that the issuing entity comply with standard business practices such as filing tax returns, paying taxes, obtaining appropriate insurance, and complying with applicable laws.

Registration Rights

Preferred shareholders are also often provided with a variety of rights that apply after the company has completed an initial offering of its shares. These include a right to register the shares held by the preferred holder, a right to force the company to complete an initial public offering, piggyback rights (a right to participate in secondary offerings by the company), and rights aimed toward facilitation of a sale under Rule 144 of the U.S. Securities and Exchange Commission of unregistered shares held by the investor after the company has gone public.

Shares Restrictions

Preferred equity rounds normally include provisions affecting the founders' ownership of their common shares. These provisions include a right of first refusal given to the investors if any founder attempts to sell his or her shares. Perhaps most disturbing to many founders, investors often require the founders to vest into their shares over a four-year period after the investment is first made. If a founder's employment with the company is terminated, the founder will only be entitled to keep the vested shares as of the date of termination. Vesting can occur ratably on a month-by-month basis, ratably on a yearly basis, based on revenue milestones, or any other determinable event or events.

Board of Directors

Investors often require one or more seats on the company's board of directors. Usually

The main goal of antidilution protection is to provide the preferred holders with protection against dilution if shares in the issuing company are sold at a later date for a price that is lower than that paid by the preferred holders.

director positions are grouped into three categories: (1) directors nominated by the common shareholders, (2) directors nominated by the preferred shareholders, and (3) joint directors. The joint directors are usually nominated by mutual agreement of the common directors and preferred directors, by a specified supermajority vote, or by a majority of the common shareholders and the preferred shareholders each voting as a separate class.

Preferred equity rounds normally include provisions affecting the founders' ownership of their common shares. . . . Investors often require one or more seats on the company's board of directors.

Use of Proceeds

The definitive documents will also require the company to limit the use of the investment proceeds to working capital and general corporate purpose (and perhaps other specified items).

Debt-Based Financing

In General

Debt-based financing for a start-up or early-stage enterprise can take many forms, ranging from a simple unsecured promissory note to heavily negotiated note purchase agreements in conjunction with secured convertible debt and additional warrants issued to the investor. Exhibit 5 is a sample term sheet for a debt financing round that includes many of the standard terms for a more formal debt issuance by a start-up or early-stage company. Usually, in more structured debt arrangements, the transaction occurs pursuant to a note purchase agreement, which contains a full set of representations and warranties much like that of a series A preferred round (or any typical merger or acquisition transaction).

Promissory Note and Security

The note purchase agreement will call for secured promissory notes to be issued to each investor with a stated interest rate and maturity date. The investors will enter into an intercreditor agreement to hold the security interest in the company's assets on a pari passu basis among all investors. The intercreditor agreement may also nominate one of the investors as agent for the other investors in case of default.

The promissory note may also be convertible into shares of the company at a stated rate or pursuant to a set formula. The conversion could occur at a set maturity date, liquidation event, election by the investors at any time, election by the board of directors at any time, or some other specified event.

Warrants

Most debt financing rounds will include warrants issued to the investors to purchase company shares at terms that are similar to those described above for convertible debt. It is most common to see warrants treated as additional compensation to the investors over and above other terms of the debt transaction, including interest payments or any provisions calling for conversion of the debt to equity. The three most common exercise prices seen for warrants issued under a debt round include:

- a nominal exercise price,
- an exercise price established pursuant to a current valuation of the enterprise, and
- an exercise price set at the per-share price under the next equity round of investment into the company.

Other Terms

In addition to the above, debt-round financing will often include the nonshare specific terms outlined above for equity round financing, including, without limitation, affirmative and negative covenants, registration rights for shares received on conversion of the notes or exercise of the warrant, limitations on founder equity, board of director control provisions, and the like.

Conclusion

Michigan early-stage venture capital markets are active and full of opportunities. Each transaction brings new twists and turns that make working in this environment very rewarding. It is very exciting to see a new enterprise obtain financing and to assist in negotiations to bring all parties to the table for a successful closing. There is no right or wrong way to complete early-stage financing. This article simply attempts to outline some of the more prevalent methods currently used. Good luck to all investors and all entrepreneurs, and may all your future rounds be up rounds.

NOTES

1. Other types of venture capital markets are not discussed in this article, such as venture capital funding targeted toward more mature companies or funding targeted toward taking a controlling interest in the issuing entity.

2. Information technology being the underlying technology upon which a business enterprise is based, for example, software, pharmaceuticals, medical devices, patented technology, Internet applications, trade secrets, know-how, and the like.

3. To learn the meaning of other venture capital terms, visit either of these Web sites: http://vcexperts.com/vce/library/encyclopedia/glossary.asp or http://www.fundingpost.com/glossary/venture-glossary.asp.

Timothy R. Damschroder is a partner in the Ann Arbor office of Bodman, LLP. He is a business lawyer with a concentration on early-stage enterprises and corporate finance. During 2004, Mr. Damschroder closed over one dozen venture capital and angel investments on behalf of either the issuing entity or the funding group or entity. His corporate finance work includes debt and equity financing (venture capital and angel investments) and derivative transactions including ISDA documentation, master agreements, interest rate swaps, currency swaps and other foreign exchange transactions, and options. Mr. Damschroder is a frequent lecturer for ICLE and a contributor to Michigan Contract Law (ICLE 1998 and supplements). He is also a past chairperson of the Business Law Section of the State Bar of Michigan. He is a member of the International Law and Practice and Business Sections of the American Bar Association. Mr. Damschroder serves on the board of directors of Nonprofit Enterprise at Work and Peace Neighborhood Center, both of Ann Arbor.

Exhibit 1
Michigan-Based Venture Capital Funds

No.	Name	Location	Web Site / Information
1.	Arbor Partners LLC	Ann Arbor	arborpartners.com
2.	Arboretum Ventures	Ann Arbor	arboretumvc.com
3.	Aurora Angels	Petoskey	auroraangels.com
4.	Beringea LLC	Farmington Hills	beringea.com
5.	Center for Venture Capital and Private Equity Finance	Ann Arbor	bus.umich.edu/cvp
6.	Dearborn Capital Corporation	Dearborn	dearborncapitalcorp.com
7.	Detroit Investment Fund	Detroit	detinvfund.com
8.	Detroit Technology Ventures	Bloomfield Hills	
9.	Draper Fisher Jurvetson	Ann Arbor	www.wdc-econdev.com/financials.html
10.	EDF Ventures	Ann Arbor	edfvc.com
11.	Essex Woodlands Health Ventures	Ann Arbor	michigan.craintech.com
12.	Great Lakes Angels	Bloomfield Hills	angel-investor-network.com/Great-Lakes-Angels
13.	MedCap Leasing, LLC	Troy	
14.	North Coast Technology Investors	Ann Arbor	northcoastvc.com
15.	Parr Enterprises, LLC	Rochester Hills	michigan.craintech.com
16.	Ralph Wilson Equity Fund	Grosse Pointe Park	rwequity.com
17.	Sandab Group	Birmingham	sandab.com
18.	Sloan Ventures, LLC	Birmingham	sloanventures.com
19.	Syneptics	Ann Arbor	syneptics.com
20.	Telkite Inc	Gwinn	
21.	The Toxicology Group, LLC	Ann Arbor	npicenter.com/listings
22.	Tullis-Dickerson &Co., Inc.	Ann Arbor	michigan.craintech.com
23.	Waypoint Ventures	Ann Arbor	wpvc.com
24.	White Pines Ventures, LLC	Ann Arbor	whitepines.com
25.	Wind Point Partners	Southfield	hoovers.com/wind-point-partners/--ID__114949--/free-co-factsheet.xhtml

Source for chart: Michigan Economic Development Corporation

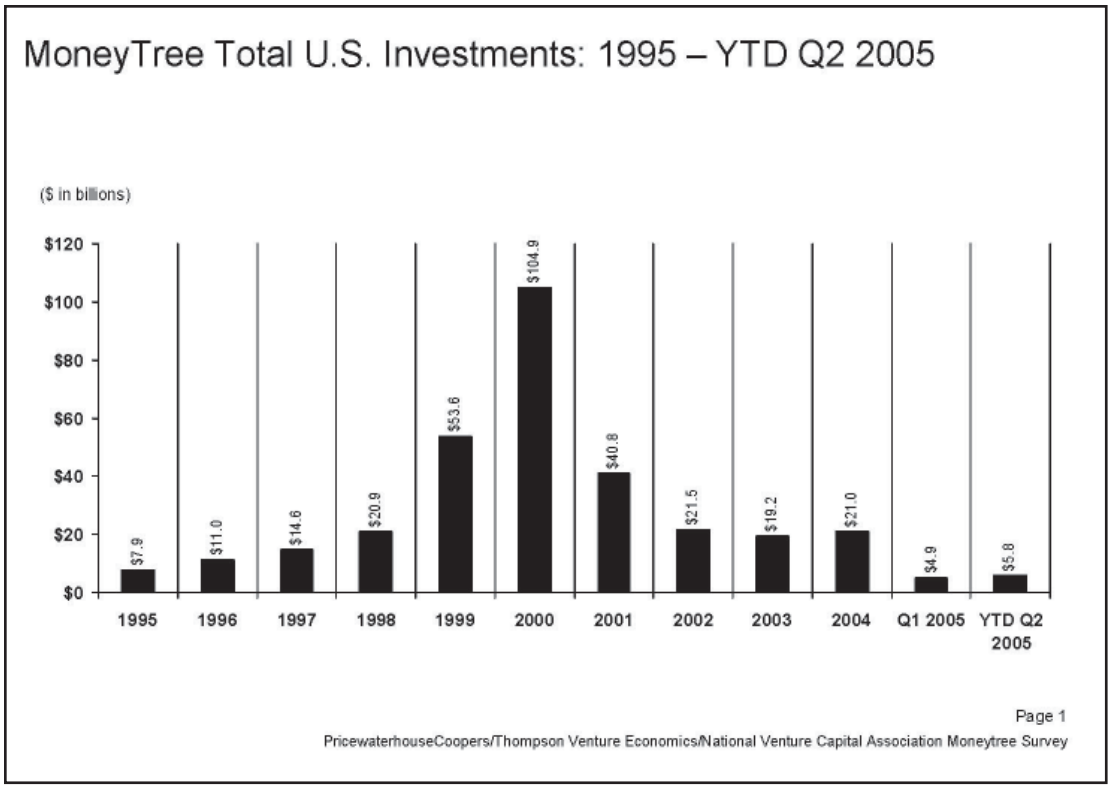
Exhibit 2
Michigan Venture Capital Transactions 2004

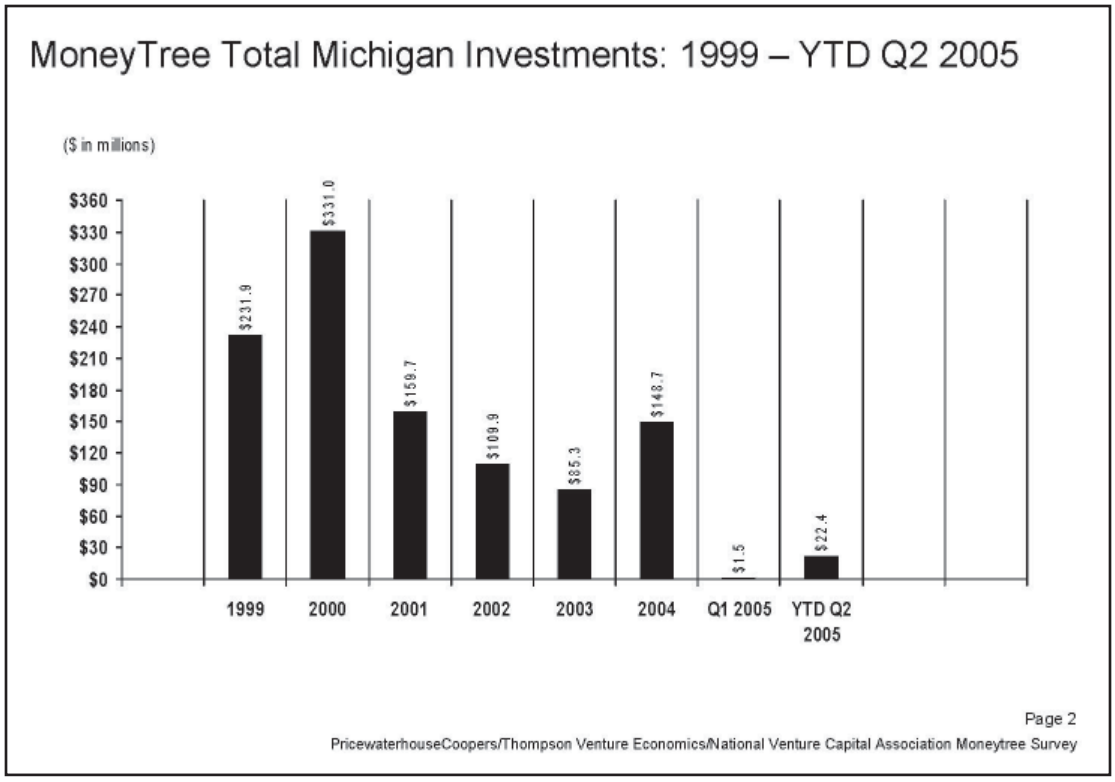
2004/2005 Qtr	Issuing Entity	City	Amount Raised	Disclosed Investors
2005 Qtr 2	Assay Designs, Inc.	Ann Arbor	$5,000,000	Ampersand Ventures
2005 Qtr 2	Asterand, Inc. (f/k/a BioSampleX Pharmaceuticals)	Detroit	$3,500,000	• Chrysalis Ventures • Fort Washington Capital Partners LLC • ApJohn Ventures, LLC • Arboretum Ventures
2005 Qtr 2	ISD Corp. (a/k/a Integrated Systems Development)	Holland	$6,000,000	• River Cities Capital Funds • Odin Capital Group • Nationwide Mutual Capital, LLC • Prism Capital
2005 Qtr 2	ProNAi Therapeutics, Inc.	Kalamazoo	$525,000	• ApJohn Ventures, LLC
2005 Qtr 2	STM Power, Inc. (f/k/a Stirling Thermal Motors)	Ann Arbor	$7,400,000	• VantagePoint Venture Partners • CDP Capital Technology Ventures (f/k/a CDP Sofinov) • Smart Technology Ventures
2005 Qtr 1	Northcoast PCS	Detroit	$403,000	Primus Venture Partners, Inc.
2005 Qtr 1	ProNAi Therapeutics, Inc.	Kalamazoo	$1,125,000	ApJohn Ventures, LLC
2004 Qtr 4	Altair Engineering, Inc.	Troy	$30,000,000	• General Atlantic Partners, LLC
2004 Qtr 4	ArborText, Inc.	Ann Arbor	$6,000,000	• Norwest Venture Partners • North Coast Technology Investors, LP
2004 Qtr 4	Qualitor, Inc.	Southfield	Not disclosed	• Baird Capital Partners • Thayer Capital Partners
2004 Qtr 4	QUATRx Pharmaceuticals Company (f/k/a Pegasus Pharmaceutical)	Ann Arbor	$15,350,000	• MPM Capital • InterWest Partners • Thomas Weisel Venture Partners • Frazier Healthcare and Technology Ventures
2004 Qtr 4	QUATRx Pharmaceuticals Company (f/k/a Pegasus Pharmaceutical)	Ann Arbor	$14,500,000	• MPM Capital • InterWest Partners • TL Ventures • Frazier Healthcare and Technology Ventures • Twilight Venture Partners
2004 Qtr 4	Sensicore, Inc.	Ann Arbor	$12,000,000	• NGEN Partners LLC (f/k/a NextGen Partners, LLC) • TopSpin Partners • Technology Partners
2004 Qtr 3	Data TV Networks	Ann Arbor	$1,190,000	• Undisclosed venture firm • KB Partners, LLC
2004 Qtr 3	Dellego Technologies (f/k/a QSSolutions Engineered Systems)	Royal Oak	$1,500,000	•Undisclosed venture firm
2004 Qtr 3	HandyLab, Inc.	Ann Arbor	$5,000,100	• EDF Ventures Partners (a/k/a Sigefi, Burnette & Vallee) • SBV Venture P • University of Michigan • Ardesta • DuPont Pharmaceuticals • XR Ventures (a/k/a X Rite Ventures) • Arboretum Ventures
2004 Qtr 3	InterLink Networks	Ann Arbor	$2,850,000	• Duchossois Technology Partners, LLC • Undisclosed venture firm • Arbor Partners, LLC
2004 Qtr 3	Northcoast PCS	Detroit	$2,500,000	• Primus Venture Partners, Inc.

2004/2005 Qtr	Issuing Entity	City	Amount Raised	Disclosed Investors
2004 Qtr 2	Genetics Squared, LLC	Milan	$1,000,000	• CrystalPoint Partners
2004 Qtr 2	Mobius Microsystems, Inc	Ann Arbor	$1,000,000	• Undisclosed venture firm • University of Michigan
2004 Qtr 2	Aveso, Inc (f/k/a Com-motion, Inc.)	Franken-muth	$5,000,000	•Arch Venture Partners • Frazier Healthcare and Technology Ventures
2004 Qtr 2	Akonni Biosystems	Gregory	$50,000	• Maryland Technology Development Corp. (TEDCO)
2004 Qtr 1	Michigan Seamless Tube (a/k/a Metal Resources, LLC)	South Lyon	$2,900,000	• Northwood Ventures
2004 Qtr 1	EcoSynthentix, Inc.	Lansing	$8,700,300	• Undisclosed venture firm • HB Fuller Ventures • Tera Capital Corporation • Cargill Ventures • Skylon Capital
2004 Qtr 1	STM Power, Inc. (f/k/a Stirling Thermal Motors)	Ann Arbor	$24,300,100	•Vantage Point Venture Partners •CDP Capital Technology Ventures (f/k/a CDP Sofinov) •Sempra Ventures •Smart Technology Ventures •Nth Power
2004 Qtr 1	Nexcerpt, Inc.	Kalamazoo	$25,000	•ARCH Development Partners, LLC
2004 Qtr 1	Discera, Inc.	Ann Arbor	$12,200,000	•Partech International •Ardesta •3i (US) •Qualcomm Ventures
2004 Qtr 1	HealthMedia, Inc.	Ann Arbor	$1,000,000	•Chrysalis Ventures •Undisclosed investors
Total			$171,018,500	

Source: PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association Money Tree™ Survey, *at* www.pwcmoneytree.com/moneytree/.

Exhibit 3
Invested Venture Capital





Source: PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association Money Tree™ Survey, *at* www.pwcmoneytree.com/moneytree/

Exhibit 4
Memorandum of Terms for Private Placement of Series A Preferred Stock

Issuer:	Big Idea, Inc., a Michigan corporation
Amount of financing:	$2,000,000
Closing:	The first closing will occur on a minimum amount raised of $1,000,000.
Minimum investment:	$25,000
Premoney value:	$5,000,000 on a fully diluted basis (including employee stock option plan as reflected on the attached capitalization schedule)
Lead investor:	Big Money Ventures, LP
Security issued and price:	Series A convertible preferred stock (Series A Stock) issued at $1 per share (based on $2,000,000 invested) [plus Common Stock issued at $0.001 per share]

Terms of Series A Stock

Dividends: Annual [8 %] dividend on the Series A Stock, payable when and if declared by the board; unpaid dividends will accumulate until paid (but will not compound into the original investment amount).

Liquidation preference: In the event of any liquidation or winding up of the Company, the holders of the Series A Stock will be entitled to receive their original purchase price plus any declared but unpaid dividends on each series (the Liquidation Preference), in preference to the holders of Common Stock.

After the above distribution, the holders of Series A Stock and Common Stock will share any distributions on a pro rata basis until Series A Stock has received [two times] the Liquidation Preference. After that, all assets will be distributed to holders of the Common Stock.

[Alternative language: After the above distribution, the holders of Series A Stock and Common Stock will share all remaining distributions on a pro rata basis as if all Series A Stock were converted to Common Stock.]

A merger, sale of substantially all assets, reorganization, or other transaction in which control of the Company is transferred will be treated as a liquidation.

Conversion: Subject to adjustment as set forth below, each share of the Series A Stock is convertible into one share of Common Stock (1) at the option of any holder of it, (2) automatically on closing of a firmly underwritten public offering of Common Stock on Form S-1 at a public offering price of at least [3] times the original per-share purchase price, with gross proceeds to the Company of more than $[amount]; and (3) automatically on the consent of holders of a majority of the then outstanding shares of Series A Stock.

Antidilution adjustments: The conversion ratio of each series of Preferred Stock will be adjusted on a weighted-

average basis for issuances below conversion price of Series A Stock, other than (1) the issuance of shares of Common Stock to employees, directors, and consultants under plans or agreements unanimously approved by the board of directors; (2) the sale of shares of the Company's capital stock (or rights for it) to financial institutions or lessors in connection with credit and equipment financing arrangements unanimously approved by the board of directors; (3) the sale of shares of the Company's capital stock (or rights for it) to strategic

partners in connection with bona fide corporate partnering arrangements unanimously approved by the board of directors; and (4) the issuance of the Company's capital stock (or rights for it) in connection with acquisitions and mergers unanimously approved by the board of directors.

In the event of any stock split, stock dividend, combination, or the like, the conversion price of the Series A Stock will be appropriately adjusted.

Voting rights: The Series A Stock votes with the Common Stock on an as-converted basis, but the approval of a majority of the holders of the Series A Stock will be required for any (1) change in the aggregate number of authorized shares of Common Stock, Series A Stock, or any series of Preferred Stock; (2) exchange, reclassification, or recombination of any outstanding shares into securities having rights, preferences, or privileges prior to or pari passu with the Series A Stock; (3) change in the rights, preferences, privileges, or restrictions on any series of Pre ferred Stock; (4) creation of a new class of shares having rights, preferences, or privileges prior to or pari passu with the Series A Stock; (5) declaration or payment of a dividend on the Com mon Stock or any series of Preferred Stock (other than a dividend payable solely in shares of Common Stock); (6) redemption of any shares of any series of Preferred Stock or Common Stock (other than repurchases on termination or pursuant to rights of first refusal); or (7) liqui dation, dissolution, or change of control (by merger, sale of assets, or otherwise) of the Compa ny. In addition, Series A Stock will have separate series voting rights as provided by Michigan law.

Purchase Agreement

Representations and warranties: Standard representations and warranties.

Right of pro rata participation: Investors holding at least [100,000] Shares and each of _____ (the Founders) will have the right to participate in future financings to maintain their pro rata percentage of the Company's shares then outstanding (subject to the same carveouts for antidilution).

Investors' Rights Agreement

Registration rights:

1. Beginning [five] years after the closing of the initial sale of the Shares, two demand registrations on initiation by the holders of at least [40%] of the Shares. Expenses (other than underwriting discounts) paid by Company.
2. Unlimited piggybacks, subject to pro rata cutback to a minimum of [25%] of the offering at the underwriter's discretion, with possible complete cutback on initial public offering. Expenses (other than underwriting discounts) paid by Company. Each of the Founders will be entitled to participate in such piggyback registrations on the same terms as the Inves tors.
3. Two S-3 registrations of at least [$500,000] per year when the Company becomes eligible. Expenses (other than underwriting discounts) paid by the Company.
4. Agreement to provide for up to [180-day] post–initial public offering lockup as may be required by the underwriters selected by the Company.

Financial information: All Investors have the right to receive audited annual financial state-ments. Investors holding more than [100,000] Shares are also entitled to receive monthly unaudited financials and ann-

ual budget as well as standard inspection rights. Rights terminate on the Company's initial public offering.

Transfer of rights: Registration or information rights may only be transferred to affiliates, to existing stockholders, or to holders (after the transfer) of at least [100,000] Shares.

Cosale agreement: Investors have a right of first refusal (subordinate to the Company's right of first refusal) on sales of the Company's securities by the Founders. If the right of first refusal is waived, the Investors will be entitled to participate (on a pro rata basis) in any sales of securities of the Company by any of the Founders to a third party on the same terms as the Founders.

Employee Matters

Common stock: All restricted stock and stock options issued to employees are subject to [four-year] vesting with a [one-year] cliff. Vesting of initial options or restricted stock granted to employees will commence on the date of employment with the Company.

The shares initially granted to the Founders (the Founders' Shares) will be subject to vesting based on a [five-year] schedule, which is deemed to have commenced on the date [two years] prior to the closing of the financing (such that [40%] of the Founders' Shares are vested at that time).

Invention assignment agreements: Each of the employees of the Company (including the Founders) will execute Confidentiality and Inventions Assignment Agreements with the Company in an acceptable form.

Miscellaneous

Board of directors: The board of directors is set at [TBD] members. Board composition at the Closing Date will be [2] members elected by holders of Common Stock (who initially will be [name] and [name], and [2] members elected by holders of Series A Stock (who initially shall be [name] and [name]).

Use of proceeds: The Company must use the investment proceeds for working capital and general corporate purposes and may not apply any of these proceeds to the reduction of previously incurred debt, payment of any bonuses, or back pay to any employees or independent contractors.

Expenses: If the financing is completed, the Company will pay the reasonable legal fees (subject to a maximum of $ [amount] and expenses of [law firm], counsel for [Big Money Ventures], in connection with the transaction.

Closing conditions: Standard closing conditions, including satisfactory completion of due diligence, customary legal opinions, etc.

This Memorandum of Terms is intended as a summary and is for discussion purposes only. Neither party has an obligation to the other until the execution of definitive agreements relating to the transaction contemplated in this memorandum. However, (1) the parties agree to work together in good faith with respect to the transactions contemplated in this memorandum, (2) the parties agree to maintain the confidentiality of the terms in this memorandum, and (3) the Company agrees not to solicit, encourage, or entertain offers from alternate sources of funding during the 60-day period following the execution of this Memorandum of Terms.

Big Idea, Inc.	Big Money Ventures, LP
By:_____	By: _____
Title:_____	Title:_____

Exhibit 5
Memorandum of Terms for Private Placement of Secured Debt Issuance BIG IDEA, LLC

Summary

Issuer: Big Idea, LLC, a Michigan limited liability company (the Company).

Amount of financing: $1,500,000

Closing: The first closing will be for at least $600,000 and will close on [date].

Minimum investment: $25,000

Lead investor: Big Money Ventures, LP

Security issued: Convertible secured promissory note.

Terms of Secured Debt Issuance

Convertible secured promissory note: The Company will issue convertible secured promissory notes (each, a Note). Each Note will bear interest at 8½ percent per year. Subject to prior conversion of each Note as described below, all unpaid principal and interest under each Note is due and payable on the earlier of (1) [60 months] (the Maturity Date), provided that Investor has given written notice to the Company on or after [54 months], but before the Maturity Date, demanding full payment of the Note as of the Maturity Date or (2) when the amounts are declared due and payable by the Investor on or after the occurrence of an event of default under the terms of the Note. The Note is convertible into a membership interest in the Company voluntarily by Investor at any time before the Maturity Date or automatically on the Maturity Date, provided that the Investor has not given written notice to the Company on or after [54 months] but before the Maturity Date, demanding full payment of the Note as of the Maturity Date. The Conversion Price for each Note is [$45,000] per [1%] of membership interest in the Company (the Conversion Price). The Conversion Price is based on a premoney valuation of [$3,000,000] and total investment for all Notes of [$1,500,000].

Security: Each Note will be secured by a lien on substantially all of the assets of the Company in accordance with the Intercreditor Agreement described below and subject to the right of the Company in its sole discretion to subordinate the Note and its security by granting up to two security interests to one or two commercial banks that are superior in priority to the security interests granted under the Note (provided that the subordination does not exceed [$2,000,000] in the aggregate). The transaction will be subject to each Investor becoming a party to an Intercreditor Agreement among the Company and the Investors under which each Investor agrees to hold its security interest on a pari passu basis with all other Investors.

Warrant: As a part of the transaction, the Company will grant to Investor a warrant to purchase a membership interest in the Company at the Conversion Price, with the warrant being exercisable on or before [10 years]. The warrant will enable all Investors to purchase an aggregate [10%] membership interest in the Company.

Negative covenants: Without the approval of the holders of a majority of the total outstanding principal on the Notes, the Company may not (1) merge or consolidate with or into, or permit any subsidiary to merge or consolidate with or into, any other corporation or other entity or entities; (2) reorganize, dissolve,

or liquidate the Company or adopt any plan of reorganization, dissolution, or liquidation of the Company; (3) acquire voting stock or assets of another corporation or other entity or entities; (4) authorize or issue additional membership interests of the Company other than pursuant to the Company employee option plan or a strategic business relationship approved by the Company's board of directors; (5) incur, create, assume, reclassify, or guarantee any indebtedness that ranks senior or pari passu in the right of payment to the Notes; (6) amend the Articles of Organization or Operating Agreement; (7) effect any material change in the nature of the business of the Company or apply the assets of the Company other than for the conduct of the business of the Company as that business is conducted and proposed to be conducted; (8) sell, lease, transfer, or otherwise dispose of any of its assets outside the ordinary course of business or sell, lease, transfer, or otherwise dispose of any of its intellectual property, except for the grant of nonexclusive licenses entered into in the ordinary course of the Company's business; (9) make any loan, extension of credit, or capital contribution to or purchase any membership interest, bonds, notes, debentures, or other securities of or any other investment in any other entity; or (10) acquire, own, or create any subsidiary of the Company or take any action through a subsidiary that is prohibited under these covenants.

Employee Matters

Invention assignment agreements: Each of the employees of the Company (including the Founders) will execute Confidentiality and Inventions Assignment Agreements with the Company in an acceptable form.

Miscellaneous

Board of directors: The board of directors is set at [three] members. Board composition at the Closing Date will be [one] member elected by holders of the Notes (who initially will be [name] and [name]), and [two] members elected by the members of the Company (who initially will be [name] and [name]).

Use of proceeds: The Company must use the investment proceeds for working capital and general corporate purposes and may not apply any of these proceeds to the reduction of previously incurred debt, payment of any bonuses, or back pay to any employees or independent contractors.

Financial information: All Investors will have the right to receive audited annual financial statements, monthly unaudited financials, and annual budgets as well as standard inspection rights. Rights terminate on the Company's initial public offering.

Expenses: If the financing is completed, the Company will pay the reasonable legal fees (subject to a maximum of [$20,000]) and expenses of [law firm], counsel for Big Money Ventures, LP, in connection with the transaction.

Closing conditions: Standard closing conditions, including satisfactory completion of due diligence, customary legal opinions, etc.

This Memorandum of Terms is intended as a summary and is for discussion purposes only. Neither party has an obligation to the other until the execution of definitive agreements relating to the transaction contemplated in this memorandum. However, (1) the parties agree to work together in good faith with respect to the transactions contemplated in this memorandum, and (2) the parties agree to maintain the confidentiality of the terms contained in this memorandum.

Big Idea, Inc. Big Money Ventures, LP

By:_____ By: _____

Title:_____ Title:_____

Developments in Delaware Corporate Case Law: Reaffirmation of Existing Doctrine Rather than Radical Change

By Samuel A. Nolen

In the past 12 months, Delaware courts have issued a number of decisions that address important issues for Delaware corporations and their advisors.

In these decisions, the Delaware courts have reaffirmed the primacy of the internal-affairs doctrine and have tackled several current issues in mergers and acquisitions practice, such as the validity of lockups and voting agreements, the standards to apply in determining the existence of a material adverse effect, and the validity of altering preferred stock protective provisions by operation of a merger rather than by the amendment of the certificate.

The court's decisions have clarified issues of director responsibility, such as the director's duty of oversight and the effect of an exculpatory charter provision pursuant to Section 102(b)(7)[1] on claims by creditors against directors of an insolvent company for breach of fiduciary duty. The courts have also addressed several disclosure-related issues, reaffirmed the common-law requirement of reasonableness of stock transfer restrictions, and clarified when a stockholder demanding access to corporate books and records may compel production of subsidiary company records.

The Delaware Supreme Court Reaffirms the Internal-Affairs Doctrine

VantagePoint Venture Partners 1996

In *VantagePoint Venture Partners 1996 v Examen, Inc,*[2] the Delaware Supreme Court affirmed the Delaware Court of Chancery's decision refusing to apply provisions of California law that purport to govern the internal affairs of non-California corporations. The supreme court found that, under the internal-affairs doctrine, the law of the state of incorporation applied.

Examen, Inc., was a privately held Delaware corporation with its principal place of business in California. VantagePoint Venture Partners 1996 was a Delaware limited partnership that owned 83 percent of Examen's preferred stock. In February 2005, Examen entered into a merger agreement with a subsidiary of Reed Elsevier, Inc. In connection with the anticipated merger, VantagePoint asserted that Examen was a quasi-California corporation pursuant to California General Corporations Law Section 2115.[3] Broadly speaking, Section 2115 provides that non-California corporations that are privately held and satisfy a set of factual tests (including conducting a majority of their business in California and having a majority of their stockholders with California addresses) are quasi-California corporations subject to certain provisions of California's corporation law. If applied in this situation, Section 2115 would have given Examen's preferred stockholders a separate class vote on the merger not available under Delaware law, effectively giving VantagePoint a veto over the merger.

Examen brought suit in the Delaware Court of Chancery seeking a declaration that Section 2115 did not apply to the voting rights of its stockholders. Examen argued that the internal-affairs doctrine required application of Delaware law. The court of chancery agreed and granted Examen's motion for judgment on the pleadings.

On appeal, the Delaware Supreme Court explained that the internal-affairs doctrine is based on the premise that corporations should not be subject to inconsistent legal standards among states. The internal-affairs doctrine requires that the law of the state of incorporation be applied to matters pertaining to relationships among or between the corporation and its officers, directors, and stockholders. In discussing the development

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of the doctrine, the court reaffirmed its holding in *McDermott, Inc v Lewis* that the internal-affairs doctrine "is mandated by constitutional principles."[4] The court found that under the Due Process Clause of the Fourteenth Amendment, corporate directors, officers, and stockholders have a right to know what law will apply to their actions and govern their accountability. Further, under the Commerce Clause, the internal-affairs doctrine is trumped only when "the law of the state of incorporation is inconsistent with a national policy on foreign or interstate commerce."[5]

Turning to Section 2115, the court found that application of the statute to foreign (i.e., non-California) corporations would "'produce inequalities, intolerable confusion, and uncertainty, and intrude into the domain of other states that have a superior claim to regulate the same subject matter.'"[6] The court was particularly troubled by the notion that a foreign corporation could fall within the ambit of Section 2115 one year but not the next due to the 'vissitudes of the ever-changing facts.' The court reasoned that the application of Section 2115 would run afoul of the U. S. Supreme Court's decisions in *CTS Corp v Dynamics Corp of America,*[7] and *Kamen v Kemper Fin Serv.*[8] Accordingly, the supreme court affirmed the court of chancery's decision to apply Delaware law, rather than California law pursuant to Section 2115, to determine VantagePoint's voting rights.

The Vantage Point Venture Partners 1996 v Examen *decision reaffirms Delaware's strong commitment to the internal-affairs doctrine . . . .*

VantagePoint also claimed that the California courts would apply Section 2115 in these circumstances under *Wilson v Louisiana-Pacific Res, Inc*,[9] which upheld the application of California law to a Utah corporation pursuant to Section 2115. VantagePoint asserted that if Delaware refused to apply Section 2115, there would be an inconsistency among the states, and litigants would engage in unseemly forum shopping. The supreme court firmly rejected this argument. The court noted that *Wilson* was decided before *CTS Corp*, *Kamen*, and *McDermott*, *Inc*. Further, ten years after *Wilson*, the California Supreme Court cited with approval the Delaware Supreme Court's analysis of the internal affairs doctrine in *McDermott, Inc*. Two years ago the California Court of Appeals also questioned the continued validity of *Wilson* and cited *McDermott, Inc,* approvingly. Thus, the Delaware Supreme Court admitted no doubt that today the California courts would apply Delaware law to the internal affairs of a Delaware corporation.

The *VantagePoint Venture Partners 1996* decision reaffirms Delaware's strong commitment to the internal-affairs doctrine and makes clear that the doctrine will be applied even when the law of a sister state purports to mandate a contrary rule.

Issues in Mergers and Acquisitions

Lockups Revisited: Orman v Cullman

In *Orman v Cullman*,[10] the Delaware Court of Chancery revisited the case law interpreting lockup voting agreements in the context of a merger transaction. In *Orman*, plaintiff brought suit against the board of directors of General Cigar Holdings, Inc., for breach of their fiduciary duties in negotiating a minority squeeze-out merger transaction with Swedish Match AB that included a lockup voting agreement with the Cullman family, General Cigar's controlling stockholders. The lockup agreement required the controlling stockholders to vote against any alternative acquisition proposal for 18 months following a termination of the merger agreement. Applying *Omnicare v NCS Healthcare, Inc*,[11] the court concluded that because the transaction was subject to approval by a majority of the public stockholders, the lockup agreement with General Cigar's controlling stockholders did not lock up the transaction or coerce the General Cigar public stockholders to approve the merger and therefore granted defendants' motion for summary judgment.

In 1999, Swedish Match contacted General Cigar to discuss the possibility of acquiring a significant stake in General Cigar, with certain Cullman family members maintaining management responsibility. The board of directors of General Cigar formed a special committee to advise and make recommendations to the full board concerning the transaction with Swedish Match. The negotiations between General Cigar and Swedish Match resulted in an agreement to merge General Cigar with a subsidiary of Swedish Match, with the public stockholders of General Cigar receiving $15 per share (a significant premium over the market price). As a condition to entering into a merger agreement, Swedish Match required the Cullmans to enter into a voting agreement in which they agreed not to sell their shares and to vote their shares

against any alternative acquisition proposal for a period of one year following the termination of the merger agreement. In exchange for an increase in the merger consideration to the public stockholders to $15.25 per share, Swedish Match required the Cullmans to increase the restricted period in the voting agreement to 18 months. The merger agreement allowed the board of General Cigar to entertain unsolicited acquisition proposals if, on the recommendation of the special committee, the board concluded that such a proposal was bona fide and would be more favorable to the public stockholders than the merger with Swedish Match. The merger agreement also permitted the board to withdraw its recommendation of the merger agreement if, on consultation with outside counsel, the board concluded that its fiduciary duties required withdrawal from the deal. The merger agreement required that the merger agreement be submitted to the General Cigar stockholders for a vote, but, importantly, provided that the merger could not proceed without the approval of a "majority of the minority" (i.e., a majority of the public stockholders). The merger agreement also did not provide for a termination fee.[12]

Plaintiff, relying on *Paramount Communications, Inc v QVC Network, Inc*,[13] and *NCS Healthcare, Inc,* argued that the members of the Cullman family on the board of directors of General Cigar breached their fiduciary duties by entering into the voting agreement. The court found plaintiff's reliance on *Paramount Communcations, Inc and NCS Healthcare, Inc*, misplaced. While the court agreed that a provision of a contract purporting to limit a director's ability to exercise his or her fiduciary duties would be unenforceable, the provisions of the voting agreement in the present case only limited the Cullmans' ability to act in their capacity as stockholders. Thus, the Cullmans could still exercise their duties as directors to vote to withdraw their recommendation of the merger.

The court of chancery then turned to the remaining issue of whether the public stockholders of General Cigar were impermissibly coerced to vote for the merger because of the lockup provision required by Swedish Match as part of the transaction. The court noted that in *NCS Healthcare, Inc*, a bare majority of the supreme court held that deal-protection devices require the enhanced scrutiny set forth in *Unocal Corp v Mesa Petroleum Co.*[14] The first step of the *Unocal* analysis requires a board to show that it has reasonable grounds for believing that a danger to corporate policy and effectiveness would exist without the deal-protection measures. The second step requires the board to show that the deal-protection devices are not coercive or preclusive and are within the range of reasonable responses to the danger to corporate policy and effectiveness.

Applying the first step of *Unocal*, the court found that if the board had not included the deal-protection devices demanded by Swedish Match, General Cigar risked losing the transaction and being left with no comparable alternative transaction. As in *NCS Healthcare, Inc*, this was found to be reasonable grounds for believing that a danger to corporate policy and effectiveness existed.

With respect to the second step of the *Unocal* analysis, the court held that the standard for determining if deal protection devices are coercive is whether they "'have the effect of causing the stockholders to vote in favor of the proposed transaction for some reason other than the merits of that transaction.'"[15] The court found that because the merger with Swedish Match would not have occurred without the deal-protection devices, such devices were an "'integral part of the merits of the transaction.'"[16] Furthermore, unlike *NCS Healthcare, Inc*, the deal-protection devices in this case were not tantamount to a fait accompli. The court held:

> The public shareholders were free to reject the proposed deal, even though, permissibly, their vote may have been influenced by the existence of deal protection measures. Because General Cigar's public shareholders retained the power to reject the proposed transaction with Swedish Match, the fiduciary out negotiated by General Cigar's board was a meaningful and effective one—it gave the General Cigar board power to recommend that the shareholders veto the Swedish Match deal. That is to say, had the board determined that it needed to recommend that General Cigar's shareholders reject the transaction, the shareholders were fully empowered to act upon that recommendation because the public shareholders (those not "locked-up"

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> in the voting agreement) retained the power to reject the proposed merger. For these reasons, I conclude as a matter of law that the deal protection mechanisms present here were not impermissibly coercive.[17]

The court then turned to the last part of the *Unocal Corp* analysis to determine whether the deal-protection devices were within the range of reasonable responses to the danger to corporate policy and effectiveness. The court found that, without the deal-protection devices, there would have been no merger and that the General Cigar stockholders could have lost the significant premium being offered by Swedish Match. The court held that, because there was no competing bid for General Cigar, the board would be given broad latitude regarding its decision to recommend the Swedish Match merger. Thus, in light of the effective fiduciary out and the ability of the public stockholders to vote down the merger, the court concluded that "[t]he Cullman lockup hardly seems unreasonable, given the absence of other deal protection devices in this particular transaction and given the buyer's understandable concern about transaction costs and market uncertainties."[18]

Orman, the first post–*NCS Healthcare, Inc*, decision addressing the validity of deal-protection devices, may be a sign to practitioners that the chancery court is willing to limit the supreme court's *NCS Healthcare, Inc*, decision to its facts. However, the practical implications of the decision remain to be seen.

Before execution of the merger agreement, Holly's counsel discovered in the course of due diligence a news article describing plans by activist Erin Brockovich . . . to bring a mass tort claim . . . .

IBP, Inc, *is the Law in Delaware Governing MAEs:* Frontier Oil Corp v Holly Corp

In *Frontier Oil Corp v Holly Corp*,[19] the Delaware Court of Chancery addressed claims of repudiation and breach of the covenant of good faith and fair dealing in the context of a merger agreement containing a fiduciary out clause and other customary termination provisions. The claims and counterclaims at issue arose in connection with the proposed merger of two independent petroleum refiners, Frontier Oil Corporation, a Wyoming corporation, and Holly Corporation, a Delaware corporation.[20]

Before execution of the merger agreement, Holly's counsel discovered in the course of due diligence a news article describing plans by activist Erin Brockovich and related plaintiffs' law firms to bring a mass tort claim alleging that students attending Beverly Hills High School suffered from a disproportionate incidence of cancer attributable to the release of toxic chemicals from oil drilling activities next to the high school. A predecessor of Frontier Oil had operated the drilling facility in the past.

Confronted with this information, the Holly board did not initially approve the merger agreement but instead directed management to pursue various options, including bolstering Frontier's representations and warranties and strengthening the definition of a material adverse effect (MAE) in the merger agreement. As a result, several changes to the agreement were made, including modification of the merger agreement's definition of an MAE to include results of operations and prospects and revision of the agreement's schedule to provide that the disclosure of the threatened litigation did not remove this prospective litigation from Frontier's representation that there were no pending or threatened suits that could reasonably be expected to result in an MAE.

The merger agreement, as executed, contained several customary termination provisions, including the right of each party to terminate the agreement if the other party's representations or warranties were or became inaccurate or if threatened litigation would be expected to have an MAE. The agreement also provided termination rights on the exercise of a fiduciary out by the board of Holly or Frontier. Exercise of the fiduciary out required payment of a breakup fee of $15 million (plus reimbursement of expenses up to $1 million).

Following execution of the merger agreement, tort litigation was actually filed, and the parties learned that Frontier had, through leases and related agreements, guaranteed certain obligations at the oil production site. During the same period, Lehman Brothers made a presentation to Holly suggesting that Holly's pipeline assets were so undervalued that Frontier could potentially recoup more than 100 percent of the merger price simply by securitizing Holly's pipeline assets in a master limited partnership.

Holly's board expressed concern about proceeding with the merger, and the parties engaged in a month of further negotiations. The parties later formulated a restructured deal that provided that the Holly stockhold-

ers could choose between a transaction with a nominally higher value and one with a nominally lower value but a greater cash component. Following the conclusion of negotiations, Holly's CEO, C. Lamar Norsworthy III, who had agreed to recommend the reformulated deal to his board, decided instead not to recommend the revised transaction, in part due to a concern that he and his associates would be sued if the Frontier stock issued in the transaction performed poorly, since the insider group clearly planned to take the high-cash option.

The chief executives of the two companies then spoke by telephone. Frontier's CEO presented a series of questions to Holly's CEO, including whether Holly was still prepared to recommend the merger agreement to its stockholders. Holly's CEO replied that his company was not prepared to recommend the transaction and that its board was no longer willing to support the merger agreement on its existing terms. Frontier then filed an action in the Delaware Court of Chancery alleging repudiation of the merger agreement. Frontier also asserted a claim for breach of the implied covenant of good faith and fair dealing and sought damages totaling $160 million.

In response to Frontier's repudiation lawsuit, Holly claimed that the Beverly Hills tort litigation constituted an MAE. In addition, Holly argued that the CEOs' phone call could not form the basis of a repudiation claim because there was no clear expression of a refusal to comply with the terms of the merger agreement, given that Holly still had avenues of exit under the merger agreement. Holly also argued that Frontier breached its own representations and warranties in the merger agreement with respect to the tort litigation. Finally, Holly claimed that Frontier's actions constituted a repudiation of the contract, entitling Holly to recover damages.

In weighing Frontier's repudiation claim, the court applied basic principles of contract requiring an unequivocal statement by a promisor that it will not perform its promise. The court noted, however, that the merger agreement was not an ordinary contract and stated that while the existence of a fiduciary out does not preclude a finding of repudiation, it does establish the context in which the parties' conduct is to be assessed. The court found that Holly had not repudiated the merger agreement, because it had not made an unequivocal statement that it would not perform its promise. The court noted that Norsworthy had not stated that Holly intended to ignore the terms of the merger agreement and that his statement confirming that the Holly board would not recommend the merger agreement was contractually permitted. The court also found that, by declaring a repudiation following the call, Frontier deprived Holly of its right to exercise its fiduciary out or otherwise terminate the merger agreement.

The court also found that Holly did not breach the covenant of good faith and fair dealing. Frontier had argued that Holly's conduct stemmed in large part from its discovery that it had substantially undervalued its pipeline assets in the merger and that it sought to avoid paying the breakup fee by dragging the negotiations on past the drop-dead date in the merger agreement. The court found, however, that Holly did not mislead Frontier. While Holly's board had not formally opted to terminate the agreement and pay Frontier its breakup fee, the court suggested that Frontier's suing for repudiation effectively cut off that opportunity.

The court also denied Frontier's claim for the breakup fee under the agreement. The court held that Holly's board never formally withdrew or modified its recommendation, even though the directors had clearly determined individually not to proceed. In addition, the court found that Frontier's right to seek the breakup fee was conditioned on its termination of the merger agreement and rejected the argument that Frontier's institution of its litigation constituted termination. Finally, the court held that a consequence of Frontier's decision to sue for repudiation was that it could not maintain a claim for relief under the contract.

In a counterclaim, Holly sought damages from Frontier as a result of Frontier's alleged repudiation and breach of representations and warranties in the merger agreement. The court found that Frontier's decision to file the anticipatory repudiation litigation and to abandon the merger agreement constituted a breach of the merger agreement.

In assessing Holly Corporation's claim for damages as a result of Frontier Oil's breach, the court found that Holly's proof of damages at trial was defective. The court's decision not to grant Holly Corporation's damages was based in part on the finding that Holly, before Frontier Oil's repudiation, had determined that the merger agreement would not

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proceed on its terms and that the harm about which Holly complained was not caused by Frontier Oil's breach. The court awarded Holly Corporation nominal damages of one dollar.

In reviewing Holly's MAE claim, the court found that the burden of establishing an MAE with respect to Frontier fell on Holly. The court noted that, while the notion of an MAE is imprecise, the drafters of the merger agreement had the benefit of the analysis set forth in *IBP, Inc.* (*In re IBP, Inc, S'holders Litig*),[21] which discussed whether an acquiring party in a merger could invoke an MAE to escape from the transaction. The court noted that the court in *IBP, Inc*, applying New York law, found that a buyer would be required to make a strong showing to invoke an MAE exception, namely, that the complained of event would have a material effect on the long-term earnings potential of the target company. While noting that *IBP, Inc*, applied New York law, the court found no reason for Delaware to prescribe a different approach. Since under *IBP, Inc,* a defendant seeking to avoid performance of a contract due to its counterparty's breach of warranty must assert that breach as an affirmative defense, it followed that the same defendant pursuing an affirmative counterclaim would be charged with the burden as well.

The Frontier Oil Corp *case reflects the complexity that can occur when one party to a deal loses confidence that the deal is in its interest, and it provides insight into how common deal structures can play out in practice.*

Whether the Beverly Hills tort litigation was, or was reasonably likely to be, an MAE was, in the court's view, an issue with quantitative and qualitative aspects. Since Holly presented no evidence, scientific or otherwise, relating to the substance of the California plaintiffs' claims, the court found that it had failed to meet its burden. Holly also claimed that the defense costs of the litigation alone constituted an MAE. Holly variously had estimated the defense costs of the litigation as ranging from $200,000 per month, to $25 million, then $40 million, and then $50 million. Frontier produced separate estimates suggesting that the defense costs would be in the range of $11 million to $13 million. The court found that a reasonable estimate of the costs would be in the range of $15 to $20 million and concluded that this range of costs alone did not constitute an MAE.

In addition, the court found that Frontier did not breach its warranty as to the absence of material contracts (i.e., its guarantees). The court found that the documents relating to the guarantee would be material at the time of the merger agreement if the litigation risks related to it were sufficiently foreseeable and large. In light of the court's holding relating to the litigation, the court found no breach of warranty.

The *Frontier Oil Corp* case reflects the complexity that can occur when one party to a deal loses confidence that the deal is in its interest, and it provides insight into how common deal structures can play out in practice. It also clarifies that the standard articulated in *IBP, Inc,* is the standard by which the existence of an MAE will be determined under Delaware law.

Alteration of Protective Provisions of Preferred Stock by Merger: WatchMark Corp v ARGO Global Capital, LLC

In *WatchMark Corp v Argo Global Capital, LLC*,[22] the Delaware Court of Chancery added to a long line of Delaware cases holding that protective provisions in a certificate of incorporation that provide for a separate series vote on an amendment to the corporation's certificate of incorporation that results in the diminution of the rights of the holders of such series do not apply when the same change is effected by merger, absent an express provision in the charter to the contrary.

In August 2004, the board of directors of WatchMark Corporation, a privately held Delaware corporation, determined to raise capital for a pending acquisition by offering a new series of preferred stock, the Series F Preferred Stock. All of WatchMark's investors were offered an opportunity to participate in the proposed financing. The authorization of the Series F and related amendments to the certificate of incorporation triggered protective provisions in WatchMark's certificate of incorporation that offered the holders of each existing series of preferred stock a separate series vote on any amendment to the WatchMark certificate that adversely altered their preferences, rights, privileges, or powers. Defendant ARGO Global Capital, LLC, the predominant holder of WatchMark's Series B Preferred Stock, then indicated that ARGO would veto the transaction through its separate series vote.

Faced with ARGO's threatened veto of the Series F financing, the WatchMark board determined to merge a wholly owned subsidiary into WatchMark and then, by opera-

tion of that merger rather than by separate amendment, to change the WatchMark certificate of incorporation to remove the separate voting requirements for each series of WatchMark's preferred stock. The certificate of incorporation, under the proposed change, would retain all other material provisions of WatchMark's premerger certificate of incorporation, including one requiring the affirmative vote of the holders of 70 percent of the outstanding preferred stock, voting together as a single class, to approve a merger and a "no impairment" provision that would require WatchMark to seek the consent of the preferred stockholders whenever that consent was required and otherwise to act in good faith in the performance of its obligations under the certificate of incorporation.

WatchMark sought declaratory judgment in the Delaware Court of Chancery regarding the rights of the holders of the Series B to vote as a separate series on the proposed merger. ARGO brought a counterclaim against WatchMark and its board of directors alleging that the proposed merger violated contractual and fiduciary obligations owed to the holders of the Series B and moved for a preliminary injunction to enjoin the proposed merger.

The court denied ARGO a preliminary injunction and held that the holders of the Series B were not entitled to a separate series vote. Relying on a long line of Delaware cases, including the Delaware Supreme Court's decision in *Elliot Assoc, LP v Avatex Corp*,[23] the court found that the holders of the Series B were not entitled to a separate series vote on the merger, since the provision providing for a separate series vote on amendments to the WatchMark certificate of incorporation did not expressly reference changes to the charter effected by a merger. In addition, the court found that the no impairment provision of WatchMark's certificate of incorporation did not provide the Series B holders with any additional voting rights but merely required WatchMark to perform its existing obligations in good faith when undertaking a particular transaction, which in this case, the court found to be the obligation to obtain the vote of 70 percent of the holders of the preferred stock, voting together as a class, on the proposed merger. Finally, the court found that ARGO failed to rebut the business judgment rule with respect to its fiduciary duty claims, since ARGO did not show that the WatchMark board treated the holders of the series B disparately in connection with the proposed merger. On the contrary, the court found that the proposed merger would accomplish only one objective—the removal of the separate series votes of *each* of the series of WatchMark preferred stock on an amendment to the certificate of incorporation that adversely affected the rights of these series. Since this change affected all series of preferred stock equally, the court found no disparate treatment.

The *WatchMark* decision reaffirms a long line of Delaware decisions holding that protective provisions giving blocking rights on charter amendments that do not expressly reference mergers do not provide any protection in connection with changes to a charter effected by merger. The *WatchMark* decision also is one of the first cases addressing "no impairment" clauses since *Kumar Racing Corp of America, Inc*.[24] The *WatchMark* decision suggests that "no impairment" clauses will not afford investors significant independent substantive protection.

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Issues of Director Responsibility

Directors' Duty of Oversight: Saito v McCall

Saito v McCall[25] is the latest addition to a line of cases dealing with directors' duty of oversight under the standard set out in *In re Caremark Int'l Derivative Litig*.[26] In *Saito*, plaintiffs brought a derivative suit to recover damages from the directors, senior officers, merger advisors, and outside accountants of each of HBO & Company (HBOC), McKesson Corporation (McKesson), and McKesson HBOC, Inc. (the Company), the surviving corporation in the 1999 merger of HBOC and McKesson. Plaintiffs' main allegations were

- that HBOC's directors and officers presided over a fraudulent accounting scheme;
- that McKesson's officers, directors, and advisors uncovered HBOC's accounting improprieties during their due diligence but nonetheless proceeded with the proposed merger; and
- that the Company's board did not act quickly enough to rectify the accounting fraud following the merger.

Defendants moved to dismiss all counts. The court dismissed most of the claims on procedural grounds, with the notable exception of the claim against the Company's directors alleging *Caremark* violations.

In 1998, the audit committee of HBOC, a healthcare software provider, met with representatives of Arthur Andersen, HBOC's outside auditor, to discuss HBOC's 1997 audit. During this meeting, Andersen informed the audit committee that the 1997 audit was "high risk." Andersen then discussed with the audit committee risks affecting software companies in general and risks related to HBOC's sales practices in particular. Although a subsequent investigation by the Securities and Exchange Commission (SEC) established that HBOC was misapplying generally accepted accounting principles (GAAP), the Andersen partner overseeing the HBOC audit at the time did not inform HBOC of this fact but instead reported that there were no significant problems or exceptions and that Andersen enjoyed the full cooperation of HBOC management.

The Saito *decision reaffirms that the duty of oversight remains a vibrant aspect of a director's fiduciary duties in Delaware.*

During the summer of 1998, HBOC held discussions with McKesson, a healthcare supply management company, regarding a potential merger. McKesson engaged Deloitte & Touche, LLP, and Bear Stearns and Company, Inc., to assist with evaluation of proposed merger. On July 10, 1998, in a meeting with Deloitte and Bear Stearns, McKesson's board of directors discussed the proposed merger and due diligence issues. At this meeting, McKesson's board first learned of HBOC's questionable accounting practices; however, there was no indication that the McKesson board actually knew of any of HBOC's material accounting violations. Shortly after this meeting, Deloitte, in a conference call with McKesson's CFO and Bear Stearns, identified three areas where HBOC's accounting practices were questionable, two of which implicated violations of GAAP.

In October 1998, after briefly suspending merger negotiations, the parties resumed discussions and agreed on a modified deal structure, without resolving the issues related to HBOC's accounting practices. On October 16, with awareness of some of HBOC's accounting irregularities, McKesson's board approved the merger and agreed to acquire HBOC for $14 billion in McKesson stock. After the merger became effective, the Company's audit committee met with its advisor to discuss the transaction. Although they discussed certain accounting adjustments to HBOC's financial statements at this meeting, the audit committee knew that the adjustments were insufficient to remedy the accounting improprieties that Deloitte had previously identified. The Company took some remedial action in April 1999, when it announced that it would restate its prior earnings downward and, a few months later, terminated the senior management responsible for the accounting improprieties.

After the merger was consummated, plaintiffs brought a duty of oversight claim against defendants, the directors of the Company alleging, inter alia, that the Company directors had failed (1) to correct HBOC's false financial statements, (2) to monitor the accounting practices of the Company, (3) to implement sufficient internal controls to guard against wrongful accounting practices that were uncovered following the merger, and (4) to disclose HBOC's false financial statements. The court noted that, under *Caremar*k, "a derivative plaintiff must allege facts constituting 'a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information reporting system exists.'"[27] To survive a motion to dismiss, plaintiffs were required to show that the Company board should have known that the alleged accounting problems had occurred or were occurring and should have made a good-faith effort to rectify these accounting improprieties. Noting that plaintiffs were entitled to the benefit of reasonable inferences, the court found that plaintiffs had alleged sufficient facts to infer that the boards of each of McKesson and HBOC—members of which made up the board of the Company—knew, or should have known, of HBOC's accounting irregularities. To support this finding, the court noted that HBOC's audit committee became aware of the accounting problems when it learned that its 1997 audit was high risk and that some of these problems were disclosed to the McKesson board during the July 1998 board meeting during a discussion of due diligence. In addition, the court noted that the Company's audit committee had considered, but failed to act swiftly on, HBOC's accounting problems. On these facts, the court concluded that the Company board knew or should have known that HBOC's accounting practices

were unlawful and, despite this knowledge, failed to take any remedial action for several months. While noting that facts later adduced could prove that the Company directors did not violate their duties under *Caremark*, the court allowed plaintiffs' claim to survive a motion to dismiss.

The *Saito* decision reaffirms that the duty of oversight remains a vibrant aspect of a director's fiduciary duties in Delaware and that the Delaware Court of Chancery will not dismiss well-pled allegations of a breach of that duty.

Continuing Directors Provisions Revisited:
California Pub Employees' Ret Sys v Coulter

California Pub Employees' Ret Sys v Coulter[28] involved a challenge by California Public Employees' Retirement System (CALPERS) to a provision in certain change of control contracts of Lone Star Steakhouse & Saloon, Inc., requiring Lone Star to make change of control payments if a majority of the board of directors ceased to be *existing directors*. The change of control contracts defined existing directors as those directors who were in office at the time the change of control contracts were adopted and those new directors who were "approved by a vote" of at least a majority of the existing directors.

Relying on *Carmody v Toll Bros*,[29] CALPERS argued that the continuing directors provision violated Section 141(d) of the General Corporation Law of the State of Delaware[30] because the provision conferred on directors differential voting powers based on a classification not found in Lone Star's certificate of incorporation and therefore was adopted in violation of defendant directors' fiduciary duties. *Carmody* invalidated a so-called dead-hand provision in a stockholders rights agreement that purported to limit the right of new directors to vote on whether to redeem a stockholder rights agreement. The *Carmody* court held that, absent an express certificate of incorporation provision, directors could not be created "less equal" than other directors and that a board of directors must retain the power to redeem a stockholder rights agreement to fulfill its fiduciary obligation to manage the corporation as circumstances change.

In the present case, the court determined that it was necessary to consider whether the continuing directors provision affected the voting powers of Lone Star's directors. The court noted that the vote of the board of directors in the continuing directors provision related to the determination of whether a new member of the board of directors would be considered an existing director. The continuing directors provision did not require any board vote following the initial approval of the contracts and did not deny any new board member the right to vote in any instance. Instead, the continuing directors provision was simply an after-the-vote measure to determine if there was continuity within the board of directors and the status of ongoing rights of certain employees. The court concluded that the continuing directors provision did not limit or expand the voting powers of any director and therefore did not contravene *Carmody* or Section 141(d).

In so holding, the court noted that the continuing directors provision actually provided a benefit to Lone Star that allowed it to avoid making change-of-control payments when the changes in the board composition were not material. In addition, the court noted that the continuing directors provision had a limited, two-year duration compared to a duration of ten years for the dead-hand provision in *Carmody*. Finally, the court recognized that it would be possible for a board of directors to adopt a provision similar to the continuing directors provision that, in a different context, would deprive certain directors of their voting power and that, in that case, could be a breach of that board's fiduciary duties.

Thus, in one of the first decisions of a Delaware court to consider a continuing directors provision outside the context of a challenge to a stockholder rights plan, the court of chancery indicated that the question of the validity of such a provision was highly fact specific.

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Fiduciary Duties Owed to Creditors:
Production Resources Group, LLC v NCT Group, Inc

In *Production Res Group, LLC v NCT Group, Inc*,[31] the Delaware Court of Chancery addressed an action for the appointment of a receiver for a debtor corporation and, more importantly, discussed at length fiduciary duties owed its creditors and the application of exculpatory provisions under Section 102(b)(7) of the General Corporation Law[32] in connection with the fiduciary duty claims of creditors.

Production Resources Group, LLC, obtained a judgment in Connecticut state court against NCT in the amount of $2,000,000, plus interest and costs. Production Resources then tried, over an extended period, but with little success, to collect the award. To protect its interests as a judgment creditor, Production Resources brought an action in Delaware under Section 291 of the General Corporation Law,[33] which permits the court of chancery, upon application by a stockholder or creditor, to appoint a receiver for an insolvent corporation. In addition, Production Resources alleged that NCT's directors had breached their fiduciary duties as directors.

To prove NCT's insolvency, Production Resources alleged, among other things, that NCT

- had a working capital deficit,
- had negative net tangible assets,
- had little cash or cash equivalents on hand and virtually no ability to raise additional capital, and
- had issued close to all of the shares of stock it was authorized to issue—642 million out of 645 million—and had no intention of seeking a stockholder vote on a charter amendment to increase the authorized share capital until the filing of its S-1, the occurrence of which, in light of NCT's condition, seemed dubious.

The court found NCT to be insolvent and declined to grant NCT's motion to dismiss the claim for appointment of a receiver.

The court then turned to Production Resources's claims charging the members of NCT's board of directors and its CFO with a breach of their fiduciary duties. NCT argued that Production Resources's claims were derivative and that Production Resources had failed to plead them properly under Rule 23.1.[34] In the alternative, NCT argued that Production Resources's fiduciary duty claims—at least as to the directors—were barred by the exculpatory provision in NCT's charter under Section 102(b)(7) of the General Corporation Law. Section 102(b)(7) provides that a corporation may insulate its directors from personal liability for monetary damages to the corporation or its stockholders for certain claims by including a provision to this effect in its certificate of incorporation.

[A]s a general matter, creditors may not allege fiduciary duty claims against corporate directors, since creditors are capable of protecting themselves through contractual arrangements and are also protected by the law of fraudulent conveyance.

The court noted that, as a general matter, creditors may not allege fiduciary duty claims against corporate directors, since creditors are capable of protecting themselves through contractual arrangements and are also protected by the law of fraudulent conveyance. In discussing this issue, the court referred to the opinion in *Credit Lyonnais Bank Nederland, NV v Pathe Communications Corp*,[35] a decision which in the court's view was an attempt to emphasize directors' discretion to temper the risk they take on behalf of equity holders when the corporation is in the zone of insolvency but which has been read by some legal observers broadly to expose directors to a new set of fiduciary duty claims—those brought by disgruntled creditors. The court questioned such a reading and queried whether, once the myriad legal and contractual protections afforded to creditors were considered, an inequitable conduct claim would be extant in such context. The court determined, however, that in this case of actual insolvency, it was not required to resolve whether directors owe a fiduciary duty to creditors when the corporation is merely within the zone of insolvency.

The court then recited the settled Delaware law providing that, once a corporation has entered the realm of actual insolvency (rather than the zone of insolvency), its directors owe fiduciary duties to the creditors. According to the court, the fact of insolvency places creditors in the position normally occupied by the stockholders (i.e., as residual risk-bearers). Once a corporation has become insolvent, its creditors become exposed to substantial business risks as the entity goes forward (e.g., poor decisions on the part of the directors can erode the value of the remaining assets, reducing the pool from which creditors will be paid). The transformation of a creditor into one to whom a fiduciary duty is owed does not, however, change the nature of the underlying claim. Considering that any recovery received by creditors in connection with any such claim would flow to the corporation directly and benefit the creditor-plaintiffs only indirectly, these claims would necessarily be derivative in nature. Whether a corporation is solvent or insolvent, it owns a claim that a director has mismanaged the corporation or engaged in activities that would otherwise damage the corporation.

Addressing NCT's exculpatory provisions, the court stated that, while Section 102(b)(7) does not specifically mention creditors, mismanagement claims belong to the corporation, "regardless of whether those claims are brought derivatively by stockholders or creditors."[36] The court explained that transforming such a creditor claim into one not belonging to the corporation would eviscerate the protection that Section 102(b)(7) affords to directors. The court noted that a situation in which the corporation has become insolvent may be the scenario in which the protections of Section 102(b)(7) would be most valuable to directors, since there is an acute danger that a fact finder, affected with hindsight bias and with no extensive inquiry into the actual facts, would conclude that the directors had acted without due care. The court found no justification for expanding the rights of corporations to recover against their directors for the benefit of creditors as opposed to stockholders, noting that creditors, unlike stockholders, are better equipped to bargain for additional security and do not need enhanced protection under the law.

The *Production Res Group, LLC,* decision clarifies certain issues regarding the fiduciary duties owed to creditors of an insolvent corporation, and it confirms that the exculpatory provisions allowed by Section 102(b)(7) apply to fiduciary duty claims of creditors based on directorial mismanagement.

Issues of Disclosure

Defective Disclosures Affecting Appraisal Rights: Gilliland v Motorola, Inc.

In *Gilliland v Motorola, Inc*,[37] the Delaware Court of Chancery addressed the requirements for a notice of a short-form merger and appraisal rights to satisfy the parent company's fiduciary duty of disclosure. In 2003, Motorola, Inc., the holder of 74 percent of the common stock of Next Level Communications, Inc., acquired the publicly held minority shares of Next Level in a tender offer followed by a short-form merger. Pursuant to the tender offer, Motorola filed a Schedule TO with the SEC, which, as its offer to purchase distributed to Next Level's stockholders, included comprehensive disclosures about Next Level and the transaction, including financial information.

Following the short-form merger, a former Next Level stockholder sued Next Level and Motorola for breach of fiduciary duty and statutory violations arising out of this going-private transaction. Having concluded that defendants timely sent a notice to Next Level's stockholders informing them of their right to an appraisal and of the effective date of the merger and enclosing the copy of Section 262 required by Section 262(d)(2) of the General Corporation Law[38] (the Notice), the court went on to discuss whether the requirements for notice of a short-form merger and appraisal rights had been met to satisfy the parent company's fiduciary duty of disclosure.

Plaintiff alleged that Motorola, as a controlling stockholder of Next Level, violated its fiduciary duty of disclosure by not including in the Notice any information regarding the value of Next Level that would have helped the former stockholders of Next Level decide whether or not to pursue an appraisal. Motorola argued that, because it made public the requisite information during the tender offer stage of the transaction, the duty of disclosure did not require it to include any financial information in the Notice. The court stated that in a short-form merger, a majority stockholder has a duty to notify other stockholders of the merger and of their right to appraisal and to "provid[e] substantive, financial information relating to the value of the company. . . . [T]he majority shareholder need not provide all the information necessary for the stockholder to reach an independent determination of fair value; only that information material to the decision of whether or not to seek appraisal."[39] The court held that "[i]n cases where adequate information is, in fact, publicly available, it will always be a simple exercise to identify the relevant disclosure documents and either include them with the notice, or extract and disclose summary information from them, and advise stockholder how to obtain more complete information."[40] Since the Notice did not disclose any financial information about Next Level or incorporate by reference any publicly available documents containing this information, the court found that Motorola violated its fiduciary duty of disclosure.

In a subsequent decision in the case,[41] the court of chancery considered the appropriate remedy for this technical disclosure violation. The court determined that a quasi-appraisal remedy that replicated an appraisal proceeding was the appropriate remedy.

[In Gilliland v Motorola, Inc, *t]he court determined that a quasi-appraisal remedy that replicated an appraisal proceeding was the appropriate remedy.*

The Motorola II *decision confirms the court of chancery's broad discretion to tailor a remedy for a disclosure violation regarding appraisal rights.*

In fashioning the remedy for the disclosure violation, the court in *Motorola II* rejected plaintiff's request for a classwide quasi-appraisal remedy that would entitle all minority stockholders eliminated in the short-form merger to receive the difference between the merger price already paid and the court-determined fair value of the shares, even though most of those stockholders already made an informed decision to forego their appraisal remedy. The court found this remedy to be extreme and unwarranted, in light of the technical disclosure violations. Instead, the court opted to create a quasiappraisal remedy that more closely replicated an appraisal action. The court noted that there were three characteristics of an appraisal remedy:

- The appraisal statute requires that stockholders opt in by making a demand for appraisal.
- The appraisal statute requires stockholders who seek appraisal to forego the merger consideration and take the risk that the court-determined fair value is less than the merger consideration, and
- The appraisal statute awards minority stockholders the fair value of the shares as of the merger date.

In this case, the court held that it would be appropriate to require the minority stockholders to make a choice to participate in the action to replicate the situation they would have faced if they had received proper notice. Thus, any of the minority stockholders could affirmatively choose to have the fair value of their shares determined by the court. In addition, the court structured the remedy to replicate some of the risk that the minority stockholders would face if this were an actual appraisal action. Any stockholder who opted into the action would be required to pay into escrow a portion of the merger consideration he had already received. If the court appraised the shares at less than the merger consideration, the class would be exposed to a potential loss up to the amount escrowed. Finally, the court held that the valuation would be the fair value of the shares as of the merger date.

The first *Motorola* decision confirms that a notice of merger and appraisal rights in connection with a short-form merger, in addition to complying with the statutory requirements, must contain information sufficient to help stockholders decide whether to exercise their appraisal rights in connection with a merger. If significant information is already publicly available, this means "a brief summary of the financial numbers and a description of where the more exhaustive disclosures would be located."[42] The *Motorola II* decision confirms the court of chancery's broad discretion to tailor a remedy for a disclosure violation regarding appraisal rights. When there has been an unintentional technical disclosure violation and most minority stockholders have already made a knowing decision not to seek an appraisal remedy, a quasiappraisal remedy that replicates a real appraisal action may be most appropriate.

***Disclosure in Actions Taken by Written Consent:* Unanue v Unanue**

In *Unanue v Unanue*,[43] the Delaware Court of Chancery addressed a challenge to the removal of a director by stockholder written consent on the grounds that the directors soliciting the consents failed to comport with their fiduciary duty of disclosure under Delaware law. Robert Unanue and Francisco Unanue brought an action under Section 225[44] of the General Corporation Law[44] seeking a declaratory judgment that the removal of their uncle, Joseph A. Unanue, from the board of directors of Goya Foods, Inc., was valid; that they constituted the lawful Goya board; and that the subsequent removal of Joseph and his son Andrew from their positions as officers of Goya was valid.

In 2003, the Goya board consisted of Joseph and his two nephews, Robert and Francisco. After several months of disagreement with Joseph over certain key issues in the operation of the business, Robert and Francisco sought and subsequently delivered written consents from their respective family members, who collectively held 62 percent of the voting power of Goya's stock, to remove Joseph as a director of Goya after further negotiations with Joseph failed. Plaintiffs then removed Joseph and his son Andrew from their positions as officers of Goya.

Joseph challenged the validity of his removal as a director (and, along with Andrew, his subsequent removal as an officer) by stockholder written consent pursuant to Section 228 of the General Corporation

Law[45] on the basis that the plaintiffs failed to comply with their fiduciary duty of disclosure. The court stated that while, under Delaware law, "directors generally have a fiduciary duty to disclose all material facts when they seek stockholder action or communicate with stockholders,"[46] Section 228 does not contain any disclosure requirements other than the requirements that the written consents be in writing, set forth the action to be taken, and be signed by the holders of the stock. The parties stipulated that the consents met those requirements. However, defendants argued that plaintiffs' fiduciary duties included a duty of disclosure similar to that generally required in proxy solicitation cases for public companies that are subject to the federal securities laws, specifically "a duty to disclose fully and fairly all material information related to the stockholder action sought."[47] The court questioned whether directors of a closely held, family-run business who had fully complied with Section 228 even owed a fiduciary duty of disclosure under such circumstances but declined to decide the issue because, even if such a duty existed, the facts of the case demonstrated no material nondisclosure.

In finding that no material nondisclosures occurred, the court rejected defendants' claim that plaintiffs breached their fiduciary duty by not disclosing to the consenting stockholders financial information on Goya's most recent performance, on the basis that the decision to remove Joseph was in no way related to Goya's financial performance. The court also rejected as illogical defendants' claim that plaintiffs breached their fiduciary duty of disclosure by failing to disclose to the consenting stockholders that they would use the consents to do exactly what the consents purported to do—remove Joseph as a director. The court held that a reasonable stockholder executing a written consent would expect it to be used, absent allegations of a misrepresentation. The court similarly rejected defendants' claim that plaintiffs breached their duty of disclosure by failing to tell the consenting stockholders Joseph's "side of the story" because they acted "secretly" in obtaining the consents.[48] The court found that such a claim ran afoul of Section 228, which expressly permits a majority of a corporation's stockholders to act immediately and without prior notice. Having found that plaintiffs constituted the lawful Goya board, the court found that plaintiffs' subsequent actions in terminating Joseph and Andrew as Goya officers and employees also were valid.

The *Unanue* decision represents an interesting decision in the evolution of the judicial approach to disclosure issues in the context of action by written consent.

Stock Transfer Restrictions

The Reasonableness Test: The Capital Group Cos v Armour

In *The Capital Group Cos v Armour,*[49] the Delaware Court of Chancery reaffirmed *Grynberg v Burke*,[50] and held that the common-law reasonableness test continues to apply to stock transfer restrictions notwithstanding Section 202 of the General Corporation Law.[51] The court also clarified how the reasonableness test should be applied.

Plaintiff, The Capital Group Companies, Inc., a privately held Delaware corporation, brought suit against the husband-and-wife trustees of a trust holding shares of Capital Group stock, seeking declaratory relief. The two defendants were parties to a pending divorce proceeding in the Superior Court of California during which the wife claimed an interest in Capital Group stock owned by the trust. Under the wife's proposal, the husband, a director of Capital Group and executive vice president of one of its subsidiaries, would be awarded the trust's stock but would be required to pay the wife half of all dividends and of any net sale proceeds of the stock. Capital Group argued that such an interest in the stock would constitute an unauthorized transfer, violating certain stock transfer restrictions in a stock restriction agreement that disallowed transfers of stock to any nonemployee of Capital Group and permitted Capital Group to repurchase shares if they were transferred to a nonemployee. The husband and wife agreed to be bound by this agreement when they first transferred stock to the trust. Accordingly, Capital Group sought a declaration that the stock transfer restrictions were valid and enforceable and that, under the stock restriction agreement and under its certificate of incorporation, the award of a record, beneficial, or other interest in the shares to the wife in the California court would constitute an unauthorized transfer so that Capital Group would be entitled to repurchase any of its stock transferred to the wife.

The Unanue *decision represents an interesting decision in the evolution of the judicial approach to disclosure issues in the context of action by written consent.*

The court ruled that Capital Group was entitled to declaratory relief and declared that the stock transfer restrictions were valid and binding and that these restrictions barred the wife's proposed distribution, as well as any disposition of any ownership rights to the wife without Capital Group's consent.

After finding that the wife's requested distribution was, in fact, an "ownership interest" in the stock on the basis that the "righ[t] to receive dividends and proceeds from a stock are two of the sticks in the bundle of rights that have traditionally been the hallmarks of stock ownership," the court considered the wife's argument that the transfer restrictions in the stock restriction agreement were unreasonable and therefore unenforceable.[52]

[T]he Delaware Court of Chancery held that the common-law reasonableness test continues to apply to stock transfer restrictions . . . [and] also clarified how the reasonableness test should be applied.

Before Section 202 was enacted, Delaware courts required that stock transfer restrictions be reasonable. After Section 202's enactment, there was uncertainty whether the common-law reasonableness test still applied. In *Grynberg*, the Court of Chancery held that that the common-law reasonableness test continued to apply, even though Section 202 did not state that. The court expressly declined Capital Group's request to overturn *Grynberg,* invoking the principle of stare decisis and reasoning that "*Grynberg* has been the clearest statement of Delaware law on this subject for over 25 years, and has been cited approvingly numerous times by this court"[53] and that the legislature had not eliminated the requirement in two later amendments to Section 202.

The wife argued that the restrictions, as applied to her, were unreasonable. Capital Group argued that the proper inquiry is whether the restriction is reasonable to achieve a legitimate corporate purpose, not whether it is reasonable for a particular individual. The court held that, in light of the Delaware courts' reluctance to invalidate stock transfer restrictions, a deferential reasonableness inquiry is required for courts to invalidate these restrictions. Thus, resolving this issue in favor of Capital Group, the court decided that the proper inquiry was whether the restrictions were reasonable to achieve a legitimate corporate purpose.

Capital Group proffered several corporate policies advanced by the stock restrictions, which the court summarized as follows: (1) by limiting the number of Capital Group stockholders, Capital Group aimed to avoid the filing and disclosure requirements that federal securities law imposes on public companies; and (2) by restricting ownership interest in the company to employees and their immediate family members, Capital Group aimed to align the interests of the employees with those of the company, enabling greater returns.

The court found that avoiding the securities law disclosure requirements was clearly a valid purpose as a "statutory or regulatory advantage" under Section 202(d) and that the supreme court had expressly found the policy of aligning employees' interests with those of the company to be a legitimate policy.[54] Because it found that Capital Group's purposes would not be achieved if the stock were transferable in the manner proposed by the wife, the court concluded that the restrictions were reasonably related to legitimate corporate purposes.

The *Capital Group Cos* decision reaffirms that the reasonableness test continues to apply to stock transfer restrictions and clarifies that the proper inquiry for the reasonableness test is whether the stock restrictions achieve a legitimate corporate purpose.

Stockholder Inspection Rights

Inspecting Records of Subsidiaries: Weinstein Enterprises, Inc. v *Orloff*

In *Weinstein Enters v Orloff,*[55] the Delaware Supreme Court reversed a decision of the Delaware Court of Chancery interpreting Section 220 of the General Corporation Law[56] as revised in August 2003 to provide that the books and records subject to inspection by stockholders of a Delaware corporation include books and records belonging to the corporation's subsidiaries under certain circumstances. While the supreme court found that the court of chancery correctly determined that a New York corporation, Mays Corporation, in which defendant Weinstein Enterprises, Inc., held a 45 percent interest, was a subsidiary of Weinstein for purposes of Section 220, the Delaware Supreme Court found that the Delaware Court of Chancery erred in finding that Weinstein could obtain the records through the exercise of control over the subsidiary.

Plaintiff George Orloff and his immediate family owned slightly less than 34 percent of Weinstein's outstanding shares. Orloff sought to inspect the books and records of

Mays to value his interest in Weinstein and provide a prospective purchaser of his interest in Weinstein with due diligence materials. Weinstein took the position that it was not required to produce Mays' books and records under Section 220 because it did not exercise control over Mays. In particular, Weinstein argued that Mays was not "an entity directly or indirectly owned, in whole or in part, by the corporation . . . and over the affairs of which the corporation, directly or indirectly, exercises control," such that Mays would fit within the definition of a "subsidiary" under Section 220(a)(3).[57] In addition, even assuming Weinstein had a control position over Mays such that Mays was a subsidiary of Weinstein, defendant argued that Weinstein was not required to produce Mays' books and records because Section 220(b)(2) requires a corporation to produce the books and records of a subsidiary only to the extent the corporation has actual possession and control of those records or can obtain them through the "exercise of control over such subsidiary."[58]

The Delaware Supreme Court began its analysis with the question of whether Mays was a subsidiary of Weinstein, that is, an entity "over the affairs of which [Weinstein]. . . . directly or indirectly, exercises control," and concluded that Mays was such an entity.[59] The court noted that the concept of control does not have a fixed legal meaning and, as a result, must be defined contextually. In the context of Section 220(a)(3), the court determined that the "fiduciary definition" of control was the appropriate standard. Under that definition, control exists when a stockholder possesses the power to control the affairs of the corporation by possessing more than 50 percent of its voting power or when the stockholder possesses less than 50 percent of the corporation's voting power but exercises actual control over the corporation. The court found that Weinstein had the power to control the affairs of Mays (as distinguished from actually exercising that power) because Weinstein directly owned 45 percent of Mays stock and indirectly owned an additional 6–7 percent of Mays stock through an affiliate. Thus, Mays was a subsidiary of Weinstein within the meaning of Section 220(a)(3).

Having found that the threshold determination of whether Mays was a subsidiary of Weinstein was met, the Delaware Supreme Court then turned to the question of whether Weinstein had a statutory obligation under Section 220(b)(2) to produce Mays's books and records. The parties did not dispute that Weinstein did not have actual possession and control over Mays's records. Thus, the issue was whether Weinstein could obtain them through the exercise of control over Mays. The court found the use of the term "control" in Section 220(b)(2) differed from the use of the term in Section 220(a)(3). According to the court, the term "control" as used in Section 220(b)(2) requires that the parent corporation possess actual control over the subsidiary such that the parent corporation alone can cause the subsidiary to produce its books and records. The Delaware Court of Chancery had found that Weinstein lacked actual control over Mays's books and records but that control was established because the court of chancery could resort to its own equitable powers to cause Weinstein to produce Mays's books and records. The Delaware Supreme Court found such an approach to be inconsistent with the statutory mandate of Section 220, which required Weinstein itself to be capable of causing the production of Mays's books and records. Accordingly, the supreme court reversed the judgment of the court of chancery ordering Weinstein to produce Mays's books and records.

Orloff is the first case by the Delaware Supreme Court interpreting Section 220 as revised in August 2003 to provide that the books and records subject to inspection by stockholders of a Delaware corporation include books and records belonging to the corporation's subsidiaries under certain circumstances. It represents an important development in analyzing whether those circumstances are present in a particular case.

[T]he term "control" as used in Section 220(b)(2) requires that the parent corporation possess actual control over the subsidiary such that the parent corporation alone can cause the subsidiary to produce its books and records.

Summary

The cases discussed above reflect the continual refinement of corporate law in the Delaware courts. Corporate practitioners can gain significant insight from a review of this evolutionary process, enabling them to serve their clients' interests more efficiently and with greater predictability.

NOTES

1. 8 Del C § 102 (b)(7).
2. 871 A2d 1108 (Del 2005).
3. Cal Corp Code § 2115.
4. 531 A2d 206, 217 (Del 1987).
5. US Const art 1, § 8, cl. 3.
6. 531 A2d at 216 (quoting Kozyris, *Corporate Wars and Choice of Law,* 1985 Duke LJ 1, at 98).
7. 481 US 69 (1987).

8. 500 US 90 (1991).
9. 138 Cal App 3d 216, 187 Cal Rptr 852 (1982).
10. CA No 18039, 2004 Del Ch LEXIS 150 (Oct 20, 2004).
11. 818 A2d 914 (Del 2003).
12. *Orman,* 2004 Del Ch LEXIS 150, at *15.
13. 637 A2d 34 (Del 1994).
14. 493 A2d 946 (Del 1985).
15. 2004 Del Ch LEXIS 150, at *28 (quoting *Williams v Geier*, 671 A2d 1368, 1382–1383 (Del 1996)).
16. 2004 Del Ch LEXIS 150, at *30 (quoting *Brazen v Bell Atl Corp*, 695 A2d 43, 50 (Del 1997)).
17. 2004 Del Ch LEXIS 150, at *31–*32.
18. *Id.* at *36.
19. CA No 20502, 2005 Del Ch LEXIS 57 (Apr 29, 2005).
20. *Id.* at *25.
21. 789 A2d 14 (Del Ch 2001).
22. CA No 771-N, 2004 Del Ch LEXIS 175 (Nov 15, 2004).
23. 715 A2d 843 (Del 1998).
24. CA No 12039 (Del Ch Apr 26, 1999).
25. CA No 17132 (Dec 20, 2004).
26. 698 A2d 959 (Del Ch 1996).
27. CA 17132, slip op at 20–21 (quoting *Caremark Int'l,* 698 A2d at 971).
28. CA No 19191, 2005 Del Ch LEXIS 54 (Apr 21, 2005).
29. 723 A2d 1180 (Del Ch 1998).
30. 8 Del Ct Ch R 223.1.
31. 863 A2d 772 (Del Ch 2004).
32. 8 Del C §102(b)(7).
33. 8 Del C at §291.
34. Del Ct Ch R 23.1.
35. CA No 12150, 1991 Del Ch LEXIS 215 (Dec 30, 1991).
36. 863 A2d at 793.
37. 859 A2d 80 (Del Ch 2004), *later proceeding* CA No 41-N, 2005 Del Ch LEXIS 33 (Mar 4 2005).
38. 8 Del C § 262(d)(2).
39. 859 A2d at 86.
40. *Id.* at 88.
41. 2005 Del Ch LEXIS 33 (*Motorola II*).
42. 859 A2d at 89.
43. CA No 204-N, 2004 Del Ch LEXIS 153 (Nov 3, 2004).
44. 8 Del C § 225.
45. 8 Del C § 262(d)(2).
46. 2004 Del Ch LEXIS 153, at *39.
47. *Id.* at *35.
48. *Id.* at *51, *62.
49. CA No 422-N, 2005 Del Ch LEXIS 39 (Mar 15, 2005).
50. 378 A2d 139 (Del Ch 1977), *rev'd on other grounds sub nom Oceanic Exploration Co. v Grynberg*, 428 A2d 1 (Del 1981).
51. 8 Del C §202.
52. 2005 Del Ch LEXIS 38 at *25.
53. *Id.*
54. *Id.* at *28.
55. 870 A2d 499 (Del 2005).
56. 8 Del C §220.
57. 870 A2d at 505–6.
58. *See* 8 Del C § 220(b)(2).
59. 870 A2d at 505–6.

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Case Digests

*Prepared by Candace G. Hines**

Labor and Employment—Individual Liability Under Elliot–Larsen Civil Rights Act; Notice of Sexual Harassment

In *Elezovic v Ford Motor Co*, 472 Mich 408, 697 NW2d 851 (2005), plaintiff employee brought an action for sexual harassment against defendants, an employer and a supervisor, under the Elliott-Larsen Civil Rights Act (ELCRA), MCL 37.2101 et seq. The circuit court granted directed verdicts to defendants, which the Michigan Court of Appeals affirmed.

The supreme court ruled that agents can be held liable as individuals under ELCRA. The court found (1) that inclusion of the term agent within the definition for employer in MCL 37.2201(a) is not limited to establishing vicarious liability for the agent's employer but means that agents are considered employers; (2) that federal decisions construing Title VII should not be followed because it would lead to a result contrary to the text of ELCRA; and (3) that the amendment history of ELCRA does not preclude a finding of individual liability.

With respect to the issue of notice to the employer regarding sexual harassment, the supreme court stated that when an employee asks for confidentiality in discussing workplace harassment and the employer honors the request, the request is properly considered a waiver of the right to give notice. In this case, plaintiff's informing two supervisors in confidence about one instance of improper conduct did not constitute notice, notwithstanding the employer's policy that required the supervisors to report the information to human resources personnel. Regarding letters that plaintiff sent to her employer, where the evidence showed that plaintiff had filed numerous grievances and labor relations complaints over the years against the perpetrator and others that were unrelated to sexual harassment, the mention of the word harassment alone or the phrase hostile environment in the letters was insufficient to give the employer notice that sexual harassment was being claimed. Thus, even viewing the evidence in a light most favorable to plaintiff, the supreme court concluded that the employer was entitled to a directed verdict because, under the totality of the circumstances, a reasonable employer would not have been on notice of a substantial probability that sexual harassment was occurring.

Labor and Employment—Continuing Violation Doctrine

In *Garg v Macomb County Cmty Mental Health Servs*, 472 Mich 263, 696 NW2d 646 (2005), plaintiff brought a claim under the Elliott-Larsen Civil Rights Act, claiming that denials of promotion and poor treatment were due to national-origin discrimination and were in retaliation for engaging in activities protected by the act. Defendant denied the allegations and asserted that some of the allegations were barred by the three-year period of limitations.

Overruling *Sumner v Goodyear Tire & Rubber Co,* 427 Mich 505, 398 NW2d 368 (1986), and the continuing violations doctrine, the supreme court held that a person must file a claim under the act within three years of the date his or her cause of action accrues, as required by MCL 600.5805(10). An employee is not permitted to bring a lawsuit for employment acts that accrue beyond this period, because the legislature has determined that such claims should not be permitted. The court also concluded that there was insufficient evidence to support plaintiff's claims of retaliation, based on her opposition to sexual harassment and those acts by her employer following the grievance that were within the statutory limitations period.

Labor and Employment—Statute of Limitations

In *Magee v DaimlerChrysler Corp*, 472 Mich 108, 693 NW2d 166, (2005), plaintiff went on medical leave for emotional distress and, less than six months later, without going back to work, resigned. Since she based her claims of sexual harassment, sex and age discrimination, and retaliation on conduct that allegedly occurred before her leave of absence and she did not file a claim within three years after the date of her leave, plaintiff's claim was not timely filed under MCL 600.5805(10). *Collins v Comerica Bank,* 468 Mich 628, 664 NW2d 713 (2003), which held that the statute of limitations begins to run on the date of termination, did not apply to plaintiff's sexual harassment, discrimination, and retaliation claims because she was never discharged from her employment and did not allege discriminatory termination.

Contracts—Warranty of Merchantability

In *Computer Network, Inc v AM Gen Corp*, 265 Mich App 309, 696 NW2d 49 (2005), plaintiff's action alleged that a vehicle leased from a dealership required over a dozen repairs during the lease period and was out of service for an unreasonable amount of time. Summary disposition was properly granted for defendants, an automobile dealership and a manufacturer, on breach of express warranty and lemon law claims, but, in view of the multiple repairs to the vehicle and the total days out of service, a genuine issue of material fact existed as to whether one defendant breached its implied warranty of merchantability. Because there was a question of material fact with respect to whether the implied warranty was breached, summary disposition on plaintiff's claim under the Magnuson–Moss Warranty Act against one defendant was erroneously granted.

Corporations—Agency

Prentis Family Found v Barbara Ann Karmanos Cancer Inst, 266 Mich App 39, 698 NW2d 900 (2005), arose out of an endow-

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ment agreement in which the donees agreed to rename a cancer center. Plaintiff foundation brought claims against defendants, a law firm and a cancer institute, for breaching the agreement. The circuit court summarily dismissed the law firm as a defendant and granted the institute summary disposition with respect to the foundation's claims for legal damages. The foundation appealed.

On appeal, the foundation contended that the trial court should not have dismissed the law firm as a defendant because the firm owed the foundation a duty because the foundation relied on the firm and the firm engaged in a conflict of interest by representing multiple parties in the contract. The appellate court disagreed, finding that the foundation did not show that the firm owed it an independent fiduciary duty as the firm's relationship with the cancer institute was one of agency. When an attorney is hired to represent a corporation, the client is the corporation, rather than the shareholders. Since the only ground plaintiff foundation gave for finding that its trust, confidence, and reliance was reasonable was that a representative of plaintiff was a board member of the represented corporation, plaintiff failed to show that defendant law firm owed it an independent fiduciary duty. The original judgment granting the institute summary disposition was affirmed.

Lemon Law—Elements of Claim

In *Hines v Volkswagen of America, Inc,* 265 Mich App 432, 695 NW2d 84, (2005), defendant auto manufacturer appealed a judgment of the trial court that was entered in favor of plaintiff lessee involving a claim under the Michigan warranties on new motor vehicles act or Lemon Law, MCL 257.1401 et seq.

The court held that a consumer may not recover under the Lemon Law merely by showing that the new vehicle in question was out of service for repairs for 30 or more days during the term of the manufacturer's warranty or plaintiff's first year of ownership. Rather, pursuant to MCL 257.1403(3), a consumer is entitled to relief only when the consumer shows

1. that the defect or condition was reported to the manufacturer,
2. that the defect or condition continued to exist after it was reported to the manufacturer, and
3. whether the manufacturer designated a repair facility address the defect or condition and, if so, whether the repair attempt did or did not resolve the defect or condition.

In this case, the trial court erred in granting summary disposition for plaintiff on the sole basis that plaintiff's vehicle was out of service for repairs for 30 or more days during plaintiff's first year of ownership.

Sale of Business—Assumption of Liabilities

In *Zantel Mktg Agency v Whitesell Corp*, 265 Mich App 559, 696 NW2d 735 (2005), plaintiff agency filed suit claiming that defendant corporations breached an exclusive sales agency agreement that was executed between the agency and an auto fastener manufacturer, which sold its assets to the buyer corporation. The agency argued that the corporations had terminated the agency agreement without good cause before the 10-year term expired.

The court held that the trial court erred by denying defendants' directed verdict motion because the plain language of the asset purchase agreement established that the 10-year agency agreement between plaintiff and the seller corporation was not a liability assumed by one of the defendants at the time of the closing of the asset sale. Moreover, payments of commissions by the purchaser corporation to plaintiff did not serve to imply a contract between plaintiff and defendants that was contrary to the express language of the asset agreement; rather, they reflected the express agreement by the purchaser that it would assume any liabilities arising by law, contract, or otherwise after the closing of the asset sale, and commissions paid for sales made by plaintiff in Canada after the closing reflected such a liability.

Sales Representative Commission Act—Damages

In *Linsell v Applied Handling, Inc,* 266 Mich App 1, 697 NW2d 913 (2005), plaintiff was a sales representative for the corporation. After she left her position, she returned on the verbal condition that she receive commissions even if the products she sold were not paid for within 30 days of the sale. When the employee resigned due to health problems, a transition agreement could not be reached. The court held (1) that the employee clearly relied on an express oral contract and (2) that damages pursuant to the penalty provision of the Sales Representative Commission Act, MCL 600.2961(5)(b), were limited to a single award of double the amount of commissions due but unpaid or $100,000, whichever was less.

Single Business Tax Act—Apportionment

In *Fluor Enters, Inc v Department of Treasury*, 265 Mich App 711, 697 NW2d 539 (2005), an action involving the single business tax as applied to a California corporation that performed architectural and engineering services at its out-of-state offices for projects located in Michigan, the court of appeals ruled that MCL 208.53(c), which provides that receipts derived from services performed for planning, design, or construction activities within this state are deemed to be Michigan receipts, violates the internal consistency component of the fair apportionment test under the Commerce Clause, US Const art I, § 8, cl 3, and is unconstitutional because the tax was not fairly apportioned.

Single Business Tax Act—Casual Transaction

In *Manske v Department of Treasury*, 265 Mich App 455, 695 NW2d 92 (2005), defendant Michigan Department of Trea-

sury assessed plaintiff taxpayers a tax deficiency under the Single Business Tax Act (SBTA), MCL 208.1 et seq. Plaintiff's sole business activities were the establishment and operation of a hotel and a business park, and granting a deed in lieu of foreclosure was not incidental to that activity. The court of appeals reversed and remanded, holding that the trial court erred in determining that plaintiff's granting a deed in lieu of foreclosures was not a casual transaction pursuant to the SBTA and that it should not have been carried back to plaintiff's tax base.

Single Business Tax Act—Interest Income

In *ANR Pipeline Co v Department of Treasury*, No 249056, 2005 Mich App LEXIS 1062 (May 3, 2005), a Michigan corporation engaged in the interstate transportation, storage, and sale of natural gas attempted to exclude from its tax base under the Single Business Tax Act (SBTA) certain charges to its customers that it characterized as interest income. However, the Department of Treasury asserted that the amounts in question were not interest income payable to the corporation but rather were more akin to carrying charges, which should be included in the tax base under the Single Business Tax Act (SBTA). The tax tribunal agreed with the department, and the court of appeals affirmed, ruling that the corporation failed to meet its burden of demonstrating that the transactions at issue in this case fit clearly within the meaning of *interest* under the act.

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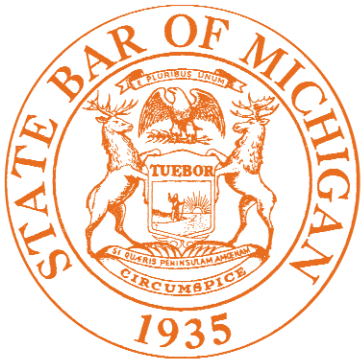

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