



The Michigan Business Law

JOURNAL

CONTENTS

Volume 31 Section Matters

Issue 3	From the Desk of the Chairperson	1
Fall 2011	Officers and Council Members	2
	Committees and Directorships	3

Columns

Did You Know? <i>G. Ann Baker</i>	5
Tax Matters: Michigan Business Lawyer <i>Paul L.B. McKenney and John C. Ray</i>	7
Technology Corner: Data Breach Developments <i>Michael S. Khoury and Jill M. Miller</i>	9

Articles

Section 488 Revisited: Opportunities for Flexible Governance for Michigan Corporations <i>John T. Schuring and Amy M. Kwiatkowski</i>	10
Director and Officer Liability Insurance Fundamentals <i>Marguerite M. Donahue</i>	17
Recent Cases Address Shareholder Oppression <i>Bruce C. Young and Jeanne F. Long</i>	25
Recent Significant Sixth Circuit Opinions Concerning Securities and Corporate Governance Litigation <i>Raymond W. Henney and Lara Fetsco Phillip</i>	29
Non-Compete Agreements: Enforceability, Reasonableness and the Court's Discretion to "Blue Pencil" <i>Ryan S. Bewersdorf and Felicia O'Connor</i>	38

Case Digests 41

Index of Articles	43
ICLE Resources for Business Lawyers	49



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

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

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

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MISSION STATEMENT

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

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

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From the Desk of the Chairperson

By Edwin J. Lukas



This issue of the *Michigan Business Law Journal* marks a new fiscal year for the Business Law Section, and I am honored and humbled by having recently been elected chair. The Section has existed and flourished since 1965. With over 3,200 members statewide, it is the second largest elective section of the

State Bar of Michigan. Being elected chair requires the confidence and respect of the membership, and I will work diligently to lead our efforts this year.

The Section's annual meeting on September 13 proved to be a memorable one. We acknowledged the contributions our immediate past-chair, Robert T. (Bob) Wilson. Bob was an effective leader who displayed thoughtfulness and dedication. In addition to handling all of the tasks that are required of the chair, Bob led an *ad hoc* committee's efforts at amending and restating the Section's bylaws. The restated bylaws will provide value to the Section for years to come. On behalf of the entire Section, I thank Bob for his extraordinary service.

Second, at the conclusion of the meeting, James R. (Jim) Cambridge was presented the Stephen H. Schulman Outstanding Business Lawyer Award. Jim is an incredibly well-deserving recipient. His heartfelt acceptance illustrated to everyone present that service to the Section not only advances the interests of our members but also constitutes a personally rewarding endeavor. Well done, Jim.

Incoming chairs traditionally propose certain initiatives for the forthcoming year. Our broad objective this year is simple and straightforward: to focus on our fundamentals, remain true to our mission and enhance the quality of the services that we deliver to our members.

Our members place tremendous value on information that advances their professional competence. One of the benefits of Section membership is access to our expert programs and presentations through the Business Law Institute, Business Boot Camp, *Michigan Business Law Journal*, and other traditional resources. Our members, though, are increasingly turning to social media as the primary way of delivering and receiving information. We will explore whether social media tools (such as facebook, LinkedIn, and twitter) can be used to more effectively encourage content creation, to improve member access to our resources, and to enhance the way that we deliver and repurpose content in the future. We will work to find more ways to use this media to improve relationships with our members; inspire new attorneys to get involved in our activities; and raise awareness of our services, programs, and benefits.

Michigan's network of in-house counsel, which consists of over 2,000 attorneys, remains largely an untapped resource for the Section. Our fellow business lawyers working in an in-house capacity include some

of our state's finest lawyers. We will encourage the Section's In-House Counsel Committee to identify outreach strategies that are consistent with our mission and that fit well with the initiatives of the Section's Programs Committee.

Finally, we will continue our efforts at helping make Michigan a more attractive place to conduct business. Although the economic recovery has stalled somewhat over the last several months, Michigan aspires to transform its economy into one that looks to innovative entrepreneurs as an additional way forward. We will examine whether we can serve as a catalyst in that process by working with the Michigan Economic Development Corporation at helping make business law services more widely available to emerging companies. We can provide value to Michigan's new Department of Licensing and Regulatory Affairs, whose Office of Regulatory Reinvention seeks to create a licensing and regulatory environment that promotes business growth and job creation and eliminates unnecessary, burdensome regulations.

When you consider the quality of our programs, publication of the *Michigan Business Law Journal*, and the good work that is constantly conducted through our various committees, it makes for an aggressive plan. By working together, however, we can realize our objectives and continue to advance the relationships that make the Business Law Section a very special organization.

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Medical Marihuana

The Michigan Court of Appeals August 23, 2011, decision in *State v McQueen*¹ reversed the trial court and held that the defendants had “no authority to actively engage in and carry out the selling of marihuana between [Compassionate Apothecary] CA members.” The court described the operation as a medical marihuana dispensary and held that it violated the Public Health Code that prohibits the possession and delivery of marihuana. This decision has significant impact on existing corporations and limited liability companies established to grow, distribute, or sell medical marihuana.

According to the opinion “Defendants opened CA in May 2010.” Registered patients and caregivers became “members” by paying \$5 a month. The defendants rented lockers to its “members” for \$50 a month. When a patient or caregiver wishes to purchase marihuana, a CA employee retrieves the marihuana from the locker, weighs and packages the marihuana, and records the purchase. Price is set by the member who rented the locker, and CA keeps a minimum of 20 percent as a service fee for the transaction. In July 2010, the Isabella County Prosecuting Attorney filed a complaint for “a temporary restraining order, preliminary injunction, and permanent injunction against defendants.” The prosecutor argued that the defendants’ operation was not in accordance with the Michigan Medical Marihuana Act and a public nuisance because it also violated the Public Health Code.

The trial court held that the defendants did operate in accordance with the Michigan Medical Marihuana Act and denied the injunction. The Michigan Court of Appeals, however, held that defendants’ operation is an enjoined public nuisance and reversed the trial court.

The case identifies defendants Brandon McQueen and Matthew Taylor as doing business as “Compassionate Apothecary, LLC.” There is no record, however, for an entity with the name “Compassionate

Apothecary, LLC.” Articles of incorporation for “Mt. Pleasant Compassion Club” a nonprofit directorship corporation were filed April 22, 2010.² The incorporators were Brandon McQueen, Matthew Taylor, and Janice LaRose.

Footnote 2 of the opinion states “During the course of the proceedings below, defendants learned that the word ‘apothecary’ can only legally be used in the name of pharmacies. Thus, they changed the name of their operation to ‘CA.’ They were in the midst of filing paperwork to finalize the name change.” Articles of organization for “C.A. of Mount Pleasant LLC” were filed October 4, 2010.³ Matthew Taylor and Brandon McQueen signed the articles of C.A. of Mt. Pleasant LLC as the organizers. Articles of organization for “C.A. Farms, LLC” were filed on March 4, 2011.⁴ Matthew Taylor and Brandon McQueen signed the articles of C. A. Farms, LLC as the organizers. It is unclear in which organization the registered patients and caregivers became members.

Several bills have been introduced to address concerns that have arisen with the implementation of the Michigan Medical Marihuana Act. Some bills would amend 2008 IL 1, and some bills amend the Public Health Code, the Penal Code, and the Code of Criminal Procedure.

Attorney General Opinion No. 7259 (June 23, 2011) addressed the issue of whether the Michigan Medical Marihuana Act authorizes patients and primary caregivers to form cooperatives to jointly cultivate, store, and share medical marihuana. The opinion discusses several provisions in the Act and concludes that it did not repeal any statutory prohibitions regarding marihuana. The Act expressly provides for an individual to acquire and cultivate marihuana for medical use, but it does not provide for the formation of cooperatives. The opinion concludes the Act “prohibits the joint cooperative cultivation or sharing of marihuana plants because each patient’s plants must be grown and maintained in a separate

enclosed, locked facility that is only accessible to the registered patient or the patient’s registered caregiver.”

The pending legislation and several cases working their way through the court system will all impact how the Michigan Medical Marihuana Act is interpreted and applied. The Corporation Division will continue to refuse to file documents that indicate a corporation or limited liability company is being formed to engage in the sale, growth, or distribution of marihuana.

Incorporation Transparency and Law Enforcement Assistance Act

On August 2, 2011, U.S. Sen. Carl Levin (Michigan) and U.S. Sen. Charles Grassley (Iowa) re-introduced the Incorporation Transparency and Law Enforcement Assistance Act.⁵ This bill is similar to legislation previously introduced in the 110th Congress and the 111th Congress. The bill would require states to obtain the names of the owners of proposed corporations and limited liability companies at the time of entity formation. An updated list of beneficial owners would be required to be submitted within 60 days of a change in beneficial ownership and annually. The bill also includes penalties for providing false ownership information.

The purpose of the legislation is to provide law enforcement with quick and easy access to the names of owners and beneficial owners of corporations and limited liability companies. In addition, the bill would comply with international standards issued by the Financial Action Task Force on Money Laundering (FATF), of which the United States is a member, by requiring disclosure of corporate beneficial ownership information.

In his floor statement, Senator Levin described several scenarios in which corporations and limited liability companies have been used in financial crimes and suspicious transactions. Examples of wrongdoing include facilitating terrorism, money laundering, financial fraud, tax evasion, and corruption. In many

instances law enforcement has difficulty in determining who the owners are, and when the owners are another corporation or limited liability company, they are unable to determine who the individual owners are.

The FATF is currently reviewing the 40 +9 recommendations⁶ and considering some revisions.⁷ The Consultation Paper on The Review of the Standards—Preparation for the 4th Round of Mutual Evaluation was distributed in June 2011. It includes possible revisions regarding what information must be available, who should be responsible for holding the information and access to the information. It includes recommendations for certain basic information on companies be available from the filing office, preventing misuse of bearer shares, preventing misuse of nominee shareholders, and preventing misuse of trusts.

The bill contains some exemptions for publicly traded companies, banks, broker-dealers, insurers, registered investment funds, and charities. However, the bill also requires “formation agents” to identify the beneficial owners of the companies being formed. “Formation agent” is defined as “a person who, for compensation, acts on behalf of another person to form, or assist in the formation, of a corporation or limited liability company under the laws of a State.” The U.S. Department of Treasury would be required to issue a rule requiring formation agents to establish anti-money laundering programs to ensure they are not forming U.S. corporations or LLCs for wrongdoers. The programs would be required to be risk-based. The bill provides any rule promulgated under this provision “shall exclude from the category of persons engaged in the business of forming a corporation or limited liability company—(A) any government agency; and (B) any attorney or law firm that uses a paid formation agent operating within the United States to form the corporation or limited liability company.” The bill may raise several issues for lawyers. The American Bar Association’s Task

Force on Gatekeeper Regulation and the Profession has reviewed the bills previously introduced and the ABA opposed the prior bills.⁸

Cremation Companies

Section 4 of the cremation company act provided, “Such corporation shall have the power to acquire by gift, devise or purchase, and hold in fee simple so much land as may be necessary and appropriate for its purposes: Provided, That no land thus held shall be in any way encumbered by such corporation.”⁹ Section 6 of the act prohibited a “mortgage or other lien or encumbrance” from being placed on lands or buildings actually used for the disposal of the dead.¹⁰ These provisions made it difficult for some cremation companies to obtain funding to acquire necessary land and buildings or to finance improvements to existing property.

HB 4456 was introduced to amend the cremation company act to permit a cremation company operating solely a columbarium, with no columbarium, to be permitted to lease land or buildings. The bill repeals the provision requiring property to be owned in fee simple and permits land and buildings to be mortgaged or otherwise encumbered.

HB 4456 was signed by Gov. Rick Snyder and became Public Act 112 of 2011, effective July 20, 2011. The amendment repealed section 4 of the cremation company act and substantially amended section 6. The bill added section 6(3), which permits a mortgage or other lien or encumbrance on property that is not used as a columbarium and requires a bond. If land or buildings are leased, the duration of the lease cannot be for less than five years.

A corporate surety bond and a cash bond conditioned on “faithful performance of all cremations and dispositions of cremated remains contracted for, by, or on behalf of the corporation that owns the crematorium” are prerequisites to lease, mortgage, or otherwise encumber such property.¹¹ The total of the surety bond and cash bond must be at least \$100,000.

The surety bond and the cash bond must be for the benefit of the state and is to ensure the performance of the cremation and disposition of cremated remains.¹² There is, however, no obligation or requirement to file the bond with any state agency.

NOTES

1. No 301951, 2011 Mich App LEXIS 1512 (Aug 23, 2011).
2. http://www.dleg.state.mi.us/bcs_corp/dt_corp.asp?id_nbr=70801R&name_entity=MT.%20PLEASANT%20COMPASSION%20CLUB.
3. http://www.dleg.state.mi.us/bcs_corp/dt_llc.asp?id_nbr=D4835N&name_entity=C.A.%20OF%20MOUNT%20PLEASANT%20LLC.
4. http://www.dleg.state.mi.us/bcs_corp/dt_llc.asp?id_nbr=D5513T&name_entity=C.A.%20FARMS,%20LLC.
5. For summary of bill and link to bill text see <http://levin.senate.gov/newsroom/press/release/summary-of-the-incorporation-transparency-and-law-enforcement-assistance-act>.
6. www.fatf-gafi.org/recommendations.
7. <http://www.fatf-gafi.org/dataoecd/3/30/46266717.pdf>.
8. http://www.americanbar.org/advocacy/governmental_legislative_work/priorities_policy/independence_of_the_legal_profession/bank_secrecy_act.html.
9. MCL 456.204.
10. MCL 456.206.
11. MCL 456.206(3).
12. *Id.*

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Michigan Business Lawyer

True Tax Cut for Most Law and Other Professional Firm Owners

Historically, lawyers and others in Michigan owning interests in professional firms have paid two sets of tax. First, was the Single Business Tax ("SBT"), later replaced by the Michigan Business Tax in 2008 ("MBT"), paid at the entity level. In addition to paying tax on compensation, any flow through of profits, such as with a PLC, partnership, or S corporation was also subject to the Michigan Income Tax at the individual level. The convoluted MBT did not work well in practice and was in need of substantial revisions. Earlier this year, the legislature responded, and Governor Snyder signed legislation making fundamental Michigan tax changes. Among other structural changes the MBT was repealed and replaced by the Michigan Corporation Income Tax ("CIT"). MCL 206.623(1).

Most important to owners of law firms is that effective January 1, 2012, the CIT will *not* apply to a "flow-through entity" such as an S corporation or an entity federally taxed as a partnership. MCL 206.607(2). This is not a rate reduction; this means entity level Michigan tax simply will no longer apply. Starting next year law firms, accounting practices, medical practices, and other businesses that are not taxed as C corporations will not have any corporate income tax liability for income or receipts properly allocable to Michigan. A simple example is that you are a partner in a PLC that is taxed as a partnership for federal income tax purposes. Starting in 2012, the PLC will no longer incur entity level Michigan tax. Their individual owners will, however, continue to have individual Michigan income tax liability for personal income attributable to Michigan. Also, while a partnership will not be subject to the CIT, if a C corporation is a partner, then that partnership income will flow through to the C corporation

and comprise part of the C corporation's tax base for CIT purposes.

The scope of the exemption of non-C corporation entities from the CIT is very broad. It is not limited to professional practices. For example, in a common situation in which a law firm, manufacturing company's individual shareholders, retail store's individual owners, etc. owns real estate via an LLC or S corporation and leases the real estate to the operational entity, that pass through real property owning entity will not incur CIT liability.

How is Lansing paying for this? The legislative solution is a number of tax changes across the board in various Michigan levies designed to make the state more competitive from a business tax perspective. Two most prominent are the elimination of scheduled decreases in the Michigan individual income tax rate and the changing of Michigan's tax system of individual income taxation of pensions from the most generous in the nation to more conventional pension taxation. The pension changes are somewhat politically contentious and the constitutionality of the reduction in pension exemptions is currently before the Michigan Supreme Court. There are numerous other changes, particularly eliminating small credits, which are beyond the scope of this article.

Non-Professional Firm Entities Also Benefit

As noted above, the elimination of the CIT for flow-through entities is not limited to just the professional practice sector. Thus, in Michigan, the age-old debate about choice of entities will have another decided tilt away from C corporation tax status. The CIT rate on C corporations is substantially 6 percent. MCL 206.623(1). Over the years, we have seen a huge migration of new entities that would have been C corporations decades ago but were instead formed as S corporations and then, starting

in the early 1990's, usually as LLCs. Also, many C corporations wisely converted to S corporation status. If a client C corporation has business with significant Michigan activities, you need to revisit the desirability of that C corporation making an S corporation election. It may entail some "S corporation clean-up" such as making sure there are only eligible shareholders, etc. It may also be time to review whether the rent charged to the C corporation by a commonly owned pass-through entity is too low and to evaluate other issues.

Review your C corporation client base to see what planning opportunities are available under the CIT.

Conclusion

2012 will represent the first time since 1976 that non-C corporations will not incur a Michigan entity level tax on income or receipts allocable to Michigan.

Michigan lawmakers have taken some substantial steps to make Michigan perceived as much more friendly to business than has been the reputation in the national business community in the past. You and your clients should take advantage of this window of opportunity that opens January 1, 2012. Remember the Nike motto, "Just Do It!"



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Data Breach Developments

There has been much written about ongoing developments in the area of data breach notification. Although 46 states, plus the District of Columbia, the U.S. Virgin Islands, and Puerto Rico have enacted some form of data breach notification law, every year there continues to be legislation regarding the topic. On the federal level, Congress is moving on several bills after years of inaction. Texas recently enacted a sweeping law, and California also continues to update its data breach notification law, recently changing organizations who must receive notice.¹ Here are some highlights.

Texas Data Breach Notification Law

Texas recently enacted a law² that appears to cover residents of all 50 states. The Texas law has broadened its reach so that it even protects residents of the four remaining states that have not enacted security breach notification laws.

In June 2011, Texas amended the state's data breach notification law. What may have seemed insignificant by changing the language from disclosing a breach "to any resident of this state" to "any individual," is quite significant to businesses that maintain personal information. Basically, this new law requires that notification is required to be given to individuals who would otherwise not receive notice under their state's laws. Texas does give credit for compliance with other state's existing security breach notification laws. If the breached individual is a resident of a state that requires notice of a breach of personal information, compliance with that state's law is sufficient.

The amended Texas law also provides for penalties of up to \$100 per individual per day for each consecutive day that an entity fails to give notice. These additional penalties may increase the overall financial exposure for non-Texas based entities that are required to pay penalties for

lack of notice or delays in providing notice, based on their own state data breach notification laws.

It seems that Texas has taken on the role as the protector of all consumers who might have their personal information stolen. Whether or not the Texas law is enforceable outside of Texas may take some time to determine.

Federal Legislative Efforts

The ongoing efforts of Congress to enact data breach legislation have rarely been productive, although several bills have recently been reported out of committee in the Senate.³ The history of the efforts in Congress has been interesting. In the past, Congress has sought to create a very watered-down data breach notification law to supersede the more stringent obligations passed by such states as Texas, California, and Massachusetts. The recent bills take a different approach and would generally follow the more robust requirements of state laws.

The various bills include the obligations of businesses to conduct risk assessments, and they would relieve the obligation of the business to send out notification if they conclude that there is no significant risk of harm. There is a debate between those who believe that notification should be the default unless there is no harm proven versus those who believe that notification should only be required if there is harm that can be shown. This debate will continue to play out, although some of the proposed legislation would require that the business share its risk assessments with the Federal Trade Commission (FTC) if it concludes that there is no significant risk of harm. Additional requirements would follow the pattern of many of the state bills, including the Michigan legislation, which would require a business to minimize the amount of sensitive personally identifiable information maintained by the business.

Although it remains unclear whether the FTC has the ability to

address these data breach and security issues, there will be substantial value if a uniform system for data breach notification requirements is established by Congress. Now that Congress is recognizing that only a robust data breach notification act has a chance of passing, we may see such legislation come from Washington that would harmonize the process for businesses in the United States.

NOTES

1. California S.B. 24 (Effective January 1, 2012).
2. Texas H.B. 300 (Effective September 1, 2012).
3. See, for example, Personal Data Privacy and Security Act of 2011 (S. 1151), sponsored by Senate Judiciary Committee Chairman Patrick Leahy.



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Section 488, Revisited: Opportunities for Flexible Governance for Michigan Corporations

By John T. Schuring and Amy M. Kwiatkowski*

Introduction

In 1997, the Michigan Legislature added Section 488¹ to the Michigan Business Corporation Act (“MBCA”).² The act was greeted with fanfare by the State Bar of Michigan and the business community, which had sought to “address the special needs of small corporations whose operations did not neatly fit” the MBCA as then enacted.³

Based on Section 7.32 of the Model Business Corporation Act (the “Model Act”),⁴ Section 488 allows a corporation’s shareholders to alter the entity’s governance by adopting a shareholder agreement (a “Section 488 Agreement”). The Section 488 Agreement can include such provisions as eliminating the board of directors, establishing the manner of electing or removing directors and officers, and the like. As a result, Section 488 “authorizes a high but not unlimited degree of flexibility”⁵ for corporations to determine their own elements of governance.

However, by the time Section 488 was adopted, the Limited Liability Company Act⁶ enacted by the Michigan Legislature in 1993, had already begun to gain favor among those forming entities in the state of Michigan. In fact, between October 1, 1997, and September 30, 1998, over 16,000 Michigan LLCs were organized, as compared to almost 26,000 corporations.⁷ In subsequent years, the shift towards LLCs in Michigan (and elsewhere) has become more pronounced; from October 1, 1998 through September 1, 2010, 464,017 LLCs were organized in Michigan; in that same time period, only 224,876 corporations were incorporated.⁸ As a consequence, many of the types of enterprises that would most benefit from the flexibility of Section 488 have opted to form LLCs instead.

It appears that Section 488 has not had as dramatic an impact as was envisioned at its enactment. In spite of the recent migration to LLCs, however, corporations continue to

be formed, and existing corporations continue to operate. For these entities, Section 488 “gives shareholders in smaller corporations a great deal of flexibility in tailoring the structures and operations of their corporations to fit their needs.”⁹ So, as the 15-year anniversary of the enactment of Section 488 approaches, perhaps now is a good time to revisit an underused and often overlooked provision.

This article will attempt to “reintroduce” Section 488 by providing an overview of the statute, as well as discussing possible practical applications, and highlighting a few issues to address when drafting a Section 488 Agreement.

Overview of Section 488

Section 488 expressly authorizes the shareholders of non-publicly traded corporations to enter into various types of agreements, even when those agreements are inconsistent with other MBCA provisions. Section 488 grants substantial power to a corporation’s shareholders to determine how the corporation will be managed and to structure the relationship among the shareholders, directors, and the corporation.

Section 488(1)(a)-(g) specifically allows Section 488 Agreements to address the following provisions:

- Restricting the power of the board of directors or eliminating the board of directors entirely.¹⁰
- Allowing unequal distributions to shareholders.¹¹
- Electing directors and officers and the manner of removing directors and officers.¹²
- Permitting weighted voting power among shareholders and directors, and director proxies.¹³
- Establishing terms and conditions

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of interested shareholder, director, officer, and employee transactions.¹⁴

- Delegating to shareholders, or other persons, management powers normally reserved for the board of directors, including the right to break deadlocks among directors or shareholders.¹⁵
- Dissolving the corporation on the request of one or more of the shareholders or the occurrence of a specified event.¹⁶

Section 488(1)(h) also contains a “catch-all” provision that adds further flexibility by validating any other provisions not specifically enumerated in the statute, as long as the provisions are not “contrary to public policy.”¹⁷

Section 488 Agreements must be set forth in the corporation’s articles, bylaws,¹⁸ or in a separate written agreement. No matter where the agreement is placed, it must be approved by all persons who are shareholders of the corporation at the time of adoption.¹⁹ Any amendments to the Section 488 Agreement must also be approved by all persons who are shareholders of the corporation at the time of the amendment, unless the original agreement provides otherwise.²⁰

The existence of a Section 488 Agreement must be conspicuously noted on all stock certificates issued by the corporation.²¹ If the corporation had already issued stock certificates at the time the Section 488 Agreement was adopted, the corporation must recall the certificates and issue substitute certificates that note the existence of the agreement.²² Although the failure to provide notice of the existence of the Section 488 Agreement does not affect the validity of the actual agreement, any persons who later become shareholders of the corporation without knowledge of the agreement²³ are entitled to rescind their purchase.²⁴

Although shareholders of a corporation are not usually protected by MBCA indemnification and limited liability provisions, shareholders who are vested with the discretion or powers of the board of directors under a Section 488 Agreement are treated as directors under the agreement for purposes of liability for acts or omissions imposed by law on directors, as well as for purposes of indemnification and limitation of such liability.²⁵

No matter how much a Section 488 Agreement may alter the typical corporate struc-

ture, Section 488 makes it clear that the existence of such an agreement is not grounds for treating the corporation as a partnership or unincorporated entity for purposes of imposing personal liability on the shareholders.²⁶

Practical Applications of Section 488

The provisions contained in Section 488(1)(a)-(g) as outlined above provide clear direction on a number of applications of Section 488 Agreements. The statute is quite expansive, however, and is generally limited only by the creativity of counsel and the constraints of public policy. Following are a few examples of how Section 488 Agreements may be used.

Whatever You Need – Within Limits

Counsel should not feel limited by the enumerated list of provisions that are specifically permitted by Section 488(1)(a)-(g). As noted in the commentary to Model Act §7.32, “[t]he enumeration of these types of agreements is not exclusive; nor should it give rise to a negative inference that an agreement of a type that is or might be embraced by one of the categories of section 7.32(a) is, *ipso facto*, a type of agreement that is not valid unless it complies with section 7.32.”²⁷ Additionally, the “catch all” provision of Section 488(1)(h) provides great flexibility, limited only by the bounds of the drafter’s imagination and public policy. However, the commentary to Section 7.32 of the Model Act notes that the “catch all” provision “is intended to be read in context with the preceding seven subsections and to be subject to a *ejusdem generis* [of the same kind] rule of construction;” as such, in addition to the public policy constraint stated in the statute, “in defining the outer limits, courts should consider whether the variation from the Model Act under consideration is similar to the variations permitted by the first seven subsections.”²⁸

Replicating LLC Governance

If parties are considering setting up an LLC or converting an existing corporation into an LLC strictly to take advantage of the flexible governance opportunities, a Section 488 Agreement might well eliminate the need to use the LLC form. At least one commentator has observed that the flexibility provided by the “catch all” provision allows a corporation to adopt many, if not all, of the governance mechanisms of a partnership or limited liability company:

Section 488 expressly authorizes the shareholders of non-publicly traded corporations to enter into various types of agreements, even when those agreements are inconsistent with other MBCA provisions.

Section 488 explicitly shields the shareholders from certain liabilities in the event that “the agreement or its performance results in failure to observe the corporate formalities otherwise applicable to the matters governed by the agreement.”

This catch-all is a very useful provision when comparing the utility of a Section 488 agreement with a partnership agreement or limited liability company operating agreement. If a particular contractual provision would be permitted under Michigan law in a partnership agreement or an operating agreement, it would be difficult to argue that such a provision would be against public policy if placed in a Section 488 agreement. Thus, a Section 488 agreement may provide more flexibility [than] a limited liability company or partnership, leaving tax issues aside.²⁹

Closely Held Corporations

A closely held corporation, where the shareholder or shareholders serve as the directors and officers and are the primary operators of the enterprise, might benefit from implementing relaxed governance requirements via a Section 488 Agreement—particularly if the corporation has historically been lax about adhering to the typical governance requirements of the MBCA. Section 488 explicitly shields the shareholders from certain liabilities in the event that “the agreement or its performance results in failure to observe the corporate formalities otherwise applicable to the matters governed by the agreement.”³⁰ This could be very useful in a corporation held by family members, where they might want to allocate most of the operating responsibility in the hands of one family member.

Strong Minority Shareholder Protections

A Section 488 Agreement can contain a number of provisions that provide protections and benefits to minority shareholders:

- The shareholders can establish the composition and number of the board of directors, which remains in place absent amendment to the Section 488 Agreement.³¹ This can preserve a board composition that is favorable to a minority shareholder, even when the stock ownership would otherwise allow majority shareholders to elect a different board of directors. Even if an agreement calls for an equal number of directors selected by a majority and a minority shareholder, the use of weighted voting can allow the minority shareholder to have the

ultimate say on at least certain matters put to a board vote.³²

- The Section 488 Agreement can allocate certain decisions to a subset of directors—who can be either permanently appointed by the minority shareholder, or elected solely by the minority shareholder.³³ Eliminating the board and allocating specific authority directly to one or more shareholders can also be done.
- The Section 488 Agreement can allocate selection or removal of the officers to the minority shareholder.³⁴ In addition, the agreement can govern the terms of services provided by the officers and employees of the corporation, allowing a minority shareholder to regulate and restrict salaries and benefits paid to such individuals.³⁵
- Dividend restrictions can be implemented, such that no dividends are paid to the majority shareholders until dividends exceeding a certain threshold are paid to the minority shareholder.³⁶
- The agreement can permit one shareholder, acting alone, to exercise the “nuclear option” of dissolving the corporation, should he or she wish to terminate the business relationship for whatever reason. The existence of such an option might provide a minority shareholder with sufficient leverage to impact management and governance issues beyond those that he or she directly controls, through other Section 488 Agreement mechanisms or otherwise.³⁷
- It can also require the board to act only in actual meetings (as opposed to consent resolutions), to ensure that there are sufficient opportunities for discussion among the directors. These types of provisions provide minority shareholders with opportunities to give input and guidance, as well as limit the ability of the majority to act precipitously and behind the backs of the minority.

While some of these actions can be accomplished in ways other than a Section 488 Agreement (by amending the corporation’s articles or through a voting agreement under

MBCA Section 461, for example), Section 488 is a broad and powerful alternative.

Once a minority shareholder has obtained these types of benefits, it is difficult for the majority shareholders to wrest them away. Absent language in the Section 488 Agreement to the contrary, the agreement can only be amended by vote of all of the shareholders,³⁸ allowing the minority shareholder to unilaterally block any efforts to change these arrangements.

Minority Business Enterprise Applications

A Section 488 Agreement can also be useful in instances where a service disabled veteran, woman, or minority individual (the “51% Shareholder”) must own 51% of the equity and control the corporation. The agreement can be used to create a two-member board of directors (for example, the 51% Shareholder and a 49% shareholder), but allow the 51% Shareholder to have the controlling vote (usually by giving him or her two votes as a director). This avoids having to recruit additional qualified individuals who may not have any connection with, or special knowledge regarding, the corporation or its business. As this approach may not match the letter of the controlling regulations (which may require “a majority of the Board” to be comprised of qualified individuals), counsel should confirm that the certifying body would accept this approach.

Limited Duration Agreement

Although Section 488 Agreements are generally not limited in duration, counsel could craft an agreement with a specific term in certain circumstances—for example, if the intent of the agreement is to grant control to a certain investor until specific performance objectives are reached.³⁹

Additional Provisions for Typical Buy-Sell Agreements

Even if the shareholders do not wish to generally alter the governance provisions of the MBCA, they may still wish to include one or more of the provisions specifically permitted by Section 488—such as director proxies, distributions not in proportion to share ownership (another opportunity to implement LLC-type aspects into the corporate form), weighted voting rights, and deadlock resolutions—into a more typical “buy-sell” type of shareholder agreement. As long as the requirements of Section 488 are met, the pro-

vision will be binding even though in conflict with other provisions of the MBCA.

Issues to Consider When Drafting a Section 488 Agreement

The following are issues to consider when drafting a Section 488 Agreement.

Consideration (and Customization) of Existing Articles, Bylaws, etc.

Counsel who engage in drafting a Section 488 Agreement must use care to make sure that the agreement works in harmony with existing governance documents, or that these documents are amended accordingly. It may be wise to include a provision in the Section 488 Agreement stating that, in the event of conflict between the agreement and the articles or bylaws, the agreement controls.⁴⁰ For example, if the agreement shifts the responsibilities of the board of directors to other persons, Section 488(6) imposes on such persons the liability for acts or omissions “imposed by law on directors to the extent that the discretion or powers of the directors are limited by the agreement.”⁴¹ The Section 488 Agreement “could also provide for exculpation from that liability to the extent otherwise authorized” by the MBCA.⁴²

Although counsel will need to consider the impact of a Section 488 Agreement on relevant bylaw provisions, it should not be necessary for the drafter to attempt to modify every provision of the MBCA that might conflict with the provisions of a Section 488 Agreement, as “courts should in such cases construe all related sections of the Act flexibly and in a manner consistent with the underlying intent of the shareholder agreement.”⁴³

Articles, Bylaws, or Standalone Agreement?

Counsel will need to give some thought as to whether a Section 488 Agreement should be included in the bylaws, articles, or separate agreement; each option has advantages and disadvantages. For example, inclusion in a written agreement or bylaws allows the provisions to remain confidential.⁴⁴ On the other hand, placing these provisions in the articles could be viewed as public notice on the limitations of management and the like contained in the agreement. However, this might limit the entity’s flexibility, as amendments to the articles must be filed before the Section 488 Agreement becomes effective.⁴⁵

Counsel will need to give some thought as to whether a Section 488 Agreement should be included in the bylaws, articles, or separate agreement; each option has advantages and disadvantages.

If the agreement is included in the articles or bylaws, counsel may wish to consider having each shareholder sign the document, or at least the resolution adopting the provisions. Although it is not necessary that the shareholders sign the document, “it may be desirable to have all the shareholders actually sign the instrument in order to establish unequivocally their agreement.”⁴⁶ The same principle applies equally to transferees of the shares.⁴⁷

Special Considerations for S Corporations

A Section 488 Agreement might be quite useful for shareholders of an S Corporation to allocate control of the corporation to certain shareholders without causing the corporation to have more than one class of stock (as forbidden by the Internal Revenue Code). To qualify as an S Corporation, a corporation may not have more than one class of stock.⁴⁸ Differences in voting rights among the shares of common stock do not cause a corporation to be treated as having more than one class of stock.⁴⁹ Treasury Regulations allow an S Corporation to have such features as voting and nonvoting common stock, a class of stock that is permitted to vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.⁵⁰ A corporation can implement one or more of these mechanisms without creating more than one class of stock for purposes of maintaining S Corporation status.⁵¹ A Section 488 Agreement can be quite useful in implementing these mechanisms without having to amend the corporation’s articles (the normal way of distinguishing between voting and non-voting shares). This is especially true if the corporation is looking for something other than an all-or-nothing approach to voting rights.

Counsel must ensure, however, that the Section 488 Agreement does not compromise each share’s identical right to distribution and liquidation proceeds. For purposes of determining S Corporation status, a corporation has only one class of stock “if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.”⁵² Determining whether all shares confer identical rights is based on the corporation’s governing provisions, including its articles, bylaws, and any binding agreements relating to distribution and liquidation proceeds.⁵³ A Section 488 Agreement

will clearly be part of any such determination. The drafter must avoid including language allowing distributions not in proportion to share ownership (as permitted under Section 488(1)(b)), which could jeopardize the corporation’s S-election.

Section 488 Has Limits

Although Section 488 provides a great deal of flexibility to shareholders to craft their own governance rules—the comment to the Model Act provision states that the provision “validates virtually all types of shareholder agreements that, in practice, normally concern shareholders and their advisors”⁵⁴—that flexibility is not limitless. Although it notes that “[f]urther development of the outer limits is left...for the courts,”⁵⁵ the commentary to the Model Act indicates that a few provisions would fail the public policy test noted above and would not be fair game for a Section 488 Agreement:

- An agreement that provides that the directors of the corporation have no duties of care or loyalty to the corporation or the shareholders. Such a provision is not very similar to the enumerated permitted arrangements and could be viewed as being contrary to public policy.⁵⁶
- A provision that exculpates directors from liability more broadly than permitted by the MBCA, as public policy reasons support the existence of these limitations.⁵⁷

Not Binding on Third Parties

The provisions of a Section 488 Agreement are not binding on third parties, including governmental entities and creditors.⁵⁸ The intent of Section 488 is to cover only “the relationship of shareholders and the corporation.”⁵⁹ As such, an agreement provision that attempts to reorder the priority of payments upon dissolution of the corporation, or to waive the requirements of filing annual reports with the Department of Licensing and Regulatory Affairs, would be ineffective.⁶⁰

What if Not Unanimous?

One treatise has noted that “the section leaves open the validity of any 488-type agreement that fails to satisfy its unanimity requirement,” and hypothesized that “[i]f, for example, two out of three shareholders agree to limit board powers, a court might

The provisions of a Section 488 Agreement are not binding on third parties, including governmental entities and creditors.

consider whether the shareholder who neither approved nor signed the agreement was prejudiced by it and under appropriate circumstances might sustain the agreement.”⁶¹ However, the validity of such an agreement “is at best uncertain, and, if at all possible, counsel should attempt to bring such agreements within the safe harbor of section 488.”⁶²

Vote Required for Amendment

The Section 488 Agreement can only be amended by unanimous vote of the shareholders at the time of the amendment, unless the agreement provides otherwise.⁶³ Counsel should give careful thought to whether there is any reason to permit less than all of the shareholders to make a change. If the intent is to include a provision specifically permitted by Section 488 (such as director proxies) into a typical buy-sell type of shareholder agreement, it might be advantageous to opt out of the unanimous amendment requirement—but you must do so in the body of the agreement. If a unanimous vote is desired and the agreement is placed in the corporation’s bylaws, it is prudent to include language in the agreement to that effect, “to avoid an argument that the majority vote provisions generally found in most bylaws constitute the statutory permitted agreement of the shareholders for amendment of the Section 488 agreement by less than a unanimous vote.”⁶⁴

Is the Corporation a Party to the Agreement?

While the corporation itself is not required by statute to be a party to the Section 488 Agreement, it may be wise to include it, as the corporation may be better situated to enforce the rights and remedies provided therein.⁶⁵ If the corporation is not included as a party, it should be granted the right to enforce the agreement.⁶⁶

All Shareholders—Even Holders of Nonvoting Shares—Must Approve

Keep in mind that Section 488(2)(a) requires that a Section 488 Agreement be approved by “all persons who are shareholders at the time of the agreement”—whether or not those shareholders hold voting or non-voting shares.⁶⁷

Conclusion

Section 488 remains a useful—if often overlooked—tool at the disposal of Michigan

corporations and their counsel. Although the emergence of the limited liability company may have reduced the impact of Section 488 for creating an entity with flexible governance that can be determined by the entity’s owners, the provision can be used by Michigan corporations seeking additional flexibility with respect to governance provisions without using or converting to an LLC.

NOTES

1. MCL 450.1488.
2. MCL 450.1101 *et seq.*
3. Senate Bill 414, House Legislative Analysis (June 3, 1997).
4. See James C. Bruno, *Business Problems and Planning—Shareholder and Joint Venture Agreements under Section 488 of the Michigan Business Corporation Act*, 78 MICH. B.J. 72 (1999).
5. Stephen H. Schulman *et al.*, Michigan Corporation Law & Practice §4.21a (2010).
6. MCL 450.4101 *et seq.*
7. See New Business Entities, Michigan Department of Licensing and Regulatory Affairs, *available at* http://www.michigan.gov/lara/0,4601,7-154-35299_35413-114905--,00.html (last visited September 1, 2011) (between October 1, 1997 and September 30, 1998, 16,297 LLCs were organized or given certificates of authority to transact business in Michigan, as opposed to 25,909 corporations).
8. *Id.*
9. Schulman *et al.*, *supra* note 5.
10. MCL 450.1488(1)(a).
11. MCL 450.1488(1)(b).
12. MCL 450.1488(1)(c).
13. MCL 450.1488(1)(d).
14. MCL 450.1488(1)(e).
15. MCL 450.1488(1)(f).
16. MCL 450.1488(1)(g).
17. MCL 450.1488(1)(h).
18. If a Section 488 Agreement is contained or referred to in a corporation’s articles of incorporation or bylaws, and the agreement ceases to be effective for any reason, the board of directors may without shareholder action adopt an amendment to the articles of incorporation or bylaws to delete the agreement and any references to it. MCL 450.1488(5).
19. Incorporators or subscribers for shares may act as shareholders with respect to a Section 488 Agreement if no shares have been issued when the agreement is made. MCL 450.1488(2). Also note that Section 488(10) states that the failure to satisfy the unanimity requirement of Section 488(2) with respect to a Section 488 Agreement does not invalidate any agreement that would otherwise be considered valid.
20. MCL 450.1488(2).
21. The existence of a Section 488 Agreement may also be noted on an information statement required under Section 336(2). MCL 450.1488(3).
22. MCL 450.1488(3).
23. A purchaser has knowledge of the existence of a Section 488 Agreement at the time ownership is transferred if the agreement’s existence is noted on the certificate or information statement in compliance with Section 488(3) and, if the shares are not represented by a certificate, the information statement is delivered to the purchaser at or prior to the time ownership of the shares is transferred. MCL 450.1488(3).

The Section 488 Agreement can only be amended by unanimous vote of the shareholders at the time of the amendment, unless the agreement provides otherwise.

24. An action to enforce the right of rescission must be commenced within 90 days after discovery of the Section 488 Agreement or 2 years after the shares are transferred, whichever is earlier. MCL 450.1488(3).

25. MCL 450.1488(6).

26. MCL 450.1488(7).

27. Model Bus. Corp. Act §7.32, cmt. at 7-62.

28. *Id.* at 7-64.

29. Bruno, *supra* note 4, at 73.

30. MCL 450.1488(7).

31. MCL 450.1488(1)(c).

32. MCL 450.1488(1)(d).

33. MCL 450.1488(1)(c) and (d).

34. MCL 450.1488(1)(c).

35. MCL 450.1488(1)(e).

36. MCL 450.1488(1)(b). Note, however, that any restrictions on dividends are subject to the provisions of Sections 345 and 855a of the MBCA pertaining to the protection of creditors. *Id.*

37. MCL 450.1488(1)(g).

38. MCL 450.1488(2)(b).

39. Bruno, *supra* note 4, at 74.

40. *Id.*

41. MCL 450.1488(6).

42. Model Bus. Corp. Act §7.32, cmt. at 7-68.

43. *Id.* at 7-64. For example, as noted in the commentary to the Model Act, “in the case of an agreement that provides for weighted voting by directors, every reference in the Act to a majority or other proportion of directors should be construed to refer to a majority or other proportion of the votes of the directors.” *Id.*

44. Bruno, *supra* note 4, at 73.

45. *Id.*

46. Model Bus. Corp. Act §7.32, cmt. at 7-65.

47. *Id.*

48. 26 USC 1361(b)(1)(D).

49. 26 USC 1361(c)(4).

50. *See* Treas. Reg. 1.1361-1(l)(1).

51. *Id.*

52. Treas. Reg. 1.1361-1(l)(1).

53. Treas. Reg. 1.1361-1(l)(2)(i).

54. Model Bus. Corp. Act §7.32, cmt. at 7-63.

55. *Id.* at 7-64.

56. *Id.*

57. *Id.*

58. *Id.* at 7-62.

59. Schulman *et al.*, *supra* note 5.

60. Model Bus. Corp. Act §7.32, cmt. at 7-64.

61. Schulman *et al.*, *supra* note 5.

62. *Id.*

63. MCL 450.1488(2)(b).

64. Bruno, *supra* note 4, at 74.

65. *Id.*

66. *Id.*

67. Model Bus. Corp. Act §7.32, cmt. at 7-65.



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Director and Officer Liability Insurance Fundamentals

By Marguerite M. Donahue

Introduction and Background

Directors and officers of both public and private companies face a harsh litigation environment and increased scrutiny by state and federal regulators for actions taken in their official capacities. Securities fraud class action lawsuits historically have presented the greatest threat of liability. The median and average securities class action settlement amounts reached record highs of \$11.1 million and \$109 million, respectively, in 2010.¹ Despite these record settlement amounts, the number of securities class action filings recently has declined somewhat. In 2010, there were 176 securities class action lawsuits filed, which was 9.7 percent below the annual average of 195 filings between 1997 and 2009.² As the percentage of securities class action lawsuits has decreased, however, breaches of fiduciary duty lawsuits against corporate directors and officers have risen.³ There is a shift in the mix in the types of actions being asserted against directors and officers, but overall litigation activity is up. At the same time, the U.S. Securities and Exchange Commission (SEC) and the U.S. Department of Justice (DOJ) are stepping up their efforts to enforce the securities laws and the Foreign Corrupt Practices Act, and are now coordinating investigations and sharing evidence and information with each other and with state law enforcement officials.⁴ The financial incentives under the Dodd-Frank legislation for whistleblowers who provide information to the SEC regarding violation of the securities laws are likely to result in increased federal regulatory investigations. Defending against regulatory investigations and indictments, some of which may trigger follow on civil litigation, often requires substantial attorney and consultant fees and document management expenses, even if there is ultimately no monetary fine, settlement, or judgment.

The first line of protection for directors and officers of Michigan companies against personal exposure for these risks is often provisions in the company's organizational documents that require the company to indemnify

them for liabilities and defense costs⁵ and, in the case of directors, limit their liability to the company and its owners for money damages.⁶ While indemnification provisions and liability limitations in a company's organizational documents are important, many companies find they do not provide sufficient protection for their directors and officers for a number of reasons. There may be gaps in the liability protection offered by the company's organizational documents, the company's board of directors or other governing body may choose (rightly or wrongly) not to indemnify a director or officer if indemnification is not mandated by state law, or state or federal law may prohibit indemnity on public policy grounds. Also, a company that is willing to cover defense costs and liabilities for its directors and officers may be unable to do so because of lack of funds or insolvency. For these reasons, most public and many private companies purchase director and officer (D&O) liability insurance to further protect their directors and officers against personal liability.

The size and financial stability of the insurer, the insurer's history of handling and paying claims, and the policy's limits and retentions are high on the list of considerations when placing or renewing D&O insurance. The true value of the policy, however, often depends on the policy's terms and conditions. D&O insurance policy forms vary from insurer to insurer, and the coverage they provide may be expanded or limited by separately negotiated endorsements to the policy. This article describes how most director and officer liability insurance policies are structured, and highlights issues to be considered in reviewing and negotiating these policies.

Claims Made Policies

D&O insurance policies are claims made policies. They provide coverage up to a policy limit (subject to applicable retentions) if a covered claim is asserted against one or more of the insureds during the policy period, and if the policyholder notifies the insurer of the claim in accordance with the policy's notice

The size and financial stability of the insurer, the insurer's history of handling and paying claims, and the policy's limits and retentions are high on the list of considerations when placing or renewing D&O insurance.

provisions. In some cases, the timing of the events giving rise to the claim is irrelevant. Some director and officer insurance policies, however, have "retroactive dates" or "continuity dates" that restrict coverage under the policy only to wrongful acts that occur after those dates. In this way, insurers limit their liability for the insureds' wrongful acts to defined time frames.

Under many D&O policies, the policyholder may give advance notice to the insurer of the facts and circumstances it reasonably believes may lead to a claim. Such advance notice may anchor coverage such that the claim will be covered if it arises after the policy period.⁷ This type of advance notice typically is provided when the insured is changing insurers, or when the current insurer notifies the policyholder that renewal of the existing policy will be available only at a significantly higher premium.

In addition, there are D&O policies available with extended reporting periods that allow the policyholder to report the claim for a period of time following the end of the policy period (typically 30 to 90 days, but sometimes up to a year or longer) to address situations where a third party asserts a claim against an insured just before the policy terminates. If the policyholder notifies the insurer of the claim within the extended reporting period, it is treated as if it were reported during the policy period. Any claim noticed to the insurer during the extended reporting period is subject to the policy limits and retentions that apply during the policy period.

Types of Coverage

Side A/B/C Coverage and Excess "Follow Form" Coverage

The insuring clauses are the heart of the D&O insurance policy. Most D&O insurance policies have insuring clauses referred to as Side A, B, and C coverage, each serving a different purpose.

Side A coverage insures the company's covered directors and officers for the costs of defending against, settling, or satisfying judgments for wrongful acts taken in their capacities as directors and officers. Side A coverage protects directors and officers from paying these costs personally when the company chooses not to indemnify them, is prohibited by law from indemnifying them, or is financially incapable of indemnifying them due to lack of funds or insolvency, provided

that one or more of the policy's exclusions do not apply. Typically, Side A coverage is not subject to any retention (similar to a deductible) that must be satisfied before it applies.

Side B coverage is available to reimburse the company for payments it has made to directors and officers for defense costs, settlements, and judgments constituting covered losses under the policy. Side B coverage does not insure the company for its own actions and omissions that may result in losses or damages. Side B coverage is subject to a retention, which the company must satisfy before coverage applies.

Side C or entity coverage insures the company itself against securities claims brought directly against the company. Not all policies contain Side C coverage. When Side C coverage is contained in a policy, it is subject to a retention that the company must self-insure before coverage applies.

The policy limits under a standard D&O insurance policy may be separate or combined. If the policy limits are combined, the policyholder and the insurer may need to address the issue of allocation for indivisible losses, which can arise when the directors or officers and the company are joint defendants in the same litigation.

Large companies often purchase excess D&O coverage from one or more insurance companies other than their primary D&O insurer, as the primary insurer may be unwilling or unable to underwrite a large company's entire D&O liability risk. These policies are often referred to as excess "follow form" policies because they mirror the terms of the primary D&O policy to provide seamless coverage for the same losses. The excess insurer's coverage is triggered only after the policy limit of the primary insurer, and the policy limit of any other excess insurers beneath it in the "stack" or "tower" of coverage, has been paid out.

Side A Only Coverage

Side A only policies are becoming increasingly popular. In Towers Watson's 2010 D&O Insurance Survey, more than 80 percent of public company respondents indicated that they purchased Side A only policies.⁸ Companies typically purchase Side A only coverage to supplement their standard D&O policy, but there are some companies that purchase Side A only coverage without a standard policy. Side A only coverage offers the insured directors and officers a number

of advantages. Coverage available under a Side A only policy is dedicated to losses incurred by the directors and officers and is not subject to erosion for losses the company itself incurs. Side A only coverage often is subject to fewer exclusions than a standard D&O policy and may be non-rescindable by the insurer. Directors and officers also favor Side A only coverage because the proceeds of the policy are far less likely to be considered available for the company's creditors if the company becomes insolvent or files for bankruptcy. When the Side A only policy is a supplement to the company's standard D&O policy, it confers the additional benefit of protecting against the insolvency of the primary D&O insurer.

Independent/Outside Director Only Coverage

Occasionally, independent or outside directors have D&O insurance policies that cover them exclusively. An outside director policy ensures that the policy will not be exhausted by the defense costs and liabilities of the company and its management. Some outside directors have required such coverage as a condition to serving as an outside director following the notorious Worldcom and Enron class action settlements in which outside directors contributed their own uninsured and unindemnified funds to resolve the pending litigation. In Towers Watson's 2010 D&O insurance survey, half of the respondents who had outside director only coverage said the company paid the premiums, whereas half said the outside directors paid the policy premiums themselves.⁹

Important Definitions

Three of the most important definitions in D&O policies are "claim," "loss," and "wrongful act," because D&O policies provide coverage for losses up to a policy limit (subject to applicable retentions) if a covered claim for a wrongful act is asserted against one or more of the insureds during the policy period.

A "claim" is a third-party demand that seeks to hold one or more of the insureds responsible for the consequences of an alleged wrongful act. The following is an example of a definition of "claim" in a D&O policy:

1. a written demand for monetary or nonmonetary relief; or
2. a civil, criminal, or administrative proceeding for monetary or non-

monetary relief that is commenced by:

- (a) service of a complaint or similar pleading;
- (b) return of an indictment (in the case of a criminal proceeding); or
- (c) receipt or filing of a notice of charges.¹⁰

Some policies are more detailed and may state that civil proceedings cover arbitration, mediation, or other forms of alternative dispute resolution. Newer policy forms often address regulatory and administrative proceedings in greater detail and may impose sublimits for them.

The term "loss" typically includes defense costs, damages, judgments, settlements, and awards, but it usually excludes fines, penalties, taxes, and matters that are uninsurable under the law under which the policy is construed. Some policies include punitive and exemplary damages in the definition of loss, but the inclusion will only be effective when not prohibited by applicable law. Under Michigan law, punitive damages may be awarded only when expressly authorized by statute.¹¹ Punitive damages are insurable under Michigan law.¹²

The term "wrongful act" in most policies includes breaches of duty, neglect, errors, misstatements, misleading statements, omissions, or acts by the directors or officers while acting in their professional capacities, as well as "status" claims brought against them solely because of their positions with the policyholder.

Key Issues

When placing or renewing D&O insurance, there are several key issues to keep in mind that could greatly affect whether coverage will be available if a claim is asserted.

Severability

A severability provision addresses who loses coverage if the insurer either rescinds the policy or denies coverage when the conduct of one or more insureds falls within a policy exclusion (such as the crime/fraud or the personal profit exclusions). In essence, severability provisions provide that the wrongdoing or knowledge of one insured may not be imputed to another insured. They are designed to prevent innocent insureds from losing coverage. However, severability provisions in policies and endorsements can vary significantly in scope, and thus merit careful review. A D&O policy may contain a

Three of the most important definitions in D&O policies are "claim," "loss," and "wrongful act."

severability of application provision, a severability of exclusion provision, or both.

Severability of application provisions come into play when an insurer seeks to rescind the policy because of material misrepresentations in the policy application. Under Michigan caselaw, an insurer may rescind an insurance policy based on a material misrepresentation, even if innocently made,¹³ unless the insurance policy provides otherwise. Severability of application provisions contractually limit an insurer's ability to rescind an insurance policy for all insureds. In a common scenario, a company announces that it is required to restate its financial statements because the company overstated revenue in prior accounting periods, which causes the company's stock price to plunge and results in securities fraud litigation or an SEC investigation. The insurer then seeks to rescind the policy as void *ab initio*, contending that it relied on those financial statements, as an important part of the company's D&O insurance application, in issuing the policy.

Whether an insurer may rescind coverage for all insureds often turns on the wording of the severability of application provision. In *Cutter & Buck, Inc v Genesis Ins Co*,¹⁴ the severability of application policy provision allowed the insurer to rescind the policy if the application, and related materials submitted to it, contained misrepresentations made with the actual intent to deceive, or contained misrepresentations that materially affected the acceptance of risk or hazard, with the following proviso:

provided, however, that no knowledge possessed by any DIRECTOR or OFFICER shall be imputed to any other DIRECTOR or OFFICER except for material information known to the person or persons who signed the Application.¹⁵

The court found Cutter & Buck's policy to be void as to all directors and officers because its chief financial officer knew at the time of the application that the company's financial statements significantly overstated revenue due to a violation of the company's revenue recognition policy. The chief financial officer signed the policy renewal application, and his knowledge was thus imputed to the other officers and directors.

A stronger severability provision preserved coverage for similarly situated directors and officers in the *In re HealthSouth Corp Ins Litig*¹⁶ insurance litigation that involved

an underlying securities fraud case against the company. The insurer's severability of application provision in that case provided:

[W]ritten application(s) for coverage shall be construed as a separate application for coverage by each of the Insured Persons. With respect to the declarations and statements contained in such written application(s) for coverage, no statement in the application or knowledge possessed by any Insured Person shall be imputed to any other Insured Person for the purpose of determining if coverage is available.¹⁷

Based on this policy language, the court concluded that the severability clause precluded rescission for any individual insured without proof that he or she had knowledge of false statements by HealthSouth in the application. In negotiating D&O policies, it is critical for the policyholder to obtain a severability provision that specifies that one individual insured's knowledge or misrepresentation in an application is not imputed to the other individual insured.

The second type of severability provision relates to the exclusions in the policy. Typical exclusions that could result in the insurer's denial of coverage include an insured gaining a personal profit or advantage, obtaining illegal remuneration, or committing deliberate criminal, or fraudulent, acts. With a broad severability provision, the insurer would be required to prove through final adjudication that the exclusion applied to a particular insured because he or she committed a wrongful or dishonest act but could not impute that exclusion automatically to other individual insureds to deny them coverage. Policyholders should seek a policy or endorsement that provides that all exclusions are severable, as opposed to only the crime/fraud and dishonesty exclusions.

Bankruptcy Considerations

A corporate bankruptcy is one of the most dangerous situations for a company's officers and directors. Corporate bankruptcies invite increased scrutiny from regulators, creditors, shareholders, and other stakeholders who may seek to hold the company's directors and officers liable for their losses based on claims that the directors and officers failed to perform their duties or wrongfully impaired the creditors' rights to payment. A D&O policy should contain four important protections for directors and officers that will aid them

Whether an insurer may rescind coverage for all insureds often turns on the wording of the severability of application provision.

in preserving coverage if their company files for bankruptcy.

First, the D&O policy should not require the directors and officers of a bankrupt company to pay any retention before Side A coverage applies. Some D&O policies require the company to satisfy a retention before the directors and officers may access Side A coverage, which the company generally will satisfy if it is solvent. When the company is not able to satisfy this retention due to bankruptcy or insolvency, the policy should not require the directors and officers to satisfy the retention before coverage applies.

Second, the D&O policy should contain a “priority of payments” provision that requires policy proceeds to be applied to defense costs and other losses of the directors and officers first before the remaining policy proceeds are paid to the bankrupt company. When a company files for bankruptcy, the bankruptcy trustee and creditors may attempt to sequester D&O policy proceeds for the benefit of creditors on the theory that the D&O policy is an asset of the bankruptcy estate. Some courts have held that policy proceeds fall outside of the bankruptcy estate because the primary purpose of D&O insurance is to pay losses the directors and officers incur, and the debtor company is not entitled to retain policy proceeds.¹⁸ A priority of payments provision that specifies that the directors and officers are to have first priority on the policy proceeds gives the bankruptcy court grounds to grant the directors and officers immediate access to the policy proceeds for their defense costs.

Third, a D&O policy should contain a carveout from the policy’s “insured vs. insured” exclusion for claims asserted by any bankruptcy trustee, creditors’ committee, or debtor in possession entity against the company’s officers and directors. Most D&O policies contain an insured vs. insured exclusion that provides that coverage is not available for a claim that one insured asserts against another insured. Insurers began to include this exclusion in policies beginning in the 1980s, when a number of failed financial institutions brought suits against their own directors and officers to convert their D&O policies to cash.¹⁹ Insured vs. insured exclusions exist to prevent collusive claims against the D&O insurer that are asserted to provide coverage for business losses, as well as to protect the insurer from financing corporate infighting. The insured vs. insured

exclusion has been the basis on which D&O insurers have denied coverage for claims asserted against directors and officers by bankruptcy trustees, liquidators, and creditors committees. The insurers have asserted that bankruptcy trustees, liquidators, and creditors committees “stand in the shoes” of the company, and thus they should be treated as the company itself for purposes of D&O policies with entity coverage. For the most part, insurers have not succeeded in denying coverage in these situations based on the insured vs. insured exclusion. In a recent and significant Ninth Circuit case,²⁰ however, an insurer was successful in denying coverage by asserting the insured vs. insured exclusion in a case brought against officers by the debtor in possession following a Chapter 11 bankruptcy filing. To avoid such coverage litigation, a carveout from the insured vs. insured exclusion for claims brought against the directors and officers by bankruptcy trustees, creditors’ committees, and debtors in possession is advisable.

Fourth, the D&O policy should include an insolvency provision that states that the bankruptcy or insolvency of the company or any insured will not relieve the insurer of its obligations under the policy.

Shareholder Derivative Litigation

A shareholder derivative lawsuit is a suit filed by a shareholder on behalf of the company and alleges that the company has been damaged and has failed to act on its right to recover for its injury.²¹ It is essentially a combination of two suits—a suit against the company asserting that it violated its fiduciary duties by failing to act against certain individuals or entities, and a suit against those individuals or entities.²² Under the Michigan Business Corporation Act (MBCA), a shareholder is required to make a demand on the company before initiating a derivative suit, but may proceed if the company rejects the demand, on the expiration of ninety days from the date of the demand or earlier if irreparable injury to the company would result from the ninety-day delay.²³ If the company commences an investigation of the allegations, a court may stay the suit for a period of time the court considers appropriate.²⁴

Many D&O insurance policies restrict coverage for shareholder derivative litigation in some fashion. Some policies contain an explicit derivative action exclusion, whereas other policies contain an insured vs. insured

Many D&O insurance policies restrict coverage for shareholder derivative litigation in some fashion.

exclusion that generally bars coverage for suits in which one of the insureds sues another. In policies that contain these exclusions, there is generally a carve-back (restoration of coverage) that restores coverage if certain requirements for the derivative action are met. Such requirements generally will specify that the shareholder bringing the action must act independently from any director or officer of the company and the company itself. Thus, the policy must be reviewed to ensure that there are appropriate carve-backs if one of these exclusions would otherwise bar coverage for derivative claims.

It is now common practice for companies that receive a shareholder derivative demand to form a special litigation committee comprised of independent directors to investigate the demand to determine whether to maintain the suit on behalf of the corporation or to reject the shareholder's demand. Some policies contain a sublimit for the company's costs in investigating shareholder derivative demands. If the D&O policy is silent on this issue, disputes may arise between the policyholder and the insurer as to whether the expenses of a special litigation committee are covered, especially during the period between the shareholder's demand and the filing of derivative litigation if the shareholder's demand is rejected. In denying coverage, insurers have contended that the special litigation committees are not "insured persons" because they act independently from and are not subject to the control of the company or its board of directors. Also, insurers have argued that shareholder demands are not "claims," and pre-suit investigatory expenses are not "defense costs."

In a recent and influential case, the Second Circuit analyzed D&O insurance coverage for the expenses of a special litigation committee that took action to terminate shareholder derivative litigation filed against MBIA.²⁵ MBIA's policy contained a \$200,000 sublimit for investigation costs for shareholder derivative demands made during the policy period. MBIA is a Connecticut corporation. Connecticut's corporate statute concerning derivative lawsuits is similar to the MBCA, in that it requires a shareholder to give a ninety-day pre-suit notice to the company before filing shareholder derivative litigation against it. MBIA received two shareholder demand letters after the SEC and the New York Attorney General's office conducted investigations into its accounting

practices. MBIA created a Demand Investigation Committee to investigate the shareholders' allegations. The shareholders filed suit when MBIA did not act on their demands in the ninety-day statutory period. MBIA's Demand Investigation Committee was reconstituted as a Special Litigation Committee after the shareholder lawsuits were filed. The Special Litigation Committee filed motions to dismiss the suits after it received outside counsel's investigatory report on the suits, and the suits were subsequently terminated.

MBIA brought suit against its primary and excess D&O insurers to recover the expenses of the Special Litigation Committee after the shareholder derivative lawsuits were dismissed. The primary insurer had already agreed to pay the \$200,000 sublimit demand investigation costs when MBIA filed the suit. The Second Circuit held that all expenses of the Demand Investigation Committee and Special Litigation Committee in investigating the shareholder derivative demand and responding to the subsequently filed derivative litigation were covered under the policy. The court held that such expenses were covered by two insuring clauses, the \$200,000 sublimit for investigating shareholder derivative demands and an insuring clause for investigation expenses following the filing of a lawsuit against the company's directors and officers. Notably, the Second Circuit held the Special Litigation Committee was an "insured person" under the policy, even though Connecticut law required it to operate independently of MBIA and its board of directors in investigating the derivative actions, and despite the fact that the committees' expenses in prosecuting the actions would not have been covered if the committees had decided on that course of action instead.²⁶ The outcome of the MBIA case largely turned on the policy language and the court's interpretation of Connecticut's derivative action statute. Nevertheless, the MBIA case underscores the importance of reviewing the D&O policy carefully for coverage of investigation costs for shareholder derivative litigation and asking about the availability of a special endorsement if the policy does not address this issue.

Government Agency Investigations and Proceedings

Coverage for government agency investigations and proceedings is an increasingly important consideration in D&O policies,

Coverage for government agency investigations and proceedings is an increasingly important consideration in D&O policies, particularly for public companies.

particularly for public companies. Public companies and their directors and officers are more likely to become the targets of protracted and expensive probes into their business and accounting practices by the SEC and the DOJ. Private companies that have issued securities in private placements or that operate in regulated industries also should consider whether their D&O policies adequately address this risk.

Whether a policyholder and its directors and officers are covered by D&O insurance for expenses incurred in responding to government agency investigations and proceedings will be influenced in large measure by fine points in the terms of the policy and how far towards a judicial or administrative complaint the investigation has progressed.

The costs of internal investigations of possible wrongdoing by the company and its directors and officers before any of them receive notice of a government investigation or the filing of an administrative or judicial complaint are rarely covered by a D&O insurance policy, even if these internal investigations are helpful in resolving a government investigation or defending against a proceeding that arises thereafter. Similarly, if a policyholder and its directors and officers voluntarily respond to requests for documents or consent to be interviewed before an agency's issuance of an investigative order or subpoena, the costs and expenses they incur in doing so generally will not be covered by a D&O policy because no "claim" will have been asserted against them at that early stage in the investigation.

Courts have differed as to how far a government agency investigation must progress before D&O coverage is triggered, if it is covered at all, but the divergence in results is often the result of nuances in the underlying policies at issue. For example, in the *MBIA* case,²⁷ the Second Circuit held that the SEC's issuance of an investigative order against the company was sufficient to trigger coverage when the policy covered "formal and informal administrative or regulatory proceedings" commenced by "a notice of charges, formal or informal investigative order or similar document." In an interesting twist, the court held that *MBIA's* voluntary compliance with subsequent verbal requests was also covered by the policy when *MBIA* agreed to comply to avoid the adverse publicity that it would suffer as a result of subsequent subpoenas. In contrast, a U.S. district court held that

coverage for Office Depot's expenses for an informal SEC investigation that progressed to a formal investigation were not covered at all in *Office Depot v National Union Fire Ins Co.*²⁸ Office Depot's policy excluded entity coverage for an "administrative or regulatory proceeding against, or investigation of" Office Depot, subject to a carve-back (restoration of coverage) for administrative or regulatory proceedings against the entity "but only if and only during the time that such proceeding is also commenced and continuously maintained against" a director or officer.²⁹ Because the policy's carve-back did not restore coverage for "investigations" against Office Depot, and the SEC's investigation did not result in a judicial or administrative complaint against Office Depot, none of Office Depot's own response costs were covered by the policy. These cases counsel that it is important to obtain coverage for both informal, as well as formal, government agency investigations and not to tie coverage for the entity's investigation response costs to the outcome of the investigation against individual officers and directors. Also, provisions in policies that require an insured to be specifically named as a target in the investigation as a condition to coverage are to be avoided.

NOTES

1. John E. Black Jr. and Ellen D. Jenkins, *D&O Litigation Trends in 2010* (March 2011), available on the IRMI Web site at www.irmi.com/expert/articles/2010/black03-directors-officers-insurance.aspx.

2. *Id.*

3. Kevin M. LaCroix, *The Top 10 D&O Stories of 2010*, posted on January 5, 2011, available on The D&O Diary Web site at www.dandodiary.com/2011/01/articles/d-o-insurance/the-top-ten-stories-of-2010.

4. *Supra* note 1.

5. Many Michigan corporations have provisions in their Bylaws that require the corporation to indemnify its directors and officers to the extent permissible by law. See MCL 450.1561 to 450.1565 for Michigan Business Corporation Act ("MBCA") provisions relating to permissive and mandatory indemnification for corporate directors and officers.

6. Section 209(1)(c) of the MBCA provides that a Michigan corporation may eliminate or limit a director's liability to the corporation and its shareholders for money damages in the corporation's articles of incorporation, except for liability for:

- (i) receipt of a financial benefit to which the director is not entitled;
- (ii) intentional infliction of harm on the corporation or its shareholders;
- (iii) distributions to shareholders, or director, officer and employee loans, that violate Section 551 of the MBCA; or
- (iv) an intentional criminal act.

Courts have differed as to how far a government agency investigation must progress before D&O coverage is triggered, if it is covered at all, but the divergence in results is often the result of nuances in the underlying policies at issue.

See MCL 450.1209(1)(c).

7. John F. Olson, Josiah O. Hatch, Ty R. Sagalow, *Director & Officer Liability: Indemnification and Insurance* § 12:29.

8. Towers Watson, *Directors and Officers Liability Survey: 2010 Survey of Insurance Purchasing Trends* at 5, available on the Towers Watson website at www.towerswatson.com/united-states/research/3790.

9. *Id.* at 17.

10. *Supra* note 7 at § 12:7 (citing Chubb 1992 Form ¶18 at Appendix 12-2; National Union D&O Gold at Appendix 12-1 ¶2(a)).

11. *Casey v Auto Owners Ins Co*, 273 Mich App 388, 729 NW2d 277 (2006), *app denied*, 478 Mich 866, 731 NW2d 746 (2007).

12. *Meijer, Inc v General Star Indemnity Co*, 826 F Supp 241, 247 (WD Mich 1993).

13. *Brooks v Liberty Mutual Fire Ins Co*, No 09-cv-10352, 2009 US Dist LEXIS 122453 (ED Mich Dec 30, 2009) (applying Michigan law); *Lakes States Ins Co v Wilson*, 231 Mich App 327, 331, 586 NW2d 113 (2009), citing *Lash v Allstate Ins Co*, 210 Mich App 98, 101, 532 NW2d 869 (1995).

14. 306 F Supp 2d 988 (WD Wash 2004).

15. *Id.* at 1011.

16. 308 F Supp 2d 1253 (ND Ala 2004).

17. *Id.* at 1261.

18. See, e.g., *In re Scott Wetzel Servs*, 243 BR 802 (Bankr MD Fla 1999).

19. *Supra* note 7 at § 12.14 (explaining the insured vs. insured exclusion).

20. *Biltmore Assocs, LLC v Twin City Fire Ins Co*, 572 F3d 663 (9th Cir 2009).

21. Brian L. Levine, *D&O Coverage of Derivative Litigation: Caveat Emptor*, 25 Andrews Corp Off & Directors Liab Litig Rep 1 (June 8, 2009).

22. *Id.*

23. MCL 450.1493a.

24. MCL 450.1494.

25. *MBIA, Inc v Federal Ins Co*, Nos 10-0355-cv (L), 10-0386-cv (con), 10-0356-cv (XAP), 2011 US App LEXIS 13402 (2d Cir July 1, 2011).

26. Richard Bortnick and Micah J. M. Knapp, *Guest Post: 2nd Cir Holds D&O Policies Cover Voluntary Expenses and Special Litigation Committee Costs*, posted on July 29, 2011, available on The D&O Diary Web site at www.dandodiary.com/2011/07/articles/d-o-insurance/guest-post-2nd-circ-holds-do-policies-cover-voluntary-compliance-expenses-and-special-litigation-committee-costs/.

27. *Supra* note 25.

28. *Office Depot, Inc v National Union Fire Ins Co of Pittsburgh, PA*, 734 F Supp 2d 1304 (SD Fla 2010).

29. *Id.* at 1309.



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Recent Cases Address Shareholder Oppression

By Bruce C. Young and Jeanne F. Long

Background

The Michigan Business Corporation Act (“the Act”),¹ in Section 489, provides certain remedies to a shareholder if the actions of those in control of a corporation are illegal, fraudulent, or willfully unfair and oppressive to the corporation or the shareholder. Two recent opinions of the Michigan Court of Appeals (“the Court”) give guidance on the scope of this provision, and, in particular, on the impact of amendments to Section 489 made in 2006.

Section 489 of the Act gives a minority shareholder in a closely held corporation a cause of action against “those in control of the corporation” for acts that are “illegal, fraudulent, or willfully unfair and oppressive” to the corporation or the shareholder.² It defines “willfully unfair and oppressive conduct” as “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.”³

In 2004, the Michigan Court of Appeals interpreted this provision specifically, the scope of “willfully unfair or oppressive conduct” in *Franchino v Franchino*.⁴ In this case, the majority shareholder had terminated the plaintiff’s employment and removed him from the board of directors. The minority shareholder brought suit under Section 489, arguing that his termination and removal were oppressive because they interfered with his “reasonable expectations” as a shareholder.

The *Franchino* court had rejected this theory on two grounds. First, it determined that employment and board membership were not among the plaintiff’s interests as a shareholder. Plaintiff’s termination and removal thus were not “willfully unfair and oppressive conduct” as defined in Section 489. Second, the court refused to apply a reasonable expectations test for minority oppression. It held that the reasonable expectations test was inconsistent with the statute, which defined “willfully unfair and oppressive conduct” in terms of the majority’s actions rather than the minority’s interests. Accordingly,

the Michigan Court of Appeals affirmed the trial court’s grant of summary judgment in favor of the defendants.

Many observers found the outcome in *Franchino* troubling.⁵ The *Franchino* court’s ruling rested on a traditional list of shareholder rights such as voting at shareholders’ meetings, electing directors, adopting by-laws, and receiving dividends.⁶ This narrow view of shareholders’ rights overlooks the fact that shareholders in close corporations occupy very different positions from shareholders in public corporations.⁷

Although most shareholders of public corporations are relatively uninvolved outsiders, shareholders in closely held corporations often participate in management as employees. Their returns may come in the form of salaries and bonuses rather than traditional dividends.⁸ Thus, changes in employment and related benefits may affect the rights of a shareholder as a shareholder in a closely held corporation (i.e., these may be benefits that a person would not be receiving but for his or her status as a shareholder).

The *Franchino* court noted that some state corporation statutes explicitly protected the rights of minority shareholders in their capacities as employees and directors.⁹ But Michigan’s minority protection statute included no such language. It unambiguously limited its reach to actions against “the interests of the shareholder as a shareholder.”¹⁰ The Michigan Court of Appeals concluded that this provision prevented them from granting relief for the actions complained of in *Franchino*.

In response to the *Franchino* decision, the Michigan Legislature sought to increase minority shareholder protection in close corporations.¹¹ In 2006, it broadened the statutory definition of oppression to encompass employment decisions that interfere with shareholders’ rights. Specifically, the 2006 amendment added: “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 or other shareholder

interests disproportionately as to the affected shareholder.”¹²

Trapp v Vollmer

On June 16, 2011, the Michigan Court of Appeals issued its first opinion interpreting the 2006 amendments to Section 489, in *Trapp v Vollmer*.¹³ This was the Court’s first opportunity to consider the new boundaries of a minority oppression claim, including the extent to which the amendment changed the scope of the protected interests. The Court faced essentially the same issues presented in *Franchino*: (1) what rights do shareholders automatically enjoy by virtue of being shareholders, and (2) are shareholders’ “reasonable expectations” protected under Michigan law.

In *Trapp*, plaintiff Daniel Trapp was an employee and shareholder of a closely held corporation founded by defendant Terry Vollmer. Trapp and Vollmer entered into an agreement to develop a succession plan to sell or exchange their stock in the company. The parties failed to implement any plan. Trapp then sued Vollmer under multiple theories, including shareholder oppression.

Trapp first contended that Vollmer had breached the agreement regarding development of a succession plan. The Court found their agreement to be an unenforceable agreement to negotiate and affirmed the trial court’s grant of summary judgment to defendant on this contract claim.

Trapp next argued that Vollmer’s failure to abide by the succession agreement constituted shareholder oppression. The Court held that under *Franchino*, willfully unfair and oppressive conduct needed to interfere with rights automatically accruing to a shareholder by virtue of being a shareholder, and that implementation of a succession agreement was not such a right.

In the alternative, Trapp argued that the 2006 amendment to Section 489 had expanded shareholder rights and completely abrogated *Franchino*’s rejection of the reasonable expectations test. *Franchino* held that a court assessing whether conduct is oppressive must focus on the majority shareholders’ actions, not on the reasonable expectations of the minority shareholder. Trapp argued that the 2006 amendment shifted the focus from the actions of the majority to the affected minority, implicitly adopting the reasonable expectations test that *Franchino* had rejected. Arguing that Vollmer had defeated

Trapp’s expectations as a shareholder by failing to implement the succession plan, Trapp claimed he was entitled to relief under the amended statute.

The Court of Appeals also rejected this argument. Although it concluded that the amendment had expanded the type of shareholder interests that could be the subject of an oppression claim, the Court found no intent to change entirely how courts evaluate other types of “willfully unfair and oppressive” conduct. The Court confirmed that, post-amendment, the proper inquiry remains focused on the majority shareholders’ actions, and not on the minority shareholders’ expectations. Accordingly, the Court in *Trapp* affirmed the trial court’s grant of summary disposition on the oppression claim.

Berger v Katz and Katz

After *Trapp*, the Michigan Court of Appeals next considered the 2006 amendment to Section 489 in *Berger v Katz and Katz*.¹⁴ There, Berger was a one-third owner of a business selling industrial cleaners. Defendants together owned the remaining two-thirds. The parties operated the company together for many years, participating equally in profits and decisions affecting the company. Then, in 2006, Berger moved to California and was no longer involved in the day-to-day operations of the business. Defendants then stopped making distributions to Berger and stopped consulting with him on matters involving the company. Berger complained, which led to some negotiations and temporary changes. However, the parties were never able to resolve their dispute, and defendants eventually stopped making any payments to Berger, claiming that the company was losing business and was no longer profitable. At the same time, they increased their salaries, among other things. Berger claimed that defendants were benefiting themselves personally and artificially lowering the corporation’s profits to avoid paying him his fair share.

After a bench trial, the trial court found that the defendants had violated Section 489 by engaging in willfully unfair and oppressive conduct as majority shareholders, specifically by “(1) the way in which they eliminated plaintiff’s salary and gave themselves raises, (2) terminating the rental payments to plaintiff that normally were made to all three directors, (3) issuing a capital call when the corporation was doing fairly well, which di-

Section 489 of the Act gives a minority shareholder in a closely held corporation a cause of action against “those in control of the corporation” for acts that are “illegal, fraudulent, or willfully unfair and oppressive” to the corporation or the shareholder.

luted plaintiff's stock and shares and forced plaintiff to put his own money into the corporation, and (4) engaging in other less oppressive actions with the intent to 'squeeze Plaintiff out of the company rather than to give him his fair share of his investment.'"¹⁵ As a remedy, the court ordered a buyout procedure where one party could purchase the fair value of the other party's interest in the corporation. If that was not possible, the court would appoint a receiver to liquidate the corporation. The trial court also ordered defendants to reimburse the corporation for certain legal fees and costs that the corporation paid for defendants. In addition, the court ordered that the plaintiff was to be paid \$2,000 a month and receive other benefits until the corporation changed hands or was sold.

On appeal, the Court noted that it was reviewing the trial court's findings of fact under the clearly erroneous standard, i.e., the Court would overturn the findings only if the Court had a firm conviction that a mistake had been made. After reviewing the trial court's findings, the Court found no such error in the factual findings.

The defendants also made several legal arguments that were addressed by the Court. First, they argued that their actions were permitted under the corporation's bylaws and therefore excluded from the definition of oppression under the last sentence of Section 483(3).¹⁶ The Court acknowledged that the bylaws gave certain authority to operate the company, but held that the exception in Section 489 for actions permitted under the bylaws was not intended to permit oppression under the guise of the general authority to run and manage the company.

Defendants next contended that Berger's salary and rental payments were not attributable to his rights as a shareholder, and accordingly, under the *Franchino* decision, could not state a claim for statutory oppression. The Court noted the 2006 amendments to Section 489 and stated that Section 489 now allowed a minority shareholder to claim willfully unfair and oppressive conduct based on reductions in salary or other employment benefits. The Court found that defendants' conduct was designed to prevent the company from showing a profit that could be distributed to Berger as either rent or salary. It also found a nexus between the payments Berger had been receiving and his status as a shareholder. Additionally, there

was evidence that the defendants refused to allow Berger to participate in corporate decisions beginning in 2006. The Court held these actions affected Berger's rights, "not only with regard to his employment, but also as a shareholder to participate in decisions affecting the corporation."¹⁷ The Court then held that the defendants' actions affected Berger's interests as a shareholder, and the defendants had thus violated Section 489.¹⁸

The defendants also challenged the remedies fashioned by the trial court, arguing that the trial court had ordered a remedy not on the list contained in Section 489. However, the Court noted the language "including, without limitation" in Section 489(1) and held that the statute gave the trial court broad discretion in deciding an appropriate remedy.¹⁹

Conclusion

The *Trapp* decision confirms that a reasonable expectations test is still not the law under the Act. *Trapp* also clearly states that an action for shareholder oppression under Section 489 still needs to be based on actions of those in control that impact *shareholder* interests. The discussion of the Court in the *Berger* decision does not focus as squarely on the requirement that actions need to impact shareholder interests. In fact, some of the language in *Berger* could be taken out of context to support the proposition that a reduction in salary or benefits alone could constitute oppression. But the facts emphasized by the Court in *Berger* included actions intended to reduce profits or other payments Berger was receiving because of his status as a shareholder, and the Court did find that those actions did affect Berger's interests as a shareholder. Accordingly, the holding of *Berger* should also be considered to require an impact on interests as a shareholder.

The different results in the *Trapp* and *Berger* cases are not based on any material difference in interpretation of the law but rather on the different facts before the Court. And, even with the *Berger* case for help, a minority shareholder who wants assurance of employment, certain compensation or benefits, or a plan for succession of ownership is still well-advised to have it embodied in an enforceable agreement.

The different results in the *Trapp* and *Berger* cases are not based on any material difference in interpretation of the law but rather on the different facts before the Court.

NOTES

1. MCL 450.1101 *et seq.* (the “Act”).
2. MCL 450.1489(1).
3. MCL 450.1489(3).
4. *Franchino v Franchino*, 263 Mich App 172, 687 NW2d 620 (2004).
5. See, e.g., Nick Daniels, *What Are the Interests of a Shareholder as a Shareholder?*, 8 TM Cooley J Prac & Clinical L 305 (2006); Karen Kissinger, *The Impact of Franchino v. Franchino on Michigan Closely-Held Corporations*, 52 Wayne L Rev 201 (Spring 2006).
6. *Franchino*, 263 Mich App at 184.
7. Daniels, *supra* note 5, at 321.
8. *Id.*
9. *Franchino*, 263 Mich App at 184.
10. *Id.* at 185.
11. Michigan Department of Labor & Economic Growth Bill Analysis Enrolled House Bill 5323, Office of Policy and Legislative Affairs, 93rd Legislature, 2005 Regular Session (Mar 3, 2006).
12. MCL 450.1489(3).
13. *Trapp v Vollmer*, No 297116, 2011 Mich Ct App LEXIS 1081 (June 16, 2011) (unpublished opinion).
14. *Berger v Katz & Katz*, No 291663, 2011 Mich App 1408 (July 28, 2011) (unpublished opinion).
15. *Id.* at *12.
16. “[Oppression] 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.” MCL 450.1489(3)
17. *Berger*, 2011 Mich App 1408, at *15.
18. *Id.* at *15-16.
19. *Id.* at *18-19.



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Recent Significant Sixth Circuit Opinions Concerning Securities and Corporate Governance Litigation

By Raymond W. Henney and Lara Fetsco Phillip

Introduction

In 2010 and 2011, the Sixth Circuit issued four important decisions concerning securities fraud claims and derivative actions. Three of those decisions pertain to the pleading standards for scienter for federal securities claims under the Private Securities Litigation Reform Act and resolved certain open issues in the Sixth Circuit. The fourth decision concerns an issue of first impression regarding the independence of a special litigation committee that was constituted to consider derivative claims.

The Sixth Circuit Clarifies the Requirements for Pleading Scienter in Securities Fraud Actions

In the past year, the Sixth Circuit has issued three significant opinions that have addressed the standards for adequately pleading scienter for claims under Section 10(b) of the Securities Exchange Act (the "Exchange Act") in light of recent United States Supreme Court precedent. In the case of *Louisiana Sch Employees' Ret Sys v Ernst & Young, LLP*,¹ the Sixth Circuit continued its trend of applying the Supreme Court's decision in *Tellabs, Inc v Makor Issues & Rights, Ltd*,² as establishing a particularly high standard for a plaintiff to plead scienter and fraud against the outside auditors of a public company. In *Frank v Dana Corp*,³ the Sixth Circuit reversed the dismissal of a class action shareholder suit and changed its approach to analyzing the adequacy of allegations concerning scienter for Section 10(b) and Rule 10b-5 claims. According to *Frank*, courts are to view the allegations of the complaint holistically rather than analyze them individually. The court also resolved the pleading requirements for control person liability under Section 20(a) of the Exchange Act. Finally, in *Ashland, Inc v Oppenheimer & Co*,⁴ the Sixth Circuit applied its recently adopted holistic approach in analyzing allegations of scienter and affirmed the dismissal of a securities fraud action

alleging that Oppenheimer & Co., had misrepresented material facts regarding auction rate securities.

Louisiana School Employees' Retirement System v Ernst & Young, LLP

In *Louisiana Sch Employees' Ret Sys v Ernst & Young, LLP*, the Sixth Circuit set forth the rigorous pleading standards applicable to a claim that an outside auditor committed securities fraud and the necessary facts to plead "red flags" that establish scienter.

Background

The *Ernst & Young* case arose out of Accredo Health, Inc.'s ("Accredo") acquisition of Gentiva Health Services, Inc. ("Gentiva"). Accredo had retained Ernst & Young to conduct due diligence prior to the closing of its purchase of Gentiva and to issue an unqualified audit opinion on Gentiva's financial statements, which Accredo then incorporated into its 2002 proxy statement filed with the SEC.⁵ Plaintiffs alleged that, during its due diligence, Ernst & Young learned that nearly \$58.5 million of Gentiva's receivables were uncollectible, and thus Gentiva's allowance for doubtful accounts was understated, causing Accredo's net income and earnings per share to be materially overstated during the class period.⁶ On April 8, 2003, Accredo issued a press release stating that the Gentiva's Division's receivables had been overstated.⁷ This press release allegedly caused a one-day 44 percent drop in Accredo's stock price.⁸ Thereafter, Accredo terminated Ernst & Young and filed a malpractice action against the firm.⁹

Subsequently, the plaintiffs brought a class action against Ernst & Young alleging that it was liable under 10b-5 of the federal securities laws as a primary violator for deceiving the investing public about Accredo's financial results and artificially inflating the price of Accredo's stock.¹⁰ The district court dismissed the complaint under Rule 9(b) and

12(b)(6) of the Federal Rules of Civil Procedure, finding that scienter had not been adequately pled as required by the Private Securities Litigation Reform Act of 1995 (the “PSLRA”).¹¹

Standard for Pleading Scienter Against Outside Auditor

The Sixth Circuit affirmed the district court’s dismissal of fraud claims based upon the standard articulated by the Supreme Court in *Tellabs*, i.e., that a complaint will survive a motion to dismiss only if “a reasonable person would deem the inference of scienter cogent and *at least as compelling* as any opposing inference one could draw from the facts alleged.”¹² The Sixth Circuit noted that, while liability in the securities fraud context can be premised on “recklessness,” the “standard of recklessness is more stringent when the defendant is an outside auditor. In that instance, recklessness requires a mental state ‘so culpable that it approximate[s] an actual intent to aid in the fraud being perpetrated by the audited company.’”¹³ Thus “[t]o allege that an independent accountant or auditor acted with scienter, the complaint must identify specific, highly suspicious facts and circumstances available to the auditor at the time of the audit and allege that those facts were ignored, either deliberately or recklessly.”¹⁴

The Sixth Circuit agreed with the district court that the allegations contained in plaintiffs’ complaint did not collectively raise a strong inference that Ernst & Young acted with scienter. However, the court did individually analyze the sufficiency of each of the plaintiffs’ allegations supporting scienter. For example, the court held that the plaintiffs’ allegations that Ernst & Young failed to include the appropriate data in its audit under Generally Accepted Accounting Principles (“GAAP”) did not create an inference that it acted with scienter. Central to the plaintiffs’ allegations was a claim that Ernst & Young failed to adhere to proper professional standards, by using “old and stale” data in calculating the reasonableness of the allowance for Gentiva’s receivables when Ernst & Young had access to more accurate and current information. The court noted that, even if true, the allegation does not constitute securities fraud.¹⁵

Moreover, with respect to the allegation that Ernst & Young ignored red flags, the court noted that “for a red flag to create

a strong inference of scienter in securities fraud claims against an outside auditor, it must consist of an ‘egregious refusal to see the obvious, or to investigate the doubtful.’”¹⁶ Plaintiffs had alleged that the red flags ignored by Ernst & Young included: an internal memorandum showing that Gentiva had been “teak[ing] the [reserve] percentages down,” the refusal of an investment bank to consummate the purchase of Gentiva’s acute care business, a “history of serious accounts receivable problems” at Gentiva, and the significant age of outstanding receivables on sales. Applying *Tellabs*, the court rejected the plaintiffs’ argument concerning the Ernst & Young memorandum stating that “[Gentiva] had tweaked the percentages down for September as a result of current collection trends, however [Ernst & Young] has not seen the basis for doing so.” Showing that Ernst & Young knew that Gentiva had been manipulating the reserve percentages was not a more compelling inference than Ernst & Young’s position that it “was resisting a lower reserve” and “required Gentiva to show why management” had reduced the reserve percentages.¹⁷ With respect to the allegation concerning an investment banker’s refusal to consummate the purchase of Gentiva’s acute care business, the Sixth Circuit noted that the complaint did not plead facts that Ernst & Young knew the circumstances of the investment bank’s withdrawal from the deal.¹⁸ The court further found that the fact that Ernst & Young had recommended in a prior engagement that Gentiva write off millions in uncollectible receivables did not constitute evidence that Ernst & Young was on notice that the accounts receivable problems in 2002 were in excess of the substantial allowance already recorded by Gentiva.¹⁹ Regarding the last of the purported red flags, that a days-sales-outstanding for the acute business approaching nearly 300 days should have alerted Ernst & Young that “a material portion of the receivables were uncollectible and worthless,” the court reiterated that Ernst & Young did not dispute that a portion of Gentiva’s accounts receivable were uncollectible, and accordingly, plaintiff’s allegation amounts to nothing more than a conclusory allegation that Ernst & Young acted with scienter.²⁰

The court further discounted the argument that Ernst & Young was motivated to commit fraud by the promise of future professional fees, noting that “allegations that the auditor earned and wished to continue

The Sixth Circuit noted that, while liability in the securities fraud context can be premised on “recklessness,” the “standard of recklessness is more stringent when the defendant is an outside auditor.”

earning fees from a client do not raise an inference that the auditor acted with the requisite scienter.”²¹ The court noted that the complaint did not contain any allegations that Ernst & Young’s fees from Accredo were more significant than its fees from other clients or that Accredo’s business represented a significant portion of Ernst & Young’s revenues.²² Accordingly, the court found that the complaint alleged no facts to support an allegation that Ernst & Young’s motive to retain Accredo as a client was any different than its general desire to retain business.²³

Relying on *Fidel v Farley*,²⁴ the court also found that the alleged magnitude of the \$58.8 million accounting errors did not support an inference of scienter, stating that “allowing such an inference would eviscerate the principle that accounting errors alone cannot support a finding of scienter.”²⁵

Finally, the Sixth Circuit found that the plaintiff’s allegations regarding post-class period events, such as Accredo’s firing of Ernst & Young and filing of a malpractice action, were irrelevant to the analysis of scienter. According to the court, to find scienter “based on such allegations would be equivalent to ‘the classic fraud by hindsight case where a plaintiff alleges that the fact that something turned out badly must mean defendant knew earlier that it would turn out badly.’”²⁶

Observation

In this decision, the Sixth Circuit continued its trend post-*Tellabs* of holding plaintiffs to a stringent standard when determining whether a complaint pleads sufficient facts to support a strong inference of scienter against a company’s outside auditors. However, notably, this decision was rendered prior to the Supreme Court’s recent decision in *Matrixx Initiatives, Inc v Siracusano*,²⁷ and the Sixth Circuit decision applying *Matrixx* in *Frank v Dana Corp*,²⁸ which both held that a court must take a holistic approach and review scienter pleadings based on a collective rather than individual view of the facts. It is uncertain whether the application of the holistic approach applied in *Frank* would have changed the outcome in this case.

Frank v Dana Corp

As previously discussed, the Sixth Circuit adopted a different approach to analyzing allegations regarding scienter under the PLSRA in *Frank v Dana Corp*. In doing so, the court reversed the district court’s dismissal

of the securities fraud action and remanded the case to the district court for the second time.

Background

The plaintiffs had initially filed a complaint alleging that Michael Burns and Robert Richter, chief executive officer and chief financial officer respectively of automotive parts manufacturer Dana Corporation (“Dana”), violated section 10(b) of the Exchange Act by making false statements regarding Dana’s financial health in filings with the SEC, press releases, and conference calls. The complaint further alleged that Burns and Richter were controlling persons regarding alleged false statements made by Dana and other employees pursuant to Section 20(a) of the Exchange Act. Burns and Richter filed a motion to dismiss pursuant to Rules 8, 9(b), and 12(b) (6) of the Federal Rules of Civil Procedure. The district court granted the motion based on the Sixth Circuit’s ruling in *Helwig v Vencor, Inc*, which had held that a plaintiff could survive a motion to dismiss only if the inference of scienter was “the most plausible of competing inferences.”²⁹ On appeal from that decision, the Sixth Circuit remanded the case back to the district court to apply the standard enunciated by the Supreme Court in the then-recent *Tellabs* decision, which held that a strong inference does not mean that scienter must be the most plausible inference, but rather at least as plausible as any other non-culpable inference.³⁰ On remand, Burns and Richter filed another motion to dismiss, which was granted by the district court.³¹

Adoption of the Holistic Analysis

On appeal, the Sixth Circuit reversed the dismissal finding that the plaintiffs adequately pled their section 10(b) claim under the holistic approach to analyzing scienter allegations mandated by the Supreme Court’s recent *Matrixx* decision.³² Prior to *Frank*, the scienter analysis of the Sixth Circuit consisted of sorting through each allegation individually before conducting a collective evaluation.³³ Indeed, the district court had followed this approach in dismissing the shareholders’ claims.³⁴ The *Frank* court, however, found that focusing on individual allegations is contrary to *Matrixx*,³⁵ as *Matrixx* required consideration of scienter allegations “holistically” and not an individual analysis of such allegations.³⁶

The Sixth Circuit applied the holistic approach mandated by *Matrixx* and analyzed

When plaintiffs’ allegations of scienter were viewed collectively, the inference that Dana’s CEO and CFO had recklessly ignored the falsity of their statements regarding the company’s financial health was at least as plausible as the inference that failed accounting systems were to blame.

the plaintiff's allegations of scienter collectively, which included allegations that Burns and Richter had received internal reports showing that Dana was under financial distress while they made false positive statements about Dana's financial health.³⁷ The court additionally pointed to allegations that Burns and Richter were motivated to earn millions in bonuses that were directly tied to Dana's reported net income and earnings.³⁸ The Sixth Circuit also cited to the size of Dana's false accounting statements, including the fact that it overstated its net income for the second quarter of 2005 by seventy percent, and the temporal proximity of Dana's positive and corrective statements.³⁹ Without reference to any specific allegation of scienter, the Sixth Circuit noted that it would be difficult to grasp that Burns and Richter, who were Dana's top two executives, had no idea when they made positive statements about Dana's financial health that Dana was on the road to financial problems, including possibly bankruptcy, given the fact that (i) the entire auto industry was spiraling toward bankruptcy, (ii) one of Dana's key product lines was operating at fifty percent of earnings, (iii) multiple factories failed to meet their budgets, and (iv) the price of steel had risen 75 to 120 percent.⁴⁰ The Sixth Circuit found that when plaintiffs' allegations of scienter were viewed collectively, the inference that Burns and Richter had recklessly ignored the falsity of their statements regarding the company's financial health was at least as plausible as the inference proffered by Burns and Richter that failed accounting systems were to blame.⁴¹

The Sixth Circuit also reversed the district court's dismissal of the plaintiffs' Section 20(a) control person liability claim.⁴² Section 20(a) provides that an individual who controls a person or entity that violates a provision of the Exchange Act also is jointly and severally liable with the controlled person, unless the controlling person acted in good faith and did not induce the act constituting the violation.⁴³ The district court dismissed the shareholders' Section 20(a) claim because, among other matters, the shareholders failed to adequately plead that the defendants did not act in good faith.⁴⁴ The Sixth Circuit reversed and adopted the holdings of the First, Fourth, Fifth, Seventh, and Eleventh Circuits that have found that good faith is an affirmative defense and is not required to be pled by plaintiffs.⁴⁵

The Sixth Circuit reversed the district court's dismissal of plaintiffs' Section 20(a) control person liability claim and held that good faith is an affirmative defense and is not required to be pled by plaintiffs.

Ashland, Inc v Oppenheimer & Co

The Sixth Circuit had an opportunity to apply its recently adopted holistic approach to reviewing the sufficiency of allegations of scienter in a securities fraud action in *Ashland, Inc v Oppenheimer & Co*.⁴⁶ Unlike *Frank*, however, the Sixth Circuit found that even when the plaintiff's allegations of scienter were viewed holistically, they still did not sufficiently plead a strong inference of scienter.

Background

Ashland, Inc. ("Ashland"), a chemical company located in Kentucky, sued Oppenheimer & Co., ("Oppenheimer") over Oppenheimer's alleged failure to disclose material information regarding auction rate securities ("ARS")⁴⁷ that Oppenheimer sold to Ashland in 2007 and 2008.⁴⁸ On Oppenheimer's advice, in May 2007, Ashland purchased tax-exempt municipal-bond-backed ARS from Oppenheimer.⁴⁹ Later that year, Ashland became concerned about the subprime-mortgage crisis's effect on those securities.⁵⁰ Oppenheimer recommended student-loan-backed ARS ("SLARS") to Ashland representing that they had the same benefits as municipal ARS, but were not tied to the market for subprime mortgages.⁵¹

In January of 2008, Ashland learned that Goldman Sachs, an underwriter for several SLARS deals, had allowed one of its auctions to fail.⁵² Concerned about the event, Ashland contacted Oppenheimer and was assured that the failure was an aberration.⁵³ However, in the weeks that followed, other underwriters also let some of their ARS auctions fail.⁵⁴ Oppenheimer continued to market SLARS to Ashland, who purchased their last SLARS from Oppenheimer in early February 2008.⁵⁵ Four days later, Oppenheimer called a meeting with Ashland and announced that there were problems in the SLARS market.⁵⁶ The next day the SLARS market imploded.⁵⁷ Oppenheimer advised Ashland to sell its SLARS, but neither Oppenheimer nor any other underwriter would place proprietary bids, which left Ashland with \$194 million in illiquid SLARS.⁵⁸

Ashland sued Oppenheimer in the Eastern District of Kentucky asserting claims under Section 10(b) of the Exchange Act, violation of Kentucky blue sky laws, and various common law tort claims.⁵⁹ In its complaint, Ashland alleged that Oppenheimer knew about the ARS meltdown months in advance

and failed to disclose other facts about the securities, including ARS' true liquidity risks as well as the fact that under Oppenheimer's sales commission structure, employees lost commissions if clients resold their ARS before a minimum holding period had passed.⁶⁰ The district court dismissed the complaint holding that Ashland's securities fraud claims did not allege "facts or scienter with the requisite particularity" and that its common law allegations failed to state a claim.⁶¹

Application of the Holistic Approach

On appeal, the Sixth Circuit focused its analysis as to whether the complaint stated a securities fraud claim under Section 10(b) of the Exchange Act on the specific issue of whether the complaint adequately pled a strong inference of scienter as required by the PSLRA.⁶² The court noted that under *Tellabs*, in examining scienter, a court must determine "whether all of the facts alleged, taken collectively, meet the PSLRA's requirements."⁶³ The Sixth Circuit further noted that in light of the Supreme Court's recent precedent in *Matrixx*, it would forego the itemized analysis of the allegations conducted by the district court and view the factual allegations as a whole.⁶⁴

Under this approach, the Sixth Circuit held that even when Ashland's factual allegations of scienter were considered together, they did not give rise to a strong inference of scienter. The court noted that apart from conclusory allegations, Ashland failed to provide any facts explaining why or how Oppenheimer possessed non-public knowledge that underwriters would jointly exit the ARS market causing its collapse.⁶⁵ Rather, according to the court, the allegations, at best, suggested that a few Oppenheimer employees were aware of what might happen if the underwriters left the ARS market, which was a seemingly remote risk given the past stability of the market.⁶⁶ Thus, the court found that while the existence of scienter was "possible" in this case, "the more compelling explanation is that the near-spontaneous collapse of the ARS market caught Oppenheimer and its employees off guard."⁶⁷

The Sixth Circuit's conclusion that Ashland insufficiently alleged scienter and its affirmance of the district court's dismissal of Ashland's 10b-5 claim is reinforced by the court's survey of dozens of ARS-related cases from other circuits. The Sixth Circuit noted that in the few fraudulent misrepresentation

cases that have survived motions to dismiss, the plaintiffs sufficiently explained why or how the defendants knew about the ARS market's impending illiquidity.⁶⁸ Whereas in those cases involving only vague allegations that market participants knew of, yet failed to disclose, the risks surrounding the ARS market, the courts readily have granted Rule 12(b)(6) motions.⁶⁹

The Sixth Circuit also affirmed the dismissal by the district court of Ashland's common law fraud claim. The court found that although Ashland's common law fraud claim need not meet the PSLRA's heightened pleading requirement, the complaint must still allege facts showing that Oppenheimer acted with intent under Federal Rule of Civil Procedure 9(b)'s particularity requirement.⁷⁰ The Sixth Circuit similarly affirmed the dismissal of Ashland's promissory estoppel and negligent misrepresentation claims due to Ashland's failure to allege facts showing that Ashland justifiably relied on Oppenheimer's ambiguous representations regarding ARS' safety and liquidity, particularly in light of Oppenheimer's warning to Ashland to read and understand the ARS offering statements, which Ashland apparently failed to do.⁷¹

The Standard of Independence for a Special Litigation Committee

In the somewhat controversial opinion of *Booth Family Trust v Jeffries*,⁷² the Sixth Circuit considered the standard for independence under Delaware law that is necessary for members of a special litigation committee to evaluate potential derivative claims. A divided panel held that the special litigation committee lacked independence and reversed the dismissal of a derivative action based upon the committee's recommendation. The majority found that the recusal of one of the committee members from considering the claims against one of the defendant directors sufficiently "infected" the judgment of the committee to taint its recommendation.

Background

Shareholders of Abercrombie & Fitch Co. ("Abercrombie") had filed a derivative suit against various officers and directors alleging that the defendants caused the corporation to make allegedly misleading public statements concerning the success of Abercrombie's business model in early 2005. The business model essentially was to sell products with low manufacturing costs at relatively

In those cases involving only vague allegations that market participants knew of, yet failed to disclose, the risks surrounding the ARS market, the courts readily have granted Rule 12(b)(6) motions.

high prices based upon the strength of the Abercrombie brand name.⁷³ According to the shareholder plaintiffs, Abercrombie issued reports regarding its strong sales and the success of its business model when officers and directors knew the company was building a large surplus inventory that would eventually require the company to engage in dramatic markdowns to reduce inventory.⁷⁴ One of the named defendants, Robert S. Singer, was Abercrombie's president and chief operating officer.

Abercrombie invoked the procedural option under Delaware law of forming a special litigation committee to investigate the derivative claims and make a recommendation concerning whether the claims should be pursued.⁷⁵ Under Delaware law, the special litigation committee is to determine whether it is in the best interest of the corporation to pursue the derivative claims or seek to have them dismissed.⁷⁶ Should the special litigation committee recommend dismissal of the claims, Delaware law requires the trial court to conduct a two-prong analysis in considering the corporation's motion to dismiss. First, the court must find that the committee acted "independently," in good faith, and had a reasonable basis for its determination.⁷⁷ Second, the court, in its discretion, applies its own independent business judgment to determine whether the committee's motion to dismiss should be granted.⁷⁸

Abercrombie's board of directors authorized a two-member special litigation committee to provide a report to the board with a recommendation on how to proceed with the derivative claims. The committee originally consisted of board members, Daniel Brestle and Allan Tuttle.⁷⁹ At the time of his appointment, Tuttle was not a defendant, but was later named as a defendant by the derivative plaintiffs. Brestle resigned prior to the special litigation committee issuing its report and he was replaced by Lauren Brisky. Brisky was a named defendant at the time of her nomination.⁸⁰ The special litigation committee retained the law firm of Cahill Gordon & Reindell, who performed most of the work for the investigation. Tuttle abstained from considering the claims against Singer because of their prior relationship. Tuttle did not attend the interview of Singer. After approximately sixteen months, the special litigation committee issued a 144-page report setting forth the committee's investigation and its conclu-

sion that there was no evidence supporting the shareholder claims.⁸¹

Based on the recommendation of the special litigation committee, Abercrombie filed a motion to dismiss the derivative claims. After conducting discovery on the special litigation committee, the plaintiffs filed an opposition, challenging, among other matters, the independence of the special litigation committee. The district court rejected plaintiffs' arguments and dismissed the derivative claims based upon the recommendation of the special litigation committee.⁸²

The Lower Court Opinion

The district court found that the corporation satisfied the factors identified under Delaware law supporting the dismissal of a derivative action grounded on the recommendation of a special litigation committee, including the independence of the committee. The plaintiffs challenged Tuttle's independence based upon Tuttle's friendship with Singer, Singer's recruitment of Tuttle to Abercrombie's Board, and the fact that the men previously worked together.⁸³ The district court recognized that there are decisions under Delaware law recognizing that a director's independence may be compromised by financial, familial, or social ties to the persons who are interested in the transaction. Under Delaware authority, however, the plaintiffs "must plead facts that would support the inference that the director would be more willing to risk his or her reputation than to risk the relationship with the interested party."⁸⁴ The district court cited to Delaware authority that rejected challenges to a director's independence based on friendships and business relationships, unless there exists a "particularly close or intimate personal or business affinity."⁸⁵ The lower court noted that Abercrombie's board considered Tuttle's friendship with Singer, but it concluded that it did not foreclose independence. The district court further stated: "yet Mr. Tuttle took the additional cautionary step of abstaining from investigation or consideration of Plaintiffs' claims directed against Defendant Singer."⁸⁶

The Majority Opinion

The Sixth Circuit majority did not find Tuttle's abstention as an "additional cautionary" measure, but as a demonstration that Tuttle, and therefore the special litigation committee, was not independent.⁸⁷ Indeed, the majority indicated that: "[h]ad Tuttle not

The majority indicated that: "[h]ad [the director] not recused himself from considering the claim against Singer, we might agree with the district court's conclusion that he was independent."

recused himself from considering the claims against Singer, we might agree with the district court's conclusion that he was independent.⁸⁸ Accordingly, the majority apparently would have concurred with the district court that Tuttle's various connections to defendant Singer would not have been enough to have found that he lacked independence. Instead, the court held that the recusal effectively constituted an admission of bias or, "[a]t the very least," created "a perception that Tuttle was not independent."⁸⁹

The majority's observation that Tuttle's recusal created a perception of bias creates analytical uncertainty for attorneys counseling corporations. In its examination of the requirements of Delaware law, the majority noted that a finding of a lack of independence need not be based on a showing of actual bias or bad faith. Instead, the issue is whether the director is situated in such a way to give the "perception" of partiality and "an unacceptable risk of bias."⁹⁰ Indeed, perception was critical to the majority as they indicated that "the mere appearance of" a lack of independence of the special litigation committee was sufficient to deny the corporation's motion to dismiss.⁹¹ Interestingly, it was exactly the concern for the appearance of bias or partiality that led Tuttle to recuse himself "as a cautionary step."⁹² Paraphrasing the old adage, the very thing that Tuttle wanted to avoid, became the very thing that he was accused of committing. Tuttle recused himself to avoid the appearance of impropriety, but, according to the majority, it was the fact that he recused himself that demonstrated Tuttle's lack of independence; otherwise, he would have been deemed sufficiently independent.⁹³

Tuttle's recusal had even more dramatic consequences than simply disqualifying Tuttle. According to the majority, Tuttle's "bias" tainted the recommendation of the special committee because Singer was the central figure in the wrongdoing.⁹⁴ The majority observed that if Tuttle "had concluded that the claims against any of the directors regarding the public statements were meritorious, he would necessarily be concluding that the claims against Singer had merit."⁹⁵ Consequently, the court concluded that because Tuttle's recusal demonstrated his inability to objectively pass judgment on Singer, "that same relationship would necessarily infect his judgment regarding other defendants."⁹⁶

The Sixth Circuit majority also found that because Abercrombie's board constituted a

two-person special committee and Tuttle's recusal left only one committee member to consider the claims against Singer, the recommendation of the special litigation committee was ineffective.⁹⁷ The majority even indicated that the committee "was acting *ultra vires*" when it considered the claims against Singer.⁹⁸ While the record is unclear, the majority failed to explain how one director's recusal from considering the claims of one of the defendant directors is inconsistent with the Board's authorization. The committee was still constituted with two members and those two members were responsible for the report and recommendation to the Board. The fact that one of the board members did not offer an opinion on one aspect of the claims does not appear to rise to the level of *ultra vires*.⁹⁹

Ultimately, the court blamed Abercrombie's board for mishandling "one of those rare situations where Abercrombie had every opportunity to create an independent special litigation committee," despite the "latitude" afforded under Delaware law.¹⁰⁰

The Dissenting Opinion

In his dissent, Judge Griffin observed that the majority failed to cite any authority for its conclusion regarding the consequence of Tuttle's recusal.¹⁰¹ He further disagreed that Tuttle's recusal confirmed a lack of independence. Instead, Judge Griffin sided with the district court in finding that Tuttle's recusal "attempted to expel any doubt regarding the independence of" the special litigation committee.¹⁰² Judge Griffin relied on Delaware decisions finding that friendships or business relationships often are not sufficient to raise a reasonable doubt regarding a director's independence.¹⁰³

Observation

The majority decision reflects the unsettled and fact intensive decisions of Delaware courts concerning director independence. However, the recusal issue is unique, and practitioners should be mindful of the possible consequences of forming a committee that has one or more members who may feel the need to recuse themselves from consideration of any aspect of the asserted derivative claims. Because Michigan courts frequently look to Delaware cases when considering actions by Michigan public corporations, the Sixth Circuit independence and recusal determinations are likely to be influential in cases involving both Delaware and Michi-

Perception was critical to the majority as they indicated that "the mere appearance of" a lack of independence of the special committee was sufficient to deny the corporation's motion to dismiss. Interestingly, it was exactly the concern for the appearance of bias of partiality that led Tuttle to recuse himself "as a cautionary step."

gan corporations. For example, the Michigan Business Corporation Act provides that a court must dismiss a derivative proceeding if the court finds, among various alternatives, that a majority of “disinterested directors” on a board or who form a special committee of the board determine it is not in the best interest of the corporation to pursue the claims.¹⁰⁴ The directors’ decision must be made in “good faith” and after a “reasonable investigation.”¹⁰⁵ The Act defines a “disinterested” director as “a director who is not a party to a derivative proceeding, or a director who is a party if the corporation demonstrates that the claim asserted against the director is frivolous or insubstantial.”¹⁰⁶ Nonetheless, to ensure the appearance that the committee or board is acting in good faith and properly, a disinterested director may consider recusing him or herself from considering an aspect of a derivative action because of a close personal relationship with one or more of the defendant directors. Based on the majority decision in *Booth Family Trust*, a director appears to be better off having the cloud of partiality and bias over his or her actions than recusing himself from considering the claims.

NOTES

1. 622 F3d 471 (6th Cir 2010).
2. 551 US 308 (2007).
3. 646 F3d 954 (6th Cir 2011).
4. 648 F3d 461 (6th Cir 2011).
5. 622 F3d at 475.
6. *Id.*, at 475-76.
7. *Id.*, at 476.
8. *Id.*
9. *Id.*
10. *Id.*
11. *Id.*
12. *Id.*, at 479, 485.
13. *Id.*, at 479 (quoting *PR Diamonds, Inc v Chandler*, 364 F3d 671, 694 (6th Cir 2004)).
14. *Id.* (citing *PR Diamonds*, 364 F3d at 694).
15. *Id.*, at 482 (citing *PR Diamonds*, 364 F3d at 693).
16. *Id.*
17. *Id.*, at 483.
18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.*, at 484 (citing *Fidel v Farley*, 392 F3d 220, 232 (6th Cir 2004)).
22. *Id.*
23. *Id.*
24. 392 F3d 220 (6th Cir 2004).
25. 622 F3d 471, 484 (citing *Fidel*, 392 F3d 220, 231; *Stambaugh v Corpro Cos*, No 03-3904, 2004 US App LEXIS 24103, at *597 (6th Cir Nov 17, 2004)).
26. *Id.* (citing *Konkol v Diebold, Inc*, 590 F3d 390, 397 (6th Cir 2009)).
27. 131 S Ct 1309 (2011).
28. 646 F3d 954 (6th Cir 2011).
29. *Frank v Dana Corp*, 251 F3d 540, 553; 547 F3d 564, 571 (6th Cir 2001) (relying on *Helwig v Vencor, Inc*, (6th Cir 2001)).
30. *Frank v Dana Corp*, 547 F3d 564 (6th Cir 2001).
31. 646 F3d at 958.
32. *Id.* at *961-962 (relying on *Matrixx Initiatives, Inc v Siracusano*, 131 S Ct 1309 (2010)).
33. *Id.* at *961 (citing *Konkol v Diebold, Inc*, 590 F3d 390, 397-404 (6th Cir 2009); *Ley v Visteon Corp*, 543 F3d 801, 809-14 (6th Cir 2008); *PR Diamonds, Inc*, 364 F3d at 684)).
34. *Frank v Dana Corp*, 547 F3d 564 (6th Cir 2001).
35. 646 F3d at 962 (citing *Matrixx*, 131 S Ct 1309 (2011)).
36. *Id.* (citing *Matrixx*, 131 S Ct at 1323-25)
37. *Id.* at *959, 961..
38. *Id.* at 960.
39. *Id.*
40. *Id.* at 961-962.
41. *Id.*
42. *Id.* at 962.
43. Section 20(a) of the Exchange Act, 15 USC 78t(a), states:
Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation there under shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable... unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.
44. 646 F3d at 962-963.
45. *Id.* at 963 (citing *Laperriere v Vesta Ins Group, Inc*, 526 F3d 715, 721 (11th Cir 2008); *Brody v Stone & Webster, Inc (In re Stone & Webster, Inc, Sec Litig)*, 424 F3d 24, 26 (1st Cir 2005); *Southland Sec Corp v INSpire Ins Solutions, Inc*, 365 F3d 353, 384 n 19 (5th Cir 2004); *Dellastatious v Williams*, 242 F3d 191, 194 (4th Cir 2001); *Donohoe v Consolidated Operating & Prod Corp*, 30 F3d 907, 912 (7th Cir 1994)).
46. 648 F3d 461 (6th Cir 2011).
47. As the Sixth Circuit explained, auction rate securities are long-term bonds whose interest rates periodically reset through recurring auctions, commonly held every seven, fourteen, twenty-eight or thirty five days. *Id.* at *2. Investors can liquidate their positions at each auction assuming that demand exceeds supply. *Id.* However, if sellers outnumber buyers at any particular auction, the auction fails and no ARS owner can sell his position. *Id.* ARS underwriters can partake in the auctions, placing proprietary bids, to help ensure that the auctions do not fail. *Id.* If an ARS auction fails, owners are provided with a penalty interest rate that is meant to compensate them for the temporary illiquidity. *Id.*
48. *Id.*, at *3-4.
49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.*
53. *Id.*
54. *Id.*
55. *Id.*, at *4.
56. *Id.*
57. *Id.*

58. *Id.*

59. *Id.*, at *8.

60. *Id.*, at *7.

61. *Id.*, at *8.

62. *Id.* at *13. . The Sixth Circuit noted that many of the purported misrepresentations and omissions alleged by Ashland were not actionable under Rule 10b-5 (either because they lacked materiality or because Oppenheimer had not duty to disclose them). *Id.* However, as to Ashland's central claim that "Oppenheimer peddled ARS to Ashland as liquid, short-term investments, all while withholding a crucial factor about the market – that its continued health depended upon the intervention of underwriters, many of whom were abandoning ARS auctions," disclosure of that fact would significantly alter the total mix of available information about ARS and thus would satisfy the materiality requirement. *Id.* (citing *Murphy v Sofamor Danek Group (In re Sofamor Danek Group)*, 123 F3d 394, 400 (6th Cir 1997).

63. 648 F3d at *14.

64. *Id.* at 15-16.

65. *Id.*, at *15-16.

66. *Id.* at *16.

67. *Id.*, at *17.

68. *Id.* at *17-18. See, e.g. *Dow Corning Corp v BB&T Corp*, No. 09-5637, 2010 US Dist LEXIS 124031, at *30 (DNJ Nov 23, 2010); *Defer LP v Raymond James Fin, Inc*, No. 08-CV-3449, 2010 US Dist LEXIS 91856, at *17 (SDNY Sept 2, 2010).

69. 648 F3d at *18. See, e.g. *Oughtred v E*Trade Fin Corp*, No. 08-CV-3295, 2011 US Dist LEXIS 35712at *2 (SDNY Mar. 31, 2011) (dismissing, for an inadequate showing of scienter, complaint alleging that defendant "defrauded purchasers of auction rate securities by making misrepresentations and omissions of material fact about the risks, value, and liquidity of those securities"); *Ashland Inc v Morgan Stanley & Co*, 700 F Supp 2d 453, 468-69 (SDNY 2010) (same).

70. 648 F3d at *21-22.

71. *Id.* at *22-27.

72. 640 F3d 134 (6th Cir 2011).

73. *Id.*, at 137-38.

74. *Id.*, at 138.

75. This procedure was recognized by the Delaware Supreme Court in *Zapata Corp v Maldonado*, 430 A2d 779 (Del 1981).

76. The special litigation committee may consider a variety of factors in determining whether pursuing the derivative claims is in the best interest of the corporation. Those interests include the merits of the claim, the injury to the corporation, the cost of prosecution, the effect on operations to pursue the claim, weighing the likelihood of success and the costs of pursuing the claims, the potential knowledge and motivation of the directors, and the remedial actions. E.g., R. Balotti & J. Finkelstein, *Delaware Corporations/Business Organizations*, Vol. 1, § 13.7, at 13-81 – 13-83 (2010 Supp.) and cases cited therein.

77. See e.g., *Zapata*, 430 A2d at 788-89; *In re Oracle Corp Derivative Litig*, 824 A2d 917, 928 (Del Ch 2003).

78. *Zapata*, 430 A2d at 788-89. The court, however, may decline to apply the second step and rely instead upon its finding concerning the first prong of the test. *Id.*

79. 640 F3d at 138.

80. Delaware courts have found a director to be independent even though the director is named as a defendant. *Kindt v Lund*, No Civ A 17751, 2003 Del Ch LEXIS 62, at *8 (Del Ch, May 30, 2003); *Katell v Mogan Stanley Group, Inc*, Civ A No 12343, 1995 Del Ch LEXIS 76, at *7 (Del Ch, June 15, 1995). Under the Michigan Business Corporation Act, a "disinter-

ested director" cannot be named as a defendant unless "the corporation demonstrates that the claim asserted against the director is frivolous or insubstantial." MCL 450.1491a(c).

81. 640 F3d at 138.

82. *In re Abercrombie & Fitch Co. Derivative Litigation*, No 2:05-cv-00819, 2009 US Dist Lexis 130850 (SD Ohio Mar 12, 2009).

83. *Id.*, at *6.

84. *Id.*

85. *Id.*

86. *Id.*, at *9.

87. 640 F3d at 143.

88. *Id.* at 144.

89. *Id.*

90. *Id.*, at 142.

91. *Id.*, at 145.

92. *In re Abercrombie & Fitch Co. Derivative Litigation*, No 2:05-cv-00819, 2009 US Dist LEXIS 130850, at *17 (SD Ohio Mar 12, 2009).

93. 640 F3d at 144. The majority notes that there was a question of the effectiveness of Tuttle's recusal. *Id.*, at 145. The majority suggests that evidence of a diligent screen of Tuttle from deliberations concerning or implicating Singer might have mitigated the circumstances. *Id.*

94. 640 F3d at 144-45.

95. *Id.*, at 144 (emphasis in original).

96. *Id.*, at 144-45.

97. *Id.*, at 145.

98. *Id.*

99. In his dissent, Judge Griffin correctly points out that the majority failed to cite any caselaw, statute or corporate document "requiring that the members act jointly on all committee business," or to provide any authority forbidding partial recusals. 640 F3d at 149-50.

100. 640 F3d at 147.

101. *Id.*, at 147-48.

102. *Id.*, at 148.

103. *Id.*, at 148-49.

104. MCL 450.1495.

105. *Id.*

106. MCL 450.1491a(c).



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Non-Compete Agreements: Enforceability, Reasonableness and the Court's Discretion to "Blue Pencil"

By Ryan S. Bewersdorf and Felicia O'Connor

Many employers use non-compete agreements as a tool to protect their business from unfair competition by former employees. When creating a non-compete agreement, the most important consideration is that it be enforceable. The enforceability of these agreements is governed by MCL 445.774a, which states the factors (discussed below) that must be considered in determining enforceability. The statute gives courts the power to not only determine reasonableness, but also to "limit the agreement to render it reasonable in light of the circumstances in which it was made."¹ Courts have the sole discretion to determine what is reasonable and thus enforceable. This judicial involvement was explicitly intended by the Michigan legislature when drafting section 445.774a.²

When an employer drafts a non-compete agreement, it is useful to not only know what the courts have considered reasonable, and thus enforced in the past, but also to understand when courts have exercised their discretion to limit an unreasonable agreement rendering it reasonable. It is also important to keep in mind that while a court has the discretion to limit an unreasonable agreement, it is under no obligation to do so.³ The court may also simply find the agreement unreasonable and unenforceable. Thus, drafting a non-compete agreement that is extremely wide in scope is not necessarily a good strategy for ensuring the widest possible scope of enforcement.

The first step to understanding what makes an agreement enforceable is to review MCL Section 445.774(a), which states:

An employer may obtain from an employee an agreement or covenant which protects an employer's reasonable competitive business interests and expressly prohibits an employee from engaging in employment or a line of business after termination of employment if the agreement or covenant is

*reasonable as to its duration, geographical area, and the type of employment or line of business. To the extent any such agreement or covenant is found to be unreasonable in any respect, a court may limit the agreement to render it reasonable in light of the circumstances in which it was made and specifically enforce the agreement as limited(emphasis added).*⁴

As stated in the statute, the agreement must be reasonable with respect to duration, geographic area and the type of employment or line of business and protect the employer's reasonable competitive business interest. "In evaluating the reasonableness of a non-compete clause, Michigan courts generally examine" these four factors.⁴ If the court determines that the non-compete agreement is unreasonable in any or all of these areas, 445.774a gives it the discretion to either determine that the agreement is unenforceable or to limit the agreement to render it reasonable and thus enforceable. Caselaw helps the agreement drafter understand how courts have treated specific agreements in the past, so they may comply with the parameters of what is considered reasonable in terms of the criteria listed in the statute. A conscientious drafter should look at the criteria separately and incorporate the court's implicit guidelines.

When evaluating the first factor, reasonable competitive business interest, the courts decline to enforce agreements that simply protect an employer from general competition.⁵ An enforceable agreement must protect an employer from an *unfair* advantage in competition from the former employee.⁶ Courts have interpreted this to include three main areas of protection: existing customers, confidential information, and specialized training.⁷ This article will not focus on reasonable competitive business interest, but rather will discuss the last three criteria in the

statute, duration, geographic area, and type of employment or line of business.

Duration

One of the main aspects of a non-compete agreement that a court will look at to determine the overall reasonableness of the agreement is duration. Courts have found agreements with durations of six months to three years reasonable.⁸ Commonly, agreements have a one-year duration, which is consistently found reasonable by courts.⁹ However, three years seems to be the outer limit of reasonableness in the eyes of the court. In an unpublished 2009 Michigan case pertaining to an agreement with a duration of three years, the court found the agreement unreasonable and limited its duration to eighteen months.¹⁰ Unfortunately for practitioners, there is limited published caselaw in this area, and often an unpublished case is the only guidance a drafter has in determining when the court will limit an agreement.

Geographic Area

Many non-compete agreements are specific to a certain geographic area. It is not uncommon for medical practices to ask doctors to refrain from practicing within several miles of the employer's clinics.¹¹ In a well-known case on this topic, *St. Clair Med, PC v Borgiel*,¹² the non-compete agreement in question prohibited a doctor from practicing within seven miles of the clinic where he worked for his former employer. The court concluded that the seven-mile limitation was reasonable. As further guidance, in *St. Clair* the court also stated that potential "injury to the public" influences whether a geographic location is reasonable.¹³

In an Eastern District of Michigan case, *Kelly Serovs v Marzullo*, the court found that a geographic area limited to the area where the defendant previously worked was reasonable.¹⁴ The court in *Kelly Services* further expanded on its method, by stating that the determination for whether a geographic area was reasonable depends on whether it is "reasonably necessary to protect the employer's legitimate business interest."¹⁵

In *Lockworks, Ltd v Keegan*, the Michigan Court of Appeals further articulated the standard used for determining reasonableness in geographic area.¹⁶ The non-compete agreement in question prohibited the defendant, a hair stylist, from working within a five-mile radius of her past employer.¹⁷ The court based its opinion as to geographic reasonableness

on "whether the defendant would gain an unfair competitive advantage over plaintiff if she worked within the five-mile limit stated in the agreement."¹⁸ The court further determined that knowledge of and relationships with the employer's clients would constitute an unfair advantage if the former employee worked within an area that would be conveniently accessible for the employer's clients. The court thus determined that five miles was a reasonable distance and that the agreement should be upheld.

However, the cases above should not be understood to mean that a large or unlimited geographic area is per se unreasonable. Courts have also found that an unlimited geographic scope can be reasonable if the plaintiff's business is sufficiently national and international in scope.¹⁹ The key to reasonableness is the context of the agreement within the industry and scope of the business as part of the employers "legitimate business interest" articulated in *St. Clair*.²⁰

Type of Employment or Line of Business

The third factor that a court will use to determine the reasonableness of a non-compete agreement is whether the agreement is reasonable as to limitations on the type of employment or line of business. Many agreements not only limit where a former employee can work and the duration of the prohibition, but also the specific type of employment that is prohibited. Courts have upheld agreements that limit the scope to employment to a specific subset of an industry as reasonable.²¹

As they have found such narrow agreements reasonable, courts have also found agreements that are broader in scope unreasonable and limited their reach. In a case where the agreement prohibited the former employer from working for a competitor in any capacity, the court found that it was unreasonable and limited the agreement to prohibit work for a competitor in the capacity of athletic trainer or consultant in sports medicine, an area where the defendant had previously worked for the former employer.²²

Conclusion

Non-compete agreements are an important tool for employers to protect their legitimate business interests and to protect themselves from unfair competition. The enforceability of these agreements is governed by MCL 445.774(a), which states that an agree-

When creating a non-compete agreement, the most important consideration is that it be enforceable.

ment must be reasonable with respect to duration, geographic area, and line of business and protect the employer's reasonable competitive business interest. Section 445.774(a) also gives courts the discretion to not only determine reasonableness in a given context but also to limit the agreement to the extent necessary to render it reasonable and thus enforceable. When drafting non-compete agreements a conscientious drafter should understand both the context in which courts have found agreements reasonable and when courts have exercised their discretion to limit an agreement. Courts have given guidance regarding reasonableness through determinations on specific agreements as well as general standards. The best course of action when drafting a non-compete agreement is to create something that falls safely within parameters found reasonable by courts. Doing so will help to avoid limitation, or worse, unenforceability of the non-compete agreement.

NOTES

1. *Id.*
2. *Grigg Box Co v Michigan Box Co*, No 285862, 2009 Mich App LEXIS 2234 at *3 (Oct 22, 2009) (quoting *Rory v Continental Ins Co*, 473 Mich 457, 475 n. 32, 703 NW2d 23 (2005) (noting that the legislature has explicitly assigned the responsibility of assessing the reasonableness of noncompetition covenants between employers and employees to the judiciary).
3. *Complete Home Care v Gutierrez*, No 246280, 2004 Mich App LEXIS 1839 (June 29, 2004) (holding that while the court may limit the agreement to render it reasonable, the statute does not dictate that the court must limit the agreement).
4. *Victory Lane Quick Oil Change, Inc v Darwich*, No 11-11786, 2011 US Dist LEXIS 70062, *6 (June 29, 2011).
5. For a full discussion of "competitive business interest" See Ryan Bewersdorf & Nicholas Ellis, *Protecting Competitive Business Interests Through Non-Compete Clauses: What Interests Can Legitimately Be Protected?*, 30 Mich Bus L J (Issue 2) 40 (2010).
6. *Id.* at 41.
7. *Id.*
8. *Kelly Servs Inc v Marzullo*, 591 F Supp 2d 924, 939 (ED Mich 2008) (citing *Bristol Window & Door, Inc v Hoogenstyn*, 250 Mich App 478, 650 NW2d 670 (2002) (enforcing a three-year, statewide non-competition agreement); *Lowry Computer Prods, Inc v Head*, 984 F Supp 1111, 1116 (ED Mich 1997) (enforcing a one-year prohibition); *Superior Consulting Co v Walling*, 851 F Supp 839, 847 (ED Mich 1994) (upholding six-month time period). See also, *Robert Half Int'l, Inc v Van Steenis*, 784 F Supp 1263, 1274 (ED Mich 1991)).
9. *Lowry Computer Prods*, 984 F Supp 1111; *Kelly Servs*, 591 F Supp 2d 924.
10. *Grigg Box Co*, 2009 Mich App LEXIS 2234 at *2.
11. *St. Clair Med, PC v Brogiel*, 270 Mich App 260 (2006).

12. *Id.*

13. *St. Clair Med, PC*, 270 Mich App at 270 (citing *Community Hosp Group, Inc v More*, 183 NJ 36, supra at 61-62 (2005) (concluding that a restrictive covenant covering a 30-mile radius is injurious to the public where it would prohibit a neurosurgeon from practicing in the an area where there was a shortage of neurosurgeons)).

14. *Kelly Servs*, 591 F Supp 2d 924.

15. *Id.* at 939.

16. *Lockworks, Ltd v Keegan*, No 279894, 2009 Mich App LEXIS 157 (Jan 27, 2009).

17. *Lockworks, Ltd*, 2009 Mich App LEXIS 157 at 1.

18. *Lockworks, Ltd*, 2009 Mich App LEXIS 157 at 3.

19. *Lowry Computer Prods*, 984 F Supp at 1116 (citing *Walling*, 851 F Supp at 847).

20. *St. Clair Med, PC*, 270 Mich App at 266.

21. *Lowry Computer Prods*, 984 F Supp at 1116 (reasonable agreement prohibited defendant from selling barcode systems and related products, a small part of the software market); *Kelly Servs*, 591 F Supp 2d at 936 (reasonable agreement required defendant to not solicit Kelly customers or business relating to employee staffing or consulting services businesses), *But see Grigg Box Co v Michigan Box Co*, 2009 Mich. App. LEXIS 2234 at *2 (Oct 22, 2009) (court limited agreement that originally prohibited solicitation and sale to clients of boxes and pallets to prohibit sale only of boxes and pallets to employer's clients).

22. *Medhealth Syst Corp v Kerr*, No 219619, 2001 Mich App LEXIS 710 (Jan 9, 2001).



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Case Digests

Quid Pro Quo Sexual Harassment—Vicarious Liability Standard

Hamed v Wayne County, 490 Mich 1, 803 NW2d 237 (2011). In *Hamed* the Michigan Supreme Court considered whether Wayne County and its sheriff's department could be held vicariously liable for a civil rights claim under MCL 37.2103(i) based on a criminal act of a deputy sheriff committed during working hours but plainly beyond the scope of his employment.

Although the decision in *Hamed* involved public services and not a quid pro quo sexual harassment employment claim, the court overruled the standard for an employer's vicarious liability used in *Champion v Nationwide Sec*, 450 Mich 702, 545 NW2d 596 (1996). The *Hamed* court noted that an employer's liability under the Elliott-Larsen Civil Rights Act is based on common-law agency principles and held that a provider of a public service may not be held vicariously liable for quid pro quo sexual harassment affecting public services on the basis of unforeseeable criminal acts that its employee committed outside the scope of employment. An employee's independent action, intended solely to further the employee's individual interests, typically does not fall within the scope of employment. The *Hamed* court stated that application of traditional agency principles does not mean that employers are insulated from vicarious liability for quid pro quo sexual harassment claims. An employer may still be liable for an act of quid pro quo sexual harassment that is committed within the scope of employment or for a foreseeable act that is committed outside the scope of employment. Accordingly, liability may attach if there is sufficient cause to impute the employee's or agent's acts to the employer because the employer knew of the employee's propensity to commit the type of act involved.

Employment—Arbitration Clause; Standing

Hall v Stark Reagan, PC, No 294647, 2011 Mich App LEXIS 1560 (Sept 13, 2011). In 2003, defendant law firm hired plaintiffs as associate attorneys. On January 1, 2004, they became shareholders in the firm, joining seven of the eight attorneys named as individual defendants in this case. On their election as shareholders in the firm, plaintiffs signed a shareholders' agreement that included an arbitration clause. Plaintiffs alleged that at a 2009 meeting, individual defendants stated that their terminations were needed "to change the 'demographics' of the firm" and that "the demographics of the firm was [sic] a problem because older attorneys lose their client bases," and two younger attorneys "'had more potential' and their practices would be going up while ours would be going down." Shortly thereafter, plaintiffs announced that the termination of their employment "constituted illegal age discrimination" and advised the other shareholders that they had retained legal counsel. Their stock was later redeemed, terminating their employment effective March 1, 2009. Plaintiffs filed

an age discrimination claim under state law, which defendants answered by contending that a binding arbitration agreement barred the lawsuit and challenged the capacity of plaintiffs to sue. The circuit court granted defendants' summary disposition motion.

The court of appeals reversed, holding that the age discrimination complaint did not fall within the purview of the arbitration clause in the law firm's shareholder agreement, and it made no mention of any relationships other than those related to the disposition of shares. Because the parties contemplated that the shareholders' agreement would serve as "the entire agreement between the parties," no record evidence supported the circuit court's finding that the shareholders' agreement implicitly incorporated within its terms the law office staff manual. As for the issue of whether plaintiffs had standing to bring an age discrimination claim because they were shareholders and not employees, the court of appeals ruled that plaintiffs had standing because the evidence showed that defendants' actions affected a term or condition of their employment.

Employment—Validity of Agreement for Compulsory Arbitration

Hergenreder v Bickford Senior Living Group, LLC, No 10-1474, 2011 US App LEXIS 18079 (6th Cir Aug 30, 2011). Plaintiff was hired as a nurse for the employer in October 2006. A short time later, she was diagnosed with cancer and took a leave of absence for treatment. The treatment was apparently successful and plaintiff was prepared to return to work by late December 2006, but she was told not to return by her supervisor because the facility at which she was to work had not yet opened and a backup nurse was not needed. On January 12, 2007, her supervisor told plaintiff over the phone that she was fired, and on January 25, 2007, plaintiff received a letter from her supervisor stating that her status at the employer was terminated on December 12, 2006 due to her surgery and recuperation time. Believing that her firing was in violation of the Americans with Disabilities Act, plaintiff sued the employer in August 2009. In response, the employer filed a motion to stay the proceedings and compel arbitration. The district court granted this motion and dismissed the case, finding that plaintiff assented to a valid agreement to arbitrate the claims she brought in this lawsuit.

The district court believed that plaintiff was bound by the arbitration terms set out in the employer's Dispute Resolution Procedure (DRP) because plaintiff was "reasonably notified of the DRP and [she] elected to accept and continue her employment." This conclusion was based on plaintiff's acknowledgment that she had read and understood the terms of the employer handbook, including the section referring to the DRP. When plaintiff began her employment, she signed numerous documents but none of these mentioned anything about arbitration. Plaintiff alleged that she had never seen or signed any documents referring to the DRP and had never signed any agreement that gave up her right to a jury trial and that compelled her to file for arbitration. The employer did not provide

a copy of the DRP with an acknowledgment form signed by plaintiff. The Sixth Circuit applied Michigan contract law in denying the employer's attempt to compel arbitration of plaintiff's discrimination claim because there was no indication that plaintiff was notified of the arbitration agreement or that she had agreed to its terms. The employer agreed that its handbook, which contained a contractual disclaimer, did not constitute a contract. The court stated that the employer's argument was essentially that if plaintiff had no reason to believe that a certain document contained an offer to enter into an agreement, and if she was not contractually obligated to read that document, then she would nonetheless be bound to the agreement contained in that document if she unwittingly took actions that the document said would constitute acceptance of the offer. The court stated that there is no support for such a proposition in Michigan law.

Limited Liability Companies—Review of Articles of Organization

Jackson v Department of Energy, Labor & Econ Growth, No 297762, 2011 Mich App LEXIS 1159 (June 23, 2011) (unpublished). The Bureau of Commercial Services (the "Bureau") refused to file articles of organization that included "guardian" in the LLC's name because the banking code generally authorizes only individuals and certain corporations to act as a fiduciary. See MCL 487.11105(2). The circuit court set aside the refusal and ordered the Bureau to accept the articles for filing. The court of appeals noted that, although the Michigan LLC Act requires that the Bureau must approve articles for filing, its review under MCL 450.4104(2) is limited and does not give the Bureau any discretion to look beyond the documents actually submitted. Instead, the Bureau must simply review the documents, determine whether they substantially conform with the act's requirements, and, if they do, it must endorse and file them, even if the Bureau suspects or knows that the organizing member intends to use the LLC to engage in business activities that the Bureau believes are unlawful for an LLC. Although the Bureau contended in this case that it could refuse to file the articles because plaintiff actually intended to offer fiduciary services, the legislature did not give the Bureau the authority to look beyond the documents actually submitted in determining whether to endorse and file articles. The Bureau's review is limited to determining whether an LLC's name substantially conforms to the requirements of MCL 450.4204(2)(a). Thus, the Bureau could not consider plaintiff's intent, and, even assuming that the LLC might later engage in business that it could not lawfully pursue under Michigan law, such an occurrence would be a matter for the attorney general and not for the Bureau assigned to review the LLC's proposed articles of organization. Given the limited nature of its review, the court of appeals ruled as a matter of law that the Bureau exceeded the scope of its authority to review documents submitted under the LLCA.

Index of Articles

(vol 16 and succeeding issues)

- Adequate assurance of performance demand, 23 No 1, p. 10; 29 No 3, p. 14
- Administrative expense claims under BACPA 2005, 26 No 3, p. 36
- ADR
- appeals of arbitrability, effect on lower courts, 26 No 2, p. 37
 - arbitration, pursuit of investors' claims, 16 No 2, p. 5
 - commercial dispute resolution, new horizons, 22 No 2, p. 17
 - mediation 17 No 1, p. 15; 26 No 3, p. 49
 - "real time" conflict solutions 28 No 2, p. 31
- Advertising injury clause, insurance coverage, 24 No 3, p. 26
- Agriculture
- Farm Security and Rural Investment Act of 2002, 22 No 3, p. 30
 - succession planning for agribusinesses, 24 No 3, p. 9
- Annuity suitability requirements, 27 No 2, p. 15
- Antiterrorism technology, federal SAFETY Act, 24 No 3, p. 34
- Antitrust compliance program for in-house counsel, 22 No 1, p. 42
- Assignments for benefit of creditors, 19 No 3, p. 32
- Assumed names of LLCs, 28 No 3, p. 5
- Attorney-client privilege, tax matters, 24 No 3, p. 7; 26 No 3, p. 9. *See also* E-mail
- Automotive suppliers
- disputes in automotive industry, lessons learned, 26 No 2, p. 11
 - extending credit in era of contractual termination for convenience, 26 No 1, p. 49
 - requirements contracts, enforceability, 28 No 2, p. 18
- Bankruptcy. *See also* preferences
- after-acquired property and proceeds in bankruptcy, 28 No 1, p. 28
 - Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 25 No 3, p. 27; 26 No 3, p. 18
 - composition agreements, alternatives to bankruptcy, 28 No 3, p. 43
 - cross-border insolvencies, 26, No 3, p. 10
 - default interest, 23 No 2, p. 47
 - dividends and other corporate distributions as avoidable transfers, 16 No 4, p. 22
 - foreclosure, bankruptcy forum to resolve disputes 30 No 1, p. 17
 - franchisors, using bankruptcy forum to resolve disputes, 16 No 4, p. 14
 - in-house counsel's survival guide for troubled times, 22 No 1, p. 33
 - intellectual property, protecting in bankruptcy cases, 22 No 3, p. 14
 - landlord-tenant issues, 26 No 3, p. 32
 - litigation roadmap, 28 No 1, p. 34
 - mortgage avoidance cases, 26 No 3, p. 27
 - ordinary course of business, 23 No 2, p. 40; 26 No 1, p. 57
 - overview of Bankruptcy Reform Act of 1994, 16 No 4, p. 1
 - partners and partnership claims, equitable subordination, 16 No 1, p. 6
 - prepayment penalty provisions in Michigan, enforceability in bankruptcy and out, 16 No 4, p. 7
 - prepayment premiums in and out of bankruptcy, 23 No 3, p. 29
 - priority for creditors providing goods to debtors in ordinary course of business, 28 No 1, p. 18
 - proof of claim, whether and how to file, 30 No 1, p. 10
 - reclamation and administrative offense claims, 26 No 3, p. 36
 - tax tips for bankruptcy practitioners, 27 No 2, p. 30
 - trust fund statutes and discharge of trustee debts, 28 No 1, p. 11
 - UCC 2-702, use in bankruptcy, 29 No 3, p. 9
- Banks. *See* Financial institutions
- Business claims, intersection of statute and common law, 27 No 1, p. 29
- Business continuity planning, 28 No 1, p. 9
- Business Court in Michigan, 25 No 3, p. 9
- Business-income-loss claims, 27 No 1, p. 24
- Business judgment rule
- corporate scandals and business judgment rule, 25 No 3, p. 19
 - Disney* derivative litigation, 25 No 2, p. 22
- Certificated goods, frontier with UCC, 24 No 2, p. 23
- Charitable Solicitations Act, proposed revisions, 26 No 1, p. 14
- Charities. *See* Nonprofit corporations or organizations
- Chiropractors and professional service corporations, 24 No 3, p. 5
- Choice of entity
- 2003 tax act considerations, 23 No 3, p. 8
 - frequently asked questions, 25 No 2, p. 27
 - getting it right the first time, 26 No 1, p. 8
- Circular 230 and tax disclaimers, 25 No 2, p. 7
- Class Action Fairness Act of 2005, 25 No 3, p. 15
- Click-wrap agreements under UCC, mutual assent, 26 No 2, p. 17
- COBRA changes under 2009 Stimulus Act, 29 No 2, p. 31
- Commercial finance lease agreements, 26 No 2, p. 21
- Commercial impracticability, issues to consider, 29 No 1, p. 16
- Commercial litigation. *See also* ADR
- business court in Michigan, 25 No 3, p. 9
 - Class Action Fairness Act of 2005, 25 no 3, p. 15
 - document production, 28 No 2, p. 13
 - economic duress, proving in Michigan, 26 No 2, p. 25
 - electronic discovery, 22 No 2, p. 25; 27 No 2, p. 9; 27 No 3, p. 37
 - future lost profits for new businesses, proving in post-*Daubert* era, 26 No 2, p. 29
- Competitor communications, avoiding sting of the unbridled tongue, 18 No 1, p. 18
- Composition agreements, alternatives to bankruptcy, 28 No 3, p. 43
- Computers. *See* Technology Corner.
- Confidentiality agreements, preliminary injunctions of threatened breaches, 16 No 1, p. 17
- Contracts. *See also* Automotive suppliers
- doctrine of *culpa in contrahendo* and its applicability to international transactions, 24 No 2, p. 36
 - drafting, 28 No 2, p. 24
 - electronic contracting, 28 No 2, p. 11; 31 No 2, p. 9
 - letters of intent, best practices, 25 No 3, p. 44
 - liquidated damages and limitation of remedies clauses 16 No 1, p. 11

- setoff rights, drafting contracts to preserve, 19 No 1, p. 1
- Conversions of entities, 31 No 1, p.7
- Corporate counsel. See In-house counsel
- Corporations. See also Business judgment rule; Nonprofit corporations; Securities
- Business Corporation Act amendments, 21 No 1, p. 28; 29 No 1, pp. 5, 10
- corporate governance, 28 No 3, p. 9
- correcting incomplete corporate records, 29 No 3, p. 31
- deadlocks in closely held corporations, planning ideas to resolve, 22 No 1, p. 14
- Delaware and Michigan incorporation, choosing between, 22 No 1, p. 21
- Delaware corporate case law update (2005), 25 No 2, p. 49
- derivatives transactions, explanation of products involved and pertinent legal compliance considerations, 16 No 3, p. 11
- dissenter's rights: a look at a share valuation, 16 No 3, p. 20
- dividends and other corporate distributions as avoidable transfers, 16 No 4, p. 22
- drag-along rights under Michigan Business Corporation Act, 28 No 3, p. 20
- employment policies for the Internet, why, when, and how, 19 No 2, p. 14
- foreign corporations, internal affairs doctrine, 27 No 1, p. 48
- insolvency, directors' and officers' fiduciary duties to creditors when company is insolvent or in vicinity of insolvency, 22 No 2, p. 12
- interested directors, advising re selected problems in sale of corporation, 16 No 3, p. 4
- minority shareholder oppression suits, 25 No 2, p. 16
- opportunity doctrine in Michigan, proposed legislative reform, 28 No. 3, p. 15
- professional service providers and *Miller v Allstate Ins Co*, 28 No 3, p. 26
- proposed amendments to Business Corporation Act (2005), 25 No 2, p. 11
- S corporations, 25 No 3, p. 7; 29 No 3, p. 7; 31 No 2, p.7
- Sarbanes-Oxley Act of 2002, 22 No 3, p. 10
- shareholder standing and direct versus derivative dilemma, 18 No 1, p. 1
- tax matters, 27 No 1, p. 8
- technical amendments to Michigan Business Corporation Act (1993), 16 No 3, p. 1
- tort liability for corporate officers, 26 No 3, p. 7
- Creditors' rights. See also Bankruptcy; Entireties property; Judgment lien statute
- assignments for benefit of creditors, 19 No 3, p. 32
- claims in nonbankruptcy litigation, 19 No 3, p. 14
- cross-border secured lending transactions in United States and Canada, representing the lender in, 16 No 4, p. 38
- debtor exemptions, history and future, 30 No 2, p. 57; 31 No 2, p. 14
- decendent's estates, eroding creditors' rights to collect debts from, 19 No 3, p. 54
- fiduciary duties of directors and officers to creditors when company is insolvent or in vicinity of insolvency, 22 No 2, p. 12
- garnishment, growing menace for Michigan employers, 31 No 2, p. 17
- judgment lien statute, advisability of legislation, 23 No 2, pp. 11, 24
- necessaries doctrine, Michigan's road to abrogation, 19 No 3, p. 50
- nonresidential real property leases, obtaining extensions of time to assume or reject, 19 No 3, p. 7
- prepayment penalty provisions in Michigan, enforceability in bankruptcy and out, 16 No 4, p. 7
- out-of-court workouts, 19 No 3, p. 9
- personal property entireties exemption, applicability to modern investment devices, 22 No 3, p. 24
- receiverships, 19 No 3, p. 16
- trust chattel mortgages, 19 No 3, p. 1.
- Criminal law and matters, white collar-crime investigation and prosecution, 27 No 1, p. 37
- Cross-border insolvencies, 26 No 3, p. 10
- Cross-cultural negotiations, 27 No 2, p. 39
- Cybercourt for online lawsuits, 21 No 1, p. 54
- Cybersquatting and domain name trademark actions, 22 No 2, p. 9
- Data breach notification act, 27, No 1, p. 9
- Deadlocks in closely held corporations, planning idea to resolve, 22 No 1, p. 14
- Defamation claims for businesses, intersection of statute and common law, 27 No 1, p. 29
- Delaware and Michigan incorporation, choosing between 22 No 1, p. 21
- Delaware corporate case law update (2005), 25 No 2, p. 49
- Derivatives transactions, explanation of products involved and pertinent legal compliance considerations, 16 No 3, p. 11
- Did You Know?
- acupuncture, 26 No 2, p. 7
- assumed names of LLCs, 28 No 3, p. 5
- Business Corporation Act 2009 amendments, 29 No 1, p. 5
- chiropractors and professional service corporations, 24 No 3, p. 5
- educational corporations or institutions, 24 No 1, p. 5; 24 No 3, p. 5
- entity conversions, 31 No 1, p. 7
- expedited filing, 25 No 3, p. 6; 26 No 1, p. 5
- fee changes for authorized shares 25 No 3, p. 6; 26 No 1, p. 5
- finding the proper agency, 25 No 2, p. 5
- LLC Act amendments (2002), 23 No 2, p. 5
- low profit LLCs, 29 No 1, p. 6; 29 No 2, p. 5
- medical marijuana, 31 No 2, p. 5
- mold lien act amendments, 22 No 2, p. 5
- names for business entities, 23 No 1, p. 5; 25 No 1, p. 5
- nonprofit corporation amendments, 28 No 2, p. 7
- professional corporations, 22 No 1, p. 5; 27 No 2, p. 6
- service of process on business entities and other parties, 30 No 1, p. 5
- special entity acts, 25 No 3, p. 5
- summer resort associations, 24 No 3, p. 6
- tort liability for corporate officers, 26 No 3, p. 7
- uniform and model acts, 24 No 2, p. 5
- viewing entity documents, 24 No 3, p. 5
- Digital signatures, 19 No 2, p. 20
- Disaster preparations for law firms, 21 No 1, p. 7
- Discovery of electronic information in commercial litigation, 22 No 2, p. 25; 28 No 2, p. 13

- Dissenter's rights: A look at a share valuation, 16 No 3, p. 20
- Dissolution of Michigan LLC when members deadlock, 25 No 3, p. 38
- Dodd-Frank Wall Street Reform and Consumer Protection Act and the Consumer Financial Protection Bureau, 30 No 3, p. 13
- Domain names, 21 No 1, p. 48; 22 No 2, p. 9
- Drag-along rights under Michigan Business Corporation Act, 28 No 3, p. 20
- Economic duress, proving in Michigan, 26 No 2, p. 25
- E-mail
- encryption and attorney-client privilege, 19 No 2, p. 26
 - monitoring of e-mail and privacy issues in private sector workplace, 22 No 2, p. 22
 - unencrypted Internet e-mail and attorney-client privilege, 19 No 2, p. 9
- Educational corporations, 24 No 1, p. 5; 24 No 3, p. 5
- Employment. *See also* Noncompetition agreements
- "honest believe" defense, 28 No 2, p. 51
 - ICE audit campaign, 30 No 2, p. 63
 - Internet policies: why, when, and how, 19 No 2, p. 14
 - monitoring of e-mail and privacy issues in private sector workplace, 22 No 2, p. 22
 - sexual harassment, employer liability for harassment of employees by third parties, 18 No 1, p. 12
 - social networking, management of legal risks, 30 No 2, p. 44
- Empowerment zones, business lawyer's guide to, 17 No 1, p. 3
- Entireties property
- exemption for personal property, applicability to modern investment devices, 22 No 3, p. 24
 - federal tax liens, 22 No 2, p. 7; 23 No 2, p. 28
 - LLC interests, 23 No 2, p. 33
- Estate tax uncertainty in 2010, 30 No 1, p. 8
- Ethics, disaster preparations, 21 No 1, p. 7
- Exemptions from securities registration, client interview flow chart, 29 No 3, p. 39
- Export controls and export administration, 24 No 1, p. 32
- Farm Security and Rural Investment Act of 2002, 22 No 3, p. 30
- Federal government, selling goods and services with reduced risk through commercial item contracting, 31 No 1, p. 41
- Fiduciary duties
- insolvent company or in vicinity of insolvency, duties of offices and directors to creditors, 22 No 2, p. 12
 - LLC members, duties and standards of conduct, 24 No 3, p. 18
- Film tax credit and secured transactions, 29 No 3, p. 21
- Financial institutions
- cross-border secured lending transactions in United States and Canada, representing the lender in, 26 No 4, p. 38
 - Dodd-Frank Wall Street Reform and Consumer Protection Act and the Consumer Financial Protection Bureau, 30 No 3, p. 13
 - federal legislation giving additional powers to banks and bank holding companies, 20 No 1, p. 1
 - Gramm-Leach-Bliley's privacy requirements, applicability to non-financial institutions, 20 No 1, p. 13
 - new Banking Code for new business of banking, 20 No 1, p. 9
 - revised UCC Article 9, impact on commercial lending, 21 No 1, p. 20
 - troubled banks mean trouble for bank directors, 30 No 3, p. 22
- Force majeure and commercial impracticability, issues to consider, 29 No 1, p. 16
- Foreclosure, use of receiver or bankruptcy as alternative to, 30 No 1, p. 17
- Foreign corporations, internal affairs doctrine, 27 No 1, p. 48
- Foreign defendants, serving in Michigan courts, 30 No 1, p. 49
- Foreign trade zones, 24 No 3, p. 40
- Forum selection clauses, enforceability of international clauses, 30 No 3, p. 40
- Franchino v Franchino*, minority shareholder oppression suits, 25 No 2, p. 16
- Franchises
- bankruptcy forum to resolve disputes, 16 No 4, p. 14
 - less-than-total breach of franchise agreement by franchisor, loss or change in format, 16 No 1, p. 1
 - Petroleum Marketing Practices Act, oil franchisor-franchisee relationship, 18 No 1, p. 6
- Gaming in Michigan, primer on charitable gaming, 26 No 1, p. 21
- Garnishment, growing menace for Michigan employers, 31 No 2, p. 17
- "Go Shop" provisions in acquisition agreements, 27 No 3, p. 18
- HITECH Act and HIPAA privacy and security issues, 29 No 2, p. 9
- I.D. cards, security vs privacy, 27 No 3, p. 11
- Identity theft-protection act amendments, 31 No 1, p. 11
- Immigration
- E-verify program and its application to federal contractors, 29 No 1, p. 36
 - ICE employer audit campaign, 30 No 2, p. 63
 - tax criminal prosecution, employer I-9 compliance, 28 No 3, p. 34
- Independent contractors, tax issues, 28 No 2, p. 9
- India, mergers and acquisitions, 28 No 2, p. 43
- Information security, 23 No 2, p. 8; 23 No 3, p. 10
- In-house counsel
- antitrust compliance program, 22 No 1, p. 42
 - pension funding basics, 25 No 1, p. 17
 - risk management, 25 No 1, p. 10
 - survival guide for troubled times, 22 No 1, p. 33
- Insolvency, directors' and officers' fiduciary duties to creditors when company is insolvent or in vicinity of insolvency, 22 No 2, p. 12
- Installment contracts under UCC 2-612, perfect tender rule, 23 No 1, p. 20
- Insurance
- business-income-loss claims, 27 No 1, p. 24
 - risk management for in-house counsel, 25 No 1, p. 10
 - scope of advertising injury clause, 24 No 3, p. 26
- Intellectual property
- bankruptcy cases, 22 No 3, p. 14
 - domain name trademark actions, 22 No 2, p. 9
 - RICO and theft of trade secrets, 31 No 2, p. 23
- Interested directors, advising re selected problems in sale of corporation, 16 No 3, p. 4
- International transactions
- applicability of doctrine of *culpa in contrahendo*, 24 No 2, p. 36
 - documentary letters of credit, 25 No 1, p. 24

- foreign trade zones, 24 No 3, p. 40
forum selection clauses, enforceability, 30 No 3, p. 40
Internal affairs doctrine, foreign corporations, 27 No 1, p. 48
Internet. *See also* E-mail; Privacy; Technology Corner
corporate employment policies: why, when, and how, 19 No 2, p. 14
cybercourt for online lawsuits, 21 No 1, p. 54
data breach notification act, 27, No 1, p. 9
digital signatures, 19 No 2, p. 20
domain names, 21 No 1, p. 48; 22 No 2, p. 9
jurisdiction and doing business online, 29 No 1, p. 23
proxy materials, Internet delivery, 27 No 3, p. 13
public records, using technology for, 19 No 2, p. 1
sales tax agreement, 23 No 1, p. 8
year 2000 problem, tax aspects, 19 No 2, p. 4
Investing by law firms in clients, benefits and risks, 22 No 1, p. 25
Joint enterprises, recognition by Michigan courts, 23 No 3, p. 23
Judgment lien statute
advisability of legislation, 23 No 2, pp. 11, 24
new collection tool for creditors, 24 No 3, p. 31
shortcomings of judgment lien statute, 31 No 1, p. 48
Judicial dissolution of Michigan LLC when members deadlock, 25 No 3, p. 38
Landlord-tenant issues under BACPA 2005, 26 No 3, p. 32
Law firms, benefits and risks of equity arrangements with clients, 22 No 1, p. 25
Leases
commercial finance lease agreements, 26 No 2, p. 21
obtaining extensions of time to assume or reject, 19 No 3, p. 7
Letters of credit in international transactions, 25 No 1, p. 24
Letters of intent, best practices, 25 No 3, p. 44
Liens. *See also* Judgment lien statute
how to find notices of state and federal tax liens, 24 No 1, p. 10
mold lien act, 22 No 2, p. 5; 26 No 3, p. 44
special tools lien act, 23 No 1, p. 26; 26 No 3, p. 44
Life insurance, critical planning decisions for split-dollar arrangements, 23 No 3, p. 41
Limited liability companies (LLCs)
2002 LLC Act amendments (PA 686), 23 No 1, p. 34; 23 No 2, p. 5
2010 LLC Act Amendments, 31 No 2, p. 10
anti-assignment provisions in operating agreements, impact of UCC 9-406 and 9-408, 24 No 1, p. 21
buy-sell provisions of operating agreements, 19 No 4, p. 60
entireties property, 23 No 2, p. 33
family property and estate planning, operating agreements for, 19 No 4, p. 49
fiduciary duties and standards of conduct of members 24 No 3, p. 18
joint venture, operating agreements for, 19 No 4, p. 34
limitations on transfer of membership interests, 31 No 1, p. 31
low profit LLCs, 29 No 1, p. 6; 29 No 2, pp. 6, 27
manufacturing business, operating agreements for, 19 No 4, p. 2
meaning of operating agreement, 30 No 2, p. 2
minority member oppression, 27 No 1, p. 11
piercing the veil of a Michigan LLC, 23 No 3, p. 18
real property, operating agreements for holding and managing, 19 No 4, p. 16
securities, interest in LLC as, 16 No 2, p. 19
self-employment tax for LLC members, 23 No 3, p. 13
series LLCs, 27 No 1, p. 19
single, 29 No 1, p. 33; 30 No 2, p. 20
Liquidated damages and limitation of remedies clauses, 16 No 1, p. 11
Litigation. *See* Commercial litigation
Lost profits for new businesses in post-*Daubert* era, 26 No 2, p. 29
Low profit LLCs, 29 No 1, p. 6; 29 No 2, p. 27
Malware grows up: Be very afraid, 25 No 3, p. 8
Material adverse effect clauses, Delaware court's pro-seller attitude towards, 29 No 1, p. 28
Mediation instead of litigation for resolution of valuation disputes, 17 No 1, p. 15
Medical marijuana, 31 No 2, p. 5
Mergers and acquisitions
disclosure of confidential information, 29 No 2, p. 39
India, framework and issues, 28 No 2, p. 43
multiples as key to value or distraction, 23 No 1, p. 31
Michigan Business Tax, 28 No 1, p. 40; 29 No 1, p. 40
Minority oppression
LLCs, minority members, 27 No 1, p. 11
shareholder suits, 25 No 2, p. 16
Mold lien act, 22 No 2, p. 5, 26 No 3, p. 44
Mortgage avoidance cases in Michigan's bankruptcy courts, 26 No 3, p. 27
Names for business entities, 23 No 2, p. 5; 25 No 1, p. 5
Necessaries doctrine, Michigan's road to abrogation, 19 No 3, p. 50
Negotiations, cross-cultural, 27 No 2, p. 39
Noncompetition agreements
geographical restrictions in Information Age, 19 No 2, p. 17
preliminary injunctions of threatened breaches, 16 No 1, p. 17
protecting competitive business interests, 30 No 2, p. 40
Nonprofit corporations or organizations
amendments, 28 No 2, p. 7
Charitable Solicitations Act, proposed revisions, 26 No 1, p. 14
compensating executives, 24 No 2, p. 31
intermediate sanctions, slippery slope to termination, 26 No 1, p. 27
IRS Form 990 changes—nonprofit governance in a fish bowl, 29 No 2, p. 11
lobbying expenses, businesses, associations, and non-deductibility of, 17 No 2, p. 14
low profit LLCs, 29 No 1, p. 6, 29 No 2, pp. 6, 27
proposed amendments to Michigan Nonprofit Corporation Act, 17 No 2, p. 1; 23 No 2, p. 70; 26, No 1, p. 9
Sarbanes-Oxley Act of 2002, impact on nonprofit entities, 23 No 2, p. 62
shuffle up and deal: a primer on charitable gaming in Michigan, 26 No, p. 21
tax exemptions, 26 No 1, p. 33
trustees, nonprofit corporations serving as, 17 No 2, p. 9
Uniform Prudent Management of Institutional Funds Act, 29 No 2, p. 17
volunteers and volunteer directors, protection of, 17 No 2, p. 6

- Offshore outsourcing of information technology services, 24 No 1, p. ; 24 No 2, p. 9
- Open source software, 25 No 2, p. 9; 29 No 2, p. 49
- Optioning the long-term value of a company, effect on shareholders, 27 No 3, p. 33
- Ordinary course of business, bankruptcy, 23 No 2, p. 40; 26 No 1, p. 57
- Partnerships
 - bankruptcy, equitable subordination of partners and partnership claims, 16 No 1, p. 6
 - interest in partnership as security under Article 9, 19 No 1, p. 24
- Pension funding basics for in-house counsel, 25 No 1, p. 17
- Perfect tender rule, installment contracts under UCC 2-612, 23 No 1, p. 20
- Personal property entireties exemption, applicability to modern investment devices, 22 No 3, p. 24
- Petroleum Marketing Practices Act, oil franchisor-franchisee relationship, 18 No 1, p. 6
- Piercing the veil of a Michigan LLC, 23 No 3, p. 18
- Preferences
 - defending against preference claims, 29 No 3, p. 26
 - earmarking defense, gradual demise in Sixth Circuit, 30 No 1, p. 25
 - minimizing manufacturer's exposure by asserting PMSI and special tools liens, 30 No 1, p. 41
 - ordinary terms defense, 30 No 1, p. 34
- Preliminarily enjoining threatened breaches of non-competition and confidentiality agreements, 16 No 1, p. 17
- Prepayment penalty provisions in Michigan, enforceability in bankruptcy and out, 16 No 4, p. 7
- Prepayment premiums in and out of bankruptcy, 23 No 3, p. 29
- Privacy
 - drafting privacy policies, 21 No 1, p. 59
 - Gramm-Leach-Bliley requirements, applicability to non-financial institutions, 20 No 1, p. 13
 - monitoring of e-mail and privacy issues in private sector workplace, 22 No 2, p. 22
 - securities industry, application of privacy laws to, 27 No 3, p. 25
 - workplace, clarification by US Supreme Court, 30 No 2, p. 11
- Professional service providers and *Miller v Allstate Ins Co*, 28 No 3, p. 26
- Proof of claim, whether and how to file, 30 No 1, p. 10
- Public debt securities, restructuring, 22 No 1, p. 36
- Public records, using technology for, 19 No 2, p. 1
- Receiverships, 19 No 3, p. 16; 28 No 2, p. 36; 20 No 1, p. 17
- Retirement plan assets to fund start-up company, 30 No 2, p. 34
- RICO and theft of trade secrets, 31 No 2, p. 23
- Risk management for in-house counsel, 25 No 1, p. 10
- ROBS transaction to fund start-up company, 30 No 2, p. 34
- S corporations
 - audit targets, 25 No 3, p. 7
 - losses, how to deal with, 29 No 3, p. 34
- SAFETY Act and antiterrorism technology, 24 No 3, p. 34
- Sarbanes-Oxley Act of 2002, 22 No 3, p. 10
- nonprofit entities, 23 No 2, p. 62
- public issuers in distress, 23 No 2, p. 55
- relief for smaller public companies, 26 No 1, p. 42
- Securities
 - abandoned public and private offerings, simplifying Rule 155, 21 No 1, p. 18
 - arbitration, pursuit of investors' claims, 16 No 2, p. 5
 - basics of securities law for start-up businesses, 24 No 2, p. 13
 - disclosure of confidential information, 29 No 2, p. 39
 - exemptions from registration, client interview flow chart, 29 No 3, p. 39
 - "Go Shop" provisions in acquisition agreements, 27 No 3, p. 18
 - investment securities, revised UCC Article 8, 19 No 1, p. 30
 - investor claims against securities brokers under Michigan law, 28 No 3, p. 50
 - Internet delivery of proxy materials, 27 No 3, p. 13
 - limited liability company interests as securities, 16 No 2, p. 19
 - overview of Michigan securities regulation, 31 No 1, p. 12
 - Plain English movement of SEC, FINRA, and OFIR, 31 No 1, p. 19
 - privacy laws and regulations, application to employment relationships in securities industry, 27 No 3, p. 25
 - public debt securities, restructuring, 22 No 1, p. 36
 - real-time disclosure, SEC, 24 No 2, p. 20
 - Sarbanes-Oxley Act of 2002, public issuers in distress, 23 No 2, p. 55
 - SEC small business initiatives, 16 No 2, p. 8
 - secondary liability and "selling away," 30 No 2, p. 49
 - short selling regulation, alternative uptick rule, 30 No 3, p. 32
 - small business regulatory initiatives, progress or puffery, 16 No 2, p. 1
 - small corporate offering registration, 16 No 2, p. 13
 - Uniform Securities Act, technical compliance is required, 17 No 1, p. 1
 - venture capital financing, terms of convertible preferred stock, 21 No 1, p. 9
 - what constitutes a security, possible answers, 16 No 2, p. 27
- Self-employment tax for LLC members, 23 No 3, p. 13
- Service of process
 - business entities and other parties, 30 No 1, p. 5
 - foreign defendants, 30 No 1, p. 49
- Sexual harassment, employer liability for harassment of employees by third parties, 18 No 1, p. 12
- Shareholders
 - dissenter's rights: a look at a share valuation, 16 No 3, p. 20
 - minority shareholder oppression suits, 25 No 2, p. 16
 - oppression and direct/derivative distinction, 27 No 2, p. 18
 - optioning the long-term value of a company, effect on shareholders, 27 No 3, p. 33
 - standing and direct versus derivative dilemma, 18 No 1, p. 1
- Short selling regulation, alternative uptick rule, 30 No 3, p. 1
- Shrink-wrap agreements under UCC, mutual assent, 26 No 2, p. 17
- Single-member LLCs, 29 No 1, p. 33; 30 No 2, p. 20
- Small Business Administration business designations and government contracting, 24 No 1, p. 29
- Social networking, management of legal risks, 30 No 2, p. 44
- Software licensing watchdogs, 25 No 1, p. 8

- Special tools lien act, 23 No 1, p. 26
- Split-dollar life insurance arrangements, critical planning decisions, 23 No 3, p. 41
- Subordination agreements under Michigan law, 24 No 1, p. 17
- Succession planning for agribusinesses, 24 No 3, p. 9
- Summer resort associations, 24 No 3, p. 6
- Taxation and tax matters
- 2001 Tax Act highlights, 22 No 1, p. 7
 - 2004 Tax Acts: What you need to tell your clients, 25 No 1, p. 30
 - 2009 tax rate increase, 28 No 3, p. 7
 - aggressive transactions, tax consequences, 27 No 3, p. 9
 - attorney-client privilege, 24 No 3, p. 7; 26 No 3, p. 9
 - avoiding gift and estate tax traps, 23 No 1, p. 7
 - bankruptcy, tax tips, 27 No 2, p. 30
 - C corporations, less taxing ideas, 27 No 1, p. 8
 - charitable property tax exemptions, 26 No 1, p. 33
 - choice of entity, 23 No 3, p. 8; 26 No 1, p. 8
 - Circular 230 and tax disclaimers, 25 No 2, p. 7
 - Disclosure requirements for uncertain tax positions, 30 No 3, p. 34
 - estate tax planning after 2010 Tax Act, 31 No 1, p. 9
 - estate tax uncertainty in 2010, 30 No 1, p. 8
 - federal tax liens, 22 No 2, p. 7; 23 No 2, p. 28; 27 No 2, p. 11
 - how to find notices of state and federal tax liens, 24 No 1, p. 10
 - immigration and tax criminal prosecution, employer I-9 compliance, 28 No 3, p. 34
 - independent contractors, 28 No 2, p. 9
 - Internet sales tax agreement, 23 No 1, p. 8
 - IRS priorities, 24 No 1, p. 7; 24 No 2, p. 7
 - Michigan Business Tax, 28 No 1, p. 40; 29 No 1, p. 40; 30 No 2, p. 27
 - nonprofit organizations, intermediate sanctions, 26 No 1, p. 27
 - payroll taxes — don't take that loan, 29 No 2, p. 7
 - preparer rules, 28 No 1, p. 7
 - property and transfer tax considerations for business entities, 30 No 2, p. 27
 - reclassification of property by State Tax Commission threatens loss of tax incentives, 30 No 3, p. 28
 - S corporations, 25 No 3, p. 7; 29 No 3, p. 7; 31 No 2, p. 7
 - self-employment tax for LLC members, 23 No 3, p. 13
 - sunset for tax cuts (2010), 30 No 2, p. 9
 - Swiss bank accounts disclosures, 29 No 1, p. 7
 - Tax Increase Prevention and Reconciliation Act of 2005, 26 No 2, p. 8
 - year 2000 problem, 19 No 2, p. 4
- Technology Corner. *See also* Internet
- business continuity planning, 28 No 1, p. 9
 - business in cyberspace, 24 No 3, p. 8; 31 No 2, p. 9
 - computer equipment, end-of-life decisions, 26 No 2, p. 9
 - contracts, liability, 31 No 2, p. 9
 - cybersquatting and domain name trademark actions, 22 No 2, p. 9
 - data breach notification act, 27, No 1, p. 9
 - electronic contracting, best practices, 28 No 2, p. 11
 - electronic discovery, 27 No 2, p. 9
 - escrows of technology, relevance, 30 No 3, p. 10
 - HITECH Act and HIPAA privacy and security issues, 29 No 2, p. 9
 - I.D. cards, security vs privacy, 27 No 3, p. 11
 - identity theft protection act amendments, 31 No 1, p. 11
 - information security, 23 No 2, p. 8; 23 No 3, p. 10; 29 No 1, p. 9
 - insider threats to critical infrastructures, 28 No 3, p. 8; 29 No 3, p. 8
 - Is It All Good? 22 No 2, p. 29
 - malware, 25 No 3, p. 8
 - offshore outsourcing of information technology services, 24 No 1, p. 8; 24 No 2, p. 9
 - open source software, 25 No 2, p. 9; 29 No 2, p. 59
 - paperless office, 22 No 2, p. 35
 - privacy in the workplace, 30 No 2, p. 11
 - software licensing watchdogs, 25 No 1, p. 8
 - UCITA, 23 No 1, p. 8
- Terrorism, federal SAFETY Act and antiterrorism technology, 24 No 3, p. 34
- Third-party beneficiaries in construction litigation, 27 No 2, p. 25
- Tools, special tools lien act, 23 No 1, p. 26; 26 No 3, p. 44
- Trade secrets, RICO, 31 No 2, p. 23
- Transfer tax considerations for business entities, 30 No 2, p. 20
- Trust chattel mortgages, 19 No 3, p. 1
- UCITA, 23 No 1, p. 8
- Uniform Commercial Code
- anti-assignment provisions in LLC operating agreements, impact of UCC 9-406 and 9-408, 24 No 1, p. 21
 - bankruptcy, use of UCC 2-702 in, 29 No 3, p. 9
 - certificated goods, frontier with UCC, 24 No 2, p. 23
 - commercial lending, impact of revised Article 9, 21 No 1, p. 20
 - compromising obligations of co-obligors under a note, unanswered questions under revised UCC Article 3, 16 No 4, p. 30
 - demand for adequate assurance of performance, 23 No 1, p. 10; 29 No 3, p. 14
 - federal tax lien searches, consequences of *Spearing Tool*, 27 No 2, p. 11
 - film tax credit and secured transactions, 29 No 3, p. 21
 - forged facsimile signatures, allocating loss under UCC Articles 3 and 4, 19 No 1, p. 7
 - full satisfaction checks under UCC 3-311, 19 No 1, p. 16
 - installment contracts under UCC 2-612, perfect tender rule, 23 No 1, p. 20
 - investment securities, revised Article 8, 19 No 1, p. 30
 - notice requirement when supplier provides defective goods, 23 No 1, p. 16
 - partnership interest as security under Article 9, 19 No 1, p. 24
 - sales of collateral on default under Article 9, 19 No 1, p. 20
 - setoff rights, drafting contracts to preserve, 19 No 1, p. 1
 - shrink-wrap and click-wrap agreements, mutual assent, 26 No 2, p. 17
- Uniform Prudent Management of Institutional Funds Act, 29 No 2, p. 17
- Valuation disputes, mediation instead of litigation for resolution of, 17 No 1, p. 15
- Venture capital
- early stage markets in Michigan, 25 No 2, p. 34
 - financing, terms of convertible preferred stock, 21 No 1, p. 9
- White collar-crime investigation and prosecution, 27 No 1, p. 37
- Year 2000 problem, tax aspects, 19 No 2, p. 4

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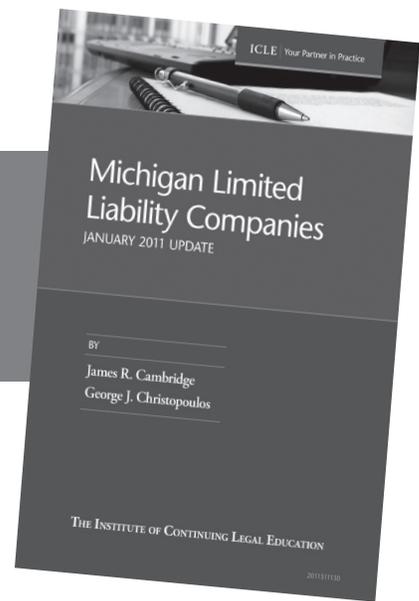
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