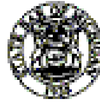
BUSINESS LAW SECTION

STATE BAR  OF MICHIGAN

November 2002

Dear Business Law Section Members:

Another year has passed and the Business Law Section has several new officers, council members, committee chairs and directorships. On behalf of the Business Law Section, I would like to thank all of the persons who are active in making this Section successful (please see pages 2 and 3 of this BLJ publication). We have plans for an active year and look forward to wide participation from all members of the Business Law Section.

As always, this issue of the BLJ offers the reader timely advice on pertinent issues. This includes a very useful summary of the Sarbanes – Oxley Act of 2002, a discussion of protection of intellectual property in bankruptcy cases, and an article exploring whether the protections of owning personal property as tenancy by the entireties apply to modern investment devices. Additionally, this issue includes columns covering current developments in Michigan law, the role of IRS attorneys in tax examinations, and technology law.

Also, please visit the Business Law Section website at http://www.michbar.org/sections/. All issues of the BLJ are posted on the Section web site, starting with the Spring 2002 issue. If you would like to send a BLJ article of interest to someone that does not receive the BLJ, just refer them to the Section web site.

The Business Law Section is planning a variety of activities for the upcoming year. The Business Boot Camp has begun and has received excellent reviews from the over 180 participants in Detroit and Grand Rapids (please contact ICLE or any Section officer for further details). Additionally, the Section's Commercial Litigation Committee continues its exploration of establishing a business court in Michigan (please contact Diane Akers for more information – her contact information is on page 3 of this BLJ).

Thank you for your continued support of the Business Law Section. Please contact me if you have any questions regarding Section activities.

Sincerely,

Timothy R. Damschroder
Chairperson, Business Law Section

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Section 365 in a manner that parallels generally the treatment of real estate leases in the existing provisions of Section 365(h)(1). While intellectual property plays a unique role in technological and economic development, the problems associated with the rejection of executory contracts are common with other special forms of property, such as real property leases. In both real estate leases and intellectual property licenses, the underlying property is unique. When the lessee or the licensee is threatened with loss of use of the property, it is not possible to obtain precise cover from another source.

In adopting the Code, Congress recognized this problem with respect to real property leases and enacted Section 365(h). That section clarified that, although a bankrupt lessor could avoid performance of future obligations under the unexpired lease, it could not cause through rejection of the lease an innocent lessee to forfeit the remainder of its leasehold. Neither the bar nor Congress then foresaw the need to protect similarly the reasonable expectations of intellectual property licensees. The bill corrects the perception of some courts that Section 365 was ever intended to be a mechanism for stripping innocent licensee of rights central to the operations of their ongoing business and stripping the American licensing system of its dependability and flexibility. Thus, the bill does not accord special treatment for intellectual property or the interests of its licensors or licensees beyond that which Congress has recognized in the past is required for these other unique property rights. The bill recognizes that there may be circumstances in which the future affirmative performance obligations under a license may not be performed in a manner that benefits the estate, but limits the consequences of the breach or rejection of the contract.[21]

Section 365(n) of the Bankruptcy Code appears as Exhibit A on page 23 of this article. The statute offers the licensee a choice if the debtor/licensor rejects the license. The licensee may elect to retain the rights in the license and pay what is due (although future development of the product may be questionable), or it may return the product and file a claim. In the interim, though, the licensor may not interfere with the licensee's rights under the license, avoiding the tacit extortion employed by the debtor in *Lubrizol Enterprises*.[22]

The Debtor as Licensee of Intellectual Property

Limited Scope of 11 USC 365(n). Section 365(n) of the Federal Bankruptcy Code only addresses the situation where the debtor is a licensor of intellectual property. There are no corresponding provisions to address the situation where the Chapter 11 debtor is a licensee. In many Chapter 11 cases, an intellectual property license is the most valuable asset and the debtor/licensee's only hope of effecting a successful reorganization or liquidation plan is through the assumption (and, perhaps, the assignment to a third party) of that license. A recent series of judicial decisions, however, has severely limited the power of a debtor/licensee to assume/assign an intellectual property license under 11 USC 365.

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***Catapult* and Its Progeny.** The power of a Chapter 11 debtor to assume and assign an executory contract under 11 USC 365 is broad but is not limitless. One of the statutory restrictions on this power is set forth in 11 USC 365(c)(1) that reads, in relevant part, as follows:

> The trustee [or debtor in possession] may not assume or assign any executory contract . . . of the debtor, whether or not such contract . . . prohibits or restricts assignment of rights or delegation of duties, if—
>
> (1)(A) applicable law excuses a party, other than the debtor, to such contract . . . whether or not such contract . . . prohibits or restricts assignment of rights or delegation of duties; and
>
> (B) such party does not consent to such assumption or assignment.

A recent line of cases has applied this statutory prohibition against assumption and assignment to intellectual property that has been licensed to debtors, thereby causing much consternation among debtors and their counsel.

In general, executory contracts that may

not be assumed or assigned under 11 USC 365(c)(1) are contracts where, under applicable nonbankruptcy law, the nondebtor party is excused from accepting performance of or rendering performance to someone other than the contracting party.[23] Under federal law, nonexclusive patent and copyright licenses that do not expressly permit their assignment by the licensee to a third party may not be so assigned over the licensor's objection.[24]

The Ninth Circuit Court of Appeals recently applied this statutory provision to prohibit the mere assumption of patent licenses by a Chapter 11 debtor/licensee. In *Perlman v Catapult Entertainment, Inc,* the Ninth Circuit held that a Chapter 11 debtor could not assume patent licenses as part of a plan of reorganization over the objection of a licensor.[25] Because federal patent law makes nonexclusive patent licenses personal and nondelegable, it constituted "applicable law excus[ing the] party, other than the debtor, . . . from accepting performance" absent consent of the nondebtor party, and therefore, such licenses could not be assumed.[26] This decision aligns the Ninth Circuit with the Third, Fourth, and Eleventh Circuits.[27] The *Catapult* decision is particularly troubling because it allows an individual creditor to prevent confirmation of a plan to the detriment of the entire creditor body and the debtor under circumstances where that creditor's rights are not being negatively impacted.

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In *Catapult*, Perlman licensed several patents to the debtor, a gaming network. The debtor entered into a merger agreement that proposed to leave the debtor as the surviving entity. This agreement also contemplated the filing of a bankruptcy petition, followed by a reorganization via a reverse triangular merger. As part of the plan, the debtor filed a motion seeking to assume 140 executory contracts and leases, including the Perlman licenses. It was clear that assumption of these licenses was critical to the success of the debtor's plan. The bankruptcy court approved the assumption over Perlman's objections, and subsequently confirmed the plan that had been accepted by the requisite majority of creditors and equity holders required under the Code. On appeal, the U.S. District Court for the Northern District of California affirmed the decision of the bankruptcy court. Perlman thereafter appealed and the Ninth Circuit Court of Appeals reversed the two courts below.

The Ninth Circuit began its analysis with section 365(c)(1) and by explaining the "hypothetical" and "actual" tests, the two primary approaches utilized by the courts in interpreting the rights and obligations of the parties under section 365(c)(1). The hypothetical test is derived from a plain statutory language approach and provides:

> The plain language of § 365(c)(1) "link[s] nonassignability under 'applicable law' together with a prohibition on assumption. . . ." In other words, the statute by its terms bars a debtor in possession from assuming an executory contract without the nondebtor's consent where applicable law precludes assignment of the contract to a third party. The literal language of § 365(c)(1) is thus said to establish a "hypothetical test": a debtor in possession may not assume an executory contract over the nondebtor's objection if applicable law would bar assignment to a hypothetical third party, even where the debtor in possession has no intention of assigning the contract in question to any such third party.[28]

The actual test is premised on reasoning that Congress did not intend to bar debtors in possession from assuming their contracts when no assignment is contemplated.

> [T]he statute bars assumption by the debtor in possession only where the reorganization in question results in the nondebtor actually having to accept performance from a third party. Under this reading of §365(c), the debtor in possession would be permitted to assume any executory contract, so long as no assignment was contemplated.[29]

The debtor urged the Ninth Circuit to adopt the actual test because (1) a literal reading of section 365(c)(1) creates inconsistencies within section 365(c) as adoption of the hypothetical test would render section 365(c)(2), prohibiting assignment of contracts to make loans or extend other debt financing or financial accommodations to or for the benefit of the debtor, unnecessary and superfluous; (2) a literal reading is inconsistent with the legislative history; and (3) a literal reading flies in the face of sound bankruptcy policy. The court, however, rejected each of these arguments in favor of a plain reading of the statute.

The court first concluded that the various subsections of section 365 could be "credibly

reconciled" because "each subsection recognizes an 'applicable law' of markedly different scope."[30] Section 365(f)(1), which permits the assignment of executory contracts, delineates a broad rule rather than a carefully crafted exception. If applicable law does not contain a general ban on assignment, but specifically excuses a party from accepting performance from an entity different from the one with whom the party originally contracted, the applicable law prevails and the proposed assignment may be vetoed by the nondebtor party.

The Ninth Circuit rejected the suggestion that adoption of the hypothetical test created inconsistencies within the statute by articulating distinctions between the two subparts of section 365(c). Subsection 365(c)(2) has been rendered superfluous by national uniformity of applicable state laws, not by the court's interpretation of subsection (c)(1). Moreover, the court reasoned that the debtor could avoid the prohibition of subsection (c)(1) by obtaining the consent of the nondebtor party, whereas consent of the nondebtor party could never alter or waive the prohibition in subsection (c)(2).

Because the court believed that a plain reading of the statute was clear and unambiguous, the legislative history of 11 USC 365(c)(1) need not have been consulted. Nevertheless, the court reviewed the legislative history and found that no contemporaneous legislative history regarding the current formulation of section 365(c)(1) existed. The legislative history from a 1980 House proposal proffered by the debtor was rejected by the court as not constituting authoritative support for the language subsequently adopted as part of the 1984 amendment to section 365(c)(1)—too much time had elapsed between the earlier proposal and the 1984 amendments without evidence of any clear connection between the two legislative proposals.

The court also rejected policy arguments advanced by the debtor because "[p]olicy arguments cannot displace the plain language of the statute; that the plain language of § 365(c)(1) may be bad policy does not justify a judicial rewrite."[31] Ultimately, if the language creates a "bad result," it is incumbent on Congress, not the courts, to rewrite the statute.

Since the Ninth Circuit decided *Catapult*, it has been cited with approval or followed by a number of other courts.[32]

Protecting the Secured Party's Interest in Intellectual Property

The Role of Secured Creditors' Counsel

Creditors claiming security interests in intellectual property owned by a Chapter 11 debtor should retain bankruptcy counsel to represent their interests in the bankruptcy case. One of counsel's first actions taken after retention should be to review all of the creditor's files relating to the debtor and the secured loans extended to it and interview the creditor's personnel responsible for the administration and collection of those loans. To determine whether a creditor's liens and interests are perfected under applicable nonbankruptcy law, counsel should order Uniform Commercial Code (UCC) searches in the appropriate jurisdictions and, in situations where the creditor asserts a security interest in a copyright, order lien searches from the U.S. Copyright Office in Washington, D.C. In the event that the creditor's liens and security interests have not been perfected as of the Chapter 11 filing date, the debtor (or a properly authorized creditors committee) may request the bankruptcy court to avoid those liens and interests under the "strong-arm powers" granted to a trustee or debtor in possession by 11 USC 544(a).

Creditors claiming security interests in intellectual property owned by a Chapter 11 debtor should retain bankruptcy counsel to represent their interests in the bankruptcy case.

Determining Perfection of Security Interests and Liens in Intellectual Property

In General. This section contains a brief overview of how security interests in trademarks, patents, and copyrights may be perfected under Revised Article 9 and applicable federal law. If a federal statute or regulation creates an alternative method of perfection, that statute or regulation will preempt Revised Article 9.[33] As discussed in more detail below, the existing case law holds that only the Federal Copyright Act, 17 USC 101 et seq., preempts Revised Article 9. Consequently, perfection of security interests in trademarks and patents may be accomplished by filing a financing statement in accordance with the applicable provisions of Revised Article 9.

Trademarks. The reported case law holds that a security interest in a common law or federally registered trademark may be perfected by filing a financing statement in the proper state filing office.[34] Because a trademark is properly classified as a "general intangible" under MCL 440.9102(1)(pp), the secured party must file a financing state-

ment with the filing office in the debtor's "location." However, when a federally registered trademark serves as collateral, the secured party should, in an abundance of caution, record its security agreement with the PTO.

Patents. Reported case law holds that a security interest in a patent may be perfected by the filing of a financing statement in the proper state filing office.[35] Like trademarks, patents are "general intangibles" and a financing statement should be filed with the proper filing office in the state where the debtor is located. Again, it is advisable, but not required, to record the security agreement with the PTO.

Copyrights. To perfect a security interest in a federally registered copyright, a secured party must record its security agreement or copyright mortgage in the U.S. Copyright Office.[36] This federal system is designed to give all persons constructive notice of the facts contained in the recorded document and, therefore, preempts Revised Article 9.[37] The failure to so record a security agreement or copyright mortgage will render the security interest unperfected.[38] In an abundance of caution, secured parties should also file financing statements listing the copyright as collateral with the proper filing office in the state where the debtor is located.

Creditors holding security interests and liens in a Chapter 11 debtor's intellectual property, as well as counsel to these creditors, should be extremely sensitive to the value of these intangible assets.

There is a split of decisional authority on how to perfect a security interest in an unregistered copyright. In the case *In re AEG Acquisition Corp*, 127 BR 34 (Bankr CD Cal 1991), the bankruptcy court held that unregistered copyrights must be registered with the U.S. Copyright Office to perfect a security interest in that property. *In re Avalon Software*, 209 BR 517 (Bankr D Ariz 1997), held that a security interest in an unregistered copyright may be perfected only by both registering the copyright and recording the security agreement with the U.S. Copyright Office. Nevertheless, at least one court has disagreed with *AEG Acquisition* and *Avalon Software* by holding that a security interest in an unregistered copyright may be perfected by the filing of a financing statement in the proper filing office dictated by Article 9 of the UCC.[39] In light of this disagreement in the case law, a secured party should require the owner to record the copyright with the U.S. Copyright Office, record the security agreement or copyright mortgage there, and then file a financing statement with the proper filing office in the state where the debtor is located.

Valuation Issues

As discussed in the section "Valuation of Intellectual Property Assets," creditors holding security interests and liens in a Chapter 11 debtor's intellectual property, as well as counsel to these creditors, should be extremely sensitive to the value of these intangible assets. The value assigned to this property by the bankruptcy court will determine the amount of the creditor's secured claims, at least for the purposes of that particular hearing.[40]

Adequate Protection Disputes. At the outset of a Chapter 11 case, valuation of a secured creditor's collateral will be important for purposes of adequate protection. Under 11 USC 363(e), a debtor may not use a secured creditor's collateral without that creditor's consent unless the bankruptcy court finds that the creditor's liens and security interests in the collateral are "adequately protected." The court will normally conclude that adequate protection exists when the secured creditor is or will be compensated for any deterioration in the value of those interests and liens caused by the debtor's use of collateral during the pendency of the Chapter 11 case.[41] For these purposes, a debtor that desires to use intellectual property over the secured creditor's objection should be prepared to introduce evidence at the hearing[42] that the value of these assets will not depreciate through their use during the Chapter 11 case or, if such depreciation does occur, the creditor will be protected against any loss, either through periodic cash payments made to the creditor or replacement liens on other property granted to the creditor.[43] The debtor may also argue that the value of the intellectual property assets far exceeds the amount of the creditor's liens and interests in that property and, consequently, this "equity cushion" provides the secured creditor with the necessary adequate protection.

In opposing the debtor's request for use of collateral under 11 USC 363(e) or in requesting relief from the automatic stay under 11 USC 362(d) to recover and dispose of collateral, the secured creditor should be prepared to introduce expert testimony of a qualified appraiser of intellectual property to establish the amount and rate of depreciation in value of the collateral caused by the debtor's anticipated use. In addition, the secured creditor should be ready to prove at the hearing that the debtor's adequate protection offers are inadequate to compensate for the depreciation in value of the creditor's lien. For example, the creditor may intro-

duce evidence that the proposed cash payments are insufficient to compensate for the decrease in value of the creditor's lien and/or that no equity cushion exists in the particular intellectual property to protect that lien.

Objections to Confirmation. In a proposed Chapter 11 plan, the debtor may provide that the value of the secured creditor's lien in intellectual property is less than the amount of the debt owed to that creditor. In these circumstances, the creditor would hold two claims: one claim for the value of the lien as its secured claim and the other claim, which would be unsecured, for the projected deficiency. The debtor would then be required to pay the "present value" of that secured claim in the plan by installment payments bearing a market rate of interest to overcome a "cram down" objection by that creditor under 11 USC 1129(b)(1).[44] If the secured creditor objects to confirmation of the plan on the basis that the debtor failed to satisfy the cram down standards of 11 USC 1129(b)(1), the secured creditor should be prepared to introduce expert testimony of a qualified appraiser of intellectual property to support the creditor's assertion of value. The debtor, in turn, will normally be prepared to introduce evidence supporting its own asset valuation.

NOTES

1. "The dotcom crash, it turns out, was merely the warm-up. The telecoms crash is many times bigger. Michael Powell [Chairman of the FCC] surprised nobody when he declared this week that the industry is facing 'utter crisis.' The situation is being likened to the Dark Ages. The old empires have fallen and a prolonged period of uncertainty looms." *Special Report: The Telecoms Crisis,* The Economist, July 20, 2002, at 59.

2. The use of the word *means* in this statute indicates that this is an exclusive list of intellectual property. The rules of statutory construction of the Federal Bankruptcy Code are contained in 11 USC 102, which states that the terms *include* and *including* are not limiting. 11 USC 102(3).

3. The Semiconductor Chip Protection Act of 1984, Pub L No 98-620. *Mask works* are defined in this statute as "a series of related images, however fixed and encoded, (A) having or representing the predetermined, three-dimensional pattern of metallic, insulating, or semiconductor material present or removed from the layers of a semiconductor chip product; and (B) in which series the relation of the images to one another is that each image has the pattern of the surface of one form of the semiconductor chip product." Production under the Federal Copyright Act extends only to the layout or topography of the chip—it does not protect any idea or concept associated with the mask work.

4. Trademarks and trade names were excepted from the scope of 11 USC 101(35A) because of concerns about the licensee's ability (or desire) to maintain quality control in the circumstance where a trademark license agreement is rejected by the debtor/licensor. *See, e.g., Licensing by Paolo, Inc v Sinatra (In re Gucci, Inc)*, 126 F3d 380, 394 (2d Cir 1997); S Rep No 100-505, at 5 (1988), reprinted in 1988 USCCAN 3200, 3203–3204.

5. S Rep No 100-505, at 7–8 (1988), reprinted in 1988 USCCAN 3200, 3204–3205.

6. *See generally Leigh v Warner Bros, Inc,* 212 F3d 1210 (11th Cir 2000); *CPC Int'l, Inc v Skippy, Inc,* 214 F3d 456 (4th Cir 2000).

7. 15 USC 1051 et seq.

8. *See, e.g., Roulo v Russ Berrie & Co, Inc,* 886 F2d 931 (7th Cir 1989), *cert denied,* 493 US 1075 (1990), and the cases cited and discussed therein.

9. *See, e.g., Wynn Oil Co v American Way Serv Corp,* 943 F2d 595 (6th Cir 1991); *Two Men & a Truck/Int'l, Inc v Two Men & a Truck/Kalamazoo, Inc,* 949 F Supp 500 (WD Mich 1996).

10. 35 USC 101 et seq.

11. *See, e.g., Wickham v Knoxville Int'l Energy Exposition, Inc,* 739 F2d 1094 (6th Cir 1984); *Ahn v Midway Mfg Co,* 965 F Supp 1134 (ND Ill 1997).

12. 17 USC 102(a).

13. 17 USC 106. *See also Stewart v Abend,* 495 US 207 (1990).

14. *See generally Arco Indus Corp v Chemcast Corp,* 633 F2d 435 (6th Cir 1980); *McAlpine v AAMCO Automatic Transmissions, Inc,* 461 F Supp 1232 (ED Mich 1978).

15. *See, e.g., In re United Equip Sales Co,* 47 BR 818 (Bankr WD Mich 1985).

16. *See, e.g., Steinberg v Kendig (In re Ben Franklin Retail Stores),* 225 BR 646 (Bankr ND Ill 1998).

17. 18 USC 152 and 18 USC 3571 permit federal courts to fine a person up to $500,000 and/or to imprison him or her for up to five years for making false statements or concealing property in a bankruptcy case.

18. *See also* Weston Anson and Rick Schioldager, *Identifying Valuable Intellectual Property in Bankruptcy: Parts I and II*, 21 Am Bankr Inst LJ (May and June 2002 issues).

19. *See, e.g., Everex Sys v Cadtrak Corp (In re CLFC, Inc),* 89 F3d 673 (9th Cir 1996) (patent license); *In re Superior Toy & Mfg Co,* 78 F3d 1169 (7th Cir 1996) (trademark license); *In re Patient Educ Media, Inc,* 210 BR 237 (Bankr SD NY 1997) (copyright license). *But see Microsoft Corp v DAK Indus, Inc (In re DAK Indus),* 66 F3d 1091 (9th Cir 1995) (license reclassified as a sale).

20. S Rep No 100-505 (1988), at 2, reprinted in 1988 USCCAN 3200, 3201.

21. *Id.* at 4–5, reprinted in 1988 USCCAN 3200, 3203.

22. *See generally Encino Bus Mgmt v Prize Frize (In re Prize Frize),* 32 F3d 426 (9th Cir 1994), which expresses the opinion that section 365(n) "has struck a fair balance between the interests of the bankrupt and the interests of a licensee of the bankrupt's intellectual property." *Id.* at 428.

23. *See In re Magness,* 972 F2d 689 (6th Cir 1992) (debtor's country club membership held nonassumable and nonassignable).

24. *See, e.g., PPG Indus, Inc v Guardian Indus Corp,* 597 F2d 1090 (6th Cir 1979); *In re Patient Educ Media, Inc,* 210 BR 237 (Bankr SD NY 1997). It is still an open question whether 11 USC 365(c)(1) would prohibit a debtor/licensee from assuming and assigning a nonexclusive trademark license in the absence of an express contractual prohibition against such assignment. Some courts have permitted a debtor/trademark licensee to assume and assign a trademark license. *See, e.g., In re Superior Toy & Mfg Co,* 78 F3d 1169 (7th Cir 1996); *In re Rooster, Inc,* 100 BR 228 (Bankr ED Pa 1989).

25. *Perlman v Catapult Entertainment (In re Catapult Entertainment),* 165 F3d 747 (9th Cir 1999), *cert filed,* 67 USWL 3749 (May 28, 1999) (No 98-1915), *cert dismissed pursuant to Rule 46.1,* 67 USWL 3749 (Oct 12, 1999).

26. 11 USC 365(c)(1).

27. *See, e.g., In re West Electronics, Inc,* 852 F2d 79 (3rd Cir 1988); *Breeden v Catron (In re Catron),* 158 BR 629 (ED Va 1993), *aff'd without op,* 25 F3d 1038 (4th Cir 1994); *City of Jamestown v James Cable Partners, LP (In re James Cable*

Partners, LP), 27 F3d 534 (11th Cir 1994). *Contra Institut Pasteur v Cambridge Biotech Corp,* 104 F3d 489 (1st Cir 1996), *cert denied,* 521 US 1120 (1997).

28. *Perlman v Catapult Entertainment, supra* note 25, at 750.

29. *Id.* at 751.

30. *Id.* at 752, citing *In re Magness,* 972 F2d 689 (6th Cir 1992).

31. *Id.* at 754.

32. *See United States v Techdyn Sys Corp (In re Techdyn Sys Corp),* 235 BR 857 (Bankr ED Va 1999) (involving government contract for telecommunications services); *In re Schick,* 235 BR 318 (Bankr SD NY 1999) (rights in partnership); *In re Access Beyond Techs,* 237 BR 32 (Bankr D Del 1999) (license that could not be assigned under applicable could not be assumed).

33. MCL 440.9109(3)(a); Official Comment 8 to Revised § 9-109.

34. *See, e.g., In re Roman Cleanser Co,* 43 BR 940 (Bankr ED Mich 1984), *aff'd,* 802 F2d 207 (6th Cir 1986); *In re Chattanooga ChooChoo Co,* 98 BR 792 (Bankr ED Tenn 1989); *In re Together Dev Corp,* 227 BR 439 (Bankr D Mass 1998), *aff'd, appeal dismissed, Trimarchi & Personal Dating Servs v Together Dev Corp,* 255 BR 606 (D Mass 2000).

35. *See, e.g., Moldo v Matsco, Inc (In re Cybernetic Servs),* 239 BR 917 (BAP 1999), *aff'd,* 252 F3d 1039 (9th Cir 2001); *In re Transportation Design & Tech, Inc,* 48 BR 635 (Bankr SD Cal 1985).

36. 17 USC 205(a).

37. MCL 440.9109(3)(a).

38. *See, e.g., In re Peregrine Entertainment, Ltd,* 116 BR 194 (CD Cal 1990); *see also Note, Transfers of Copyright for Security Under the New Copyright Act,* 88 Yale LJ 125 (1978); Steven Weinberger, *Note, Perfection of Security Interests in Copyrights: The Peregrine Effect on the Orion Pictures Plan of Reorganization,* 11 Cardozo Arts & Ent LJ 959 (1993).

39. *See Aerncon Engineering, Inv v Silicon Valley Bank (In re World Auxiliary Power Co),* 244 BR 149 (Bankr ND Cal 1999).

40. 11 USC 506(a). The last sentence of 11 USC 506(a) provides that the value of a secured creditor's collateral "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." Thus, a valuation for adequate protection purposes will not act as res judicata for confirmation purposes. *See, e.g., In re Woolley's Parkway Ctr, Inc,* 147 BR 996 (Bankr MD Fla 1992).

41. *See, e.g., In re Holly's, Inc,* 140 BR 643 (Bankr WD Mich 1992).

42. This evidentiary hearing could be held either on the debtor's motion to provide adequate protection to the secured creditor or on that creditor's motion for relief from the automatic stay provisions of the Bankruptcy Code.

43. 11 USC 361.

44. *See, e.g., In re Trevarrow Lanes,* 183 BR 475 (Bankr ED Mich 1995); *In re Eastland Partners Ltd P'ship,* 149 BR 105 (Bankr ED Mich 1992); *In re Kain,* 86 BR 506 (Bankr WD Mich 1988).

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Exhibit A

Section 365(n) of the Bankruptcy Code

(1) If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect—

(A) to treat such contract as terminated by such rejection if such rejection by the trustee amounts to such a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or an agreement made by the licensee with another entity; or

(B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law), as such rights existed immediately before the case commenced, for—

(i) the duration of such contract; and

(ii) any period for which such contract may be extended by the licensee as of right under applicable nonbankruptcy law.

(2) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, under such contract—

(A) the trustee shall allow the licensee to exercise such rights;

(B) the licensee shall make all royalty payments due under such contract for the duration of such contract and for any period described in paragraph (1)(B) of this subsection for which the licensee extends such contract; and

(C) the licensee shall be deemed to waive—

(i) any right of setoff it may have with respect to such contract under this title or applicable nonbankruptcy law; and

(ii) any claim allowable under section 503(b) of this title arising from the performance of such contract.

(3) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, then on the written request of the licensee the trustee shall—

(A) to the extent provided in such contract, or any agreement supplementary to such contract, provide to the licensee any intellectual property (including such embodiment) held by the trustee; and

(B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including such embodiment) including any right to obtain such intellectual property (or such embodiment) from another entity.

(4) Unless and until the trustee rejects such contract, on the written request of the licensee the trustee shall—

(A) to the extent provided in such contract or any agreement supplementary to such contract

(i) perform such contract; or

(ii) provide to the licensee such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law) held by the trustee; and

(B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including any embodiment), including any right to obtain such intellectual property (or such embodiment) from another entity.

Personal Property Entireties Exemption in Michigan: Does It Apply to Modern Investment Devices?

by Paul H. Steinberg*

Introduction

Under Michigan common law, the right of survivorship in jointly held personal property was not favored unless expressly intended by the parties. Consistent with this policy, entireties ownership of personal property was not recognized at common law. In 1927, the Michigan Legislature enacted MCL 557.151, which recognized entireties ownership in specifically identified items of personal property. By recognizing entireties ownership, the act enabled a judgment debtor to protect such property from most claims of creditors, except those holding joint claims against both spouses, on the theory that the entireties estate is not severable.

Six types or classes of personal property are recognized by MCL 557.151 as having the same consequences of joint ownership as those enjoyed by husband and wife in real property. The act did not envision modern and diverse property interests with similarities to the properties described in the act but not specifically named.

A recent case, decided in the bankruptcy court and affirmed on appeal, sheds some light on the protection afforded to entireties personal property sharing some common attributes with those properties specifically identified in the act. However, the practitioner should be cautious in assuring his or her client that a particular item of personal property not specifically named in the act is free from process by aggressive judgment creditors.

This act—and the entire scheme of exemptions under Michigan law—should be reexamined and updated to eliminate ambiguities and bring such exemptions into the realities of the twenty-first century. This would benefit both judgment debtors and their creditors.

*The author gratefully acknowledges and thanks Judy B. Calton, Richard F. Fellrath, Paul J. Randel, and William H. Goldenberg for their valuable comments and assistance and, in particular, Judith Greenstone Miller for enlightening the author on the Michigan Land Contract Act and for her other helpful comments.

Entireties Ownership of Property in Michigan

The definition of entireties ownership of real property is as follows: "an estate by entireties refers to a form of co-ownership held by husband and wife with right of survivorship."[1]

Under Michigan common law, in the absence of fraud, the interest of a husband and wife in entireties property cannot be reached by a creditor of one of the spouses alone.[2] One notable exception emanates from the recent case *United States v Craft*, in which the U.S. Supreme Court held that a federal tax lien filed against an entireties interest of only one spouse subjects that spouse's interest in the property to the federal tax lien. The case was remanded for a determination of the valuation of that interest.[3] Although not technically an "exemption," the protection of entireties property is the result of the nature of its ownership and not part of the statutory scheme.[4]

Entireties Ownership in Personal Property

Earlier case law disfavored joint ownership of personal property. Before 1921, the Michigan Supreme Court, in *Ludwig v Brunner*, clearly expressed the opinion that in Michigan "joint tenancy in personal property with its right of survivorship does not exist."[5] Furthermore, in *Hart v Hart,* the court stated the following:

> From an examination of the authorities, we conclude that it is the fixed and settled law of this jurisdiction that the right of survivorship does not attach, as matter of law, to personal property held in joint ownership, nor that bequests to two or more persons by operation of law pass to the survivor; in other words, joint tenancy, in personal property, with its right of survivorship, does not obtain in this jurisdiction.[6]

In the case of *Lober v Dorgan,* the Michigan Supreme Court distinguished the facts of its case from those of *Ludwig*:

> In the *Ludwig* Case we said we

> would not, *as a matter of law*, infer from the words "joint tenants" the ordinary incident of survivorship, but that is not the question here. Here it is a question of contract. The parties themselves have provided for survivorship by agreement. The parties having so contracted, is there any valid reason why we should refuse to enforce their agreement? Our statute does not prohibit such a contract. There is nothing in the agreement which is immoral or against the public good.[7]

Justice Sharpe, concurring in the majority opinion of Justice Bird, made it clear that the court was not overruling prior case law and that the facts of this case distinguished themselves from earlier cases: "The right of the survivor [in this case] to take is not in any way dependent upon the joint estate. It obtains by reason of the express language of the instruments themselves. The intention is clearly expressed."[8] Quoting from the case of *Wait v Bovee,*[9] the court noted, "'[t]he drift of policy and opinion, as shown by legislation and judicial decisions, is strongly adverse to the doctrine of taking by mere right of survivorship, *except in a few special cases, and it should not be applied except where the law in its favor is clear.*'"[10]

Following *Lober* in a case decided before the enactment of MCL 557.151, the Michigan Supreme Court recognized the right of survivorship in personalty (personal property) where created by the express act of the parties. However, the court found that an estate by the entireties "may not be created in personal property."[11]

In 1927, the Michigan Legislature enacted MCL 557.151, described as "[a]n act to provide for the joint ownership by husband and wife in joint tenancy of certain classes of personal property with right of survivorship." It provides as follows:

> All bonds, certificates of stock, mortgages, promissory notes, debentures, or other evidences of indebtedness hereafter made payable to persons who are husband and wife, or made payable to them as endorsees or assignees, or otherwise, shall be held by such husband and wife in joint tenancy unless otherwise therein expressly provided, in the same manner and subject to the same restrictions, consequences, and conditions as are incident to the ownership of real estate held jointly by husband and wife under the laws of this state, with full right of ownership by survivorship in case of the death of either.

Although it is now established law that in the absence of statutory provisions to the contrary, a right of survivorship may be created in personal property[12] as recently as 1964 (37 years after enactment of 557.151). In the case of *De Young v Mesler*, Justice Souris, in his dissenting opinion, pointed out that "as a general rule . . . [a husband and wife] cannot own personalty by the entirety":[13]

> I find it impossible to read the statutory words of joint tenancy, used as they are in the classical sense of joint tenancy of realty with survivorship rights, "as if" the legislature had intended, instead, to create a statutory presumption of title by the entirety. In the first place, as has been noted above, our State does not favor entirety ownership of personalty as, concededly, it does realty, and, absent some plausible reason therefore, it defies belief that the legislature would have intended such a sharp departure from our past legal history in this State. Secondly, had the legislature so intended, it seems to me beyond doubt that it would have expressed such intention by use of language which is appropriate therefor—that it would have said "tenancy [or, more appropriately, title] by the entirety", instead of "joint tenancy" and instead of "held jointly by husband and wife with full right of ownership by survivorship.". . . It hardly is to be doubted that had the legislature intended by . . . [557.151] to create a *statutory presumption* that all bonds, certificates of stock, mortgages, promissory notes, debentures, or other evidences of indebtedness held by husband and wife as payees, indorsees, or assignees were to be held by them as entirety property, it would have stated such intention appropriately.[14]

It is important to note that the personal property that was the subject of analysis in *De Young* was a jointly titled debenture and that the majority opinion expressly found "that the instrument, a debenture, is specifically mentioned in the statute."

I quote extensively from the dissent of

This act—and the entire scheme of exemptions under Michigan law—should be reexamined and updated to eliminate ambiguities and bring such exemptions into the realities of the twenty-first century.

Justice Souris not in an effort to promote its position, but to illustrate that joint ownership with rights of survivorship in personal property has historically neither been presumed nor favored by law. For this reason, MCL 557.151 should not be read expansively but should be limited to the specific properties identified in the statute itself. It is one thing to presume entireties ownership in personal property jointly held by husband and wife, which Justice Souris decries, but it is quite another thing to argue the expansion of the exemption provided by MCL 557.151 to property not specifically identified in the statute. *De Young* did not purport to do this.

The Statutory Scheme of Exemptions Under Bankruptcy Law

MCL 557.151 should not be read expansively but should be limited to the specific properties identified in the statute itself.

Although entireties property comes into the bankruptcy estate by operation of 11 USC 541, the Bankruptcy Code allows a debtor to exempt from property of the estate any property that the debtor may exempt under the Bankruptcy Code itself[15] or, in the alternative, any property that is exempt under nonbankruptcy federal law or state or local law that applies on the date of the filing of the petition,[16] and "any interest in property in which the debtor had, immediately before the commencement of the case, an interest as a tenant by the entirety or joint tenant to the extent that such interest as a tenant by the entirety or joint tenant is exempt from process under applicable nonbankruptcy law."[17] The right of an individual debtor to exempt his or her property is an important right because, subject to certain limitations, "property exempted under . . . [11 USC 522] is not liable during or after the case for any debt of the debtor that arose, or that is determined under section 502 title as if such debt had arisen, before the commencement of the case."[18]

The debtor has an affirmative duty to list the property claimed as exempt.[19] A party in interest, including the trustee appointed in the case, "may file an objection to the list of property claimed as exempt only within 30 days after the meeting of creditors held under §341(a) is concluded, or within 30 days after any amendment to the list or supplemental schedules is filed, whichever is later."[20] The objecting party has the burden of proof to show that the exemptions are not properly claimed.[21] Property that is not exempt may be administered by the trustee for the benefit of creditors of the bankruptcy estate.[22]

The Applicability of Case Law and MCL 557.151 to Specific Types of Personal Property

Bank Deposits

Bank deposits are not included in the phrase "other evidences of indebtedness" used in MCL 557.151.[23] In *Modderman*, the court further declared that not only are the deposits in a joint name of husband and wife subject to garnishment, but the creditor has the right to overcome the presumption that each of the parties contributed one-half of the funds.[24]

As noted above, in Michigan, the holders of a joint bank account are joint tenants with the right of survivorship.[25] Moreover, MCL 487.718 provides the following:

> Deposits in a statutory joint account shall be subject to the rights of creditors of the persons designated in the statutory joint account contract as owners of the funds to the extent of the ownership, except that the funds shall remain subject to laws applicable to transfers in fraud of creditors.[26]

The distinction between survivorship and the ability to exempt property is highlighted by *Lilly v Schmock,*[27] in which the court acknowledged the right of parties to create a joint estate with right of survivorship in personalty in the case of bank deposits but did not recognize that such ownership protects such funds from creditor claims against one of the spouses.[28]

Mortgages and Land Contract Vendors' Interests

A mortgage interest is an interest in real property. Therefore, if it is held by the entireties, it is subject only to claims of joint creditors. It is also well established that rents payable to husband and wife on property owned by the entireties are not subject to garnishment.[29]

In Michigan, a land contract vendor's interest in real property has sometimes been viewed as an interest in personal property under the doctrine of "equitable conversion." Under this doctrine, a contract for the sale of land operates as an equitable conversion: the vendee's interest under the contract becomes realty, and the vendor's interest constitutes personalty.[30]

Although several cases have found the vendor's land contract interest to be protected as an entireties interest in personal

property,[31] MCL 557.81 conclusively protects the survivorship rights of each mortgagee and land contract vendor who holds his or her interest by the entireties:

> In all cases where a husband and wife shall sell land held as a tenancy by the entirety and accept in part payment for the purchase price the note or other obligation of said purchaser payable to said husband and wife, secured by a mortgage on said land payable to husband and wife, the said debt together with all interest thereon, unless otherwise expressly stated in said mortgage, after the death of either shall be payable to the survivor, and the title to said mortgage shall vest in the survivor, and in case a contract for the sale of property owned by the husband and wife as tenants by the entirety, is entered into by them as vendors, the same provisions herein applying to the rights of the survivors in mortgages as above set forth, shall apply to the survivor of the contract.[32]

In 1998, the Land Contract Act was amended "to recognize the creation, recording, and enforcement of mortgages of the respective interests of vendors and vendees of land contracts."[33] At least for the purposes of the act itself, it defines the interests of vendors and vendees subject to a land contract as real property interests.[34] As an interest in real property, and with the support of prior case law, the ability to protect either a vendor or vendee's interest in a land contract by the entireties should be laid to rest.

Other Evidences of Indebtedness

The cases discussed previously that deal with attempts to garnish a land contract payment are instructive because they illustrate the trend of the courts to limit the scope of protection of personal property held by husband and wife to those properties specifically within the language of the statute. As noted, a land contract receivable is not considered evidence of indebtedness within MCL 557.151, but it is protected as a *real* property interest and, of course, within the specific statutory protection of MCL 557.81. The following are examples of other evidences of indebtedness that the Michigan courts have identified as either falling within or outside the protection of MCL 557.151:

- **Promissory note:** A promissory note is specifically protected under the statute.[35] In the case of *Kuklish*, the court held that a promissory note made jointly to the name of husband and wife would, under MCL 557.151, pass to the wife on the death of the husband, and that his will could not defeat that right of survivorship.
- **Check:** A check made payable to a husband and wife creates an entireties interest that passes to the surviving spouse under MCL 557.151.[36]
- **Tax refund:** In the case of *Jahn v Regan*, the U.S. District Court noted that "[u]nder Michigan law a tenancy by the entireties can only be created in personal property by statute."[37] With respect to the taxpayer's claim that a tax refund payable jointly to them as husband and wife was property protected as evidence of indebtedness and, therefore, owned by them as tenants by the entireties under MCL 557.151, the court had the following to say:

> A tax refund or overpayment for a jointly filed tax return cannot be reasonably characterized as an "evidence of indebtedness" in the same manner as a mortgage or a bond. The refund plaintiffs are pursuing is not a document of indebtedness of the government. It is not even a negotiable instrument made payable to them. Therefore, plaintiffs' joint tax overpayment is not within MCL §557.151 and not held by them as tenants by the entireties.[38]

Exemptibility of an "Investor's" Account or "Stock Brokerage" Account

Modern investment products are far more numerous and creative than the few designated joint ownership interests protected under MCL 557.151, which specifically references only bonds, certificates of stock, and debentures. The nature and scope of an individual's investment interests is limitless: options; money market, mutual fund and cash management accounts; repos; certificates of deposit; variable annuities; limited partnership investments; zero coupon bonds; and managed futures are just some of the investment devices that do not neatly fall within the definitions of the statute. In a different context, the U.S. Supreme Court examined the definition of a security within the meaning of the Security and Exchange Act of 1934:

> In defining the scope of the market

As an interest in real property, and with the support of prior case law, the ability to protect either a vendor or vendee's interest in a land contract by the entireties should be laid to rest.

that it wished to regulate, Congress painted with a broad brush. It recognized the virtually limitless scope of human ingenuity, especially in the creation of "countless and variable schemes devised by those who seek the use of the money of others on the promise of profits, "*SEC v W.J. Howey Co.*, 328 U.S. 293, 299 (1946), and determined that the best way to achieve its goal of protecting investors was "to define 'the term security in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.'"[39]

In the recent case of *Shapiro v Nicoloff (In re Nicoloff)*,[40] the debtor claimed ownership in "stocks held jointly with wife," valued at $85,598.24. In fact, the debtor's interest was an interest in an account designated as the "Olde Investor's Account," which was an investment account containing interests in publicly traded stock and money. The Olde Account was later acquired by H & R Block. The H & R investment fund did not fit within the precise definitions of bonds, certificates of stock, or debentures—the protected assets described in the statute—and so the debtor's claim of exemption in the proceeds of the account was challenged by the trustee. If the debtor were in possession of actual certificates of stock held jointly with his wife, the trustee would likely not have challenged the debtor's right to exempt them as entireties property. Instead, the trustee argued, the H & R account was more in the nature of a bank account, containing features of liquidity and ability to deposit cash proceeds. It was neither a bond nor certificate of stock.

The court's decision [in Shapiro v Nicoloff*] rested on the critical fact that any distribution from the account was required to be in the form of a check payable to both husband and wife, thus creating an entireties interest.*

The bankruptcy court overruled the trustee's objection, and this was upheld on appeal to the district court. The court's decision rested on the critical fact that any distribution from the account was required to be in the form of a check payable to both husband and wife, thus creating an entireties interest, relying on *Theisen v Theisen*.[41] The trustee's argument that the funds in the investment account should be treated as though they were in a joint bank account was rejected, noting that funds in a joint bank account are governed by MCL 487.703: "In Michigan, co-owners of a joint bank account are joint tenants with the right of survivorship. . . . Decisional law makes it plain that any of the co-owners of a joint account may withdraw the entire account."[42] Because the funds and the investment account that was the subject matter of the *Nicoloff* case could not be withdrawn by "any" of the co-owners of the joint account, the court found that it should not be treated as a joint bank account.

Nicoloff seems to rest its decision not so much on the nature of the property itself (the court does not expressly acknowledge that the investment account is property within MCL 557.151), but on the fact that it is jointly owned. However, jointly owned property is generally not exempt from process by a creditor holding a claim against either of the co-owners. Therefore, *Nicoloff* may provide some comfort of protection for something called a "jointly owned entireties investment account," but not a great deal.

Conclusion

If the rule of law is to provide predictability and fundamental fairness, MCL 557.151 and the general scheme of exemptions in Michigan do not serve these goals in the current debtor-creditor arena. The hodgepodge of common and statutory laws has resulted in uncertainty in the rights of creditors to attach property and of debtors to protect the same. And the list of exemptions range from the archaic ("10 sheep, 2 cows, 5 swine, 100 hens, 5 roosters, and a sufficient quantity of hay and grain . . . for properly keeping the animals and poultry for 6 months")[43] to the arcane (benefit, charity, relief, or aid to be paid, provided, or rendered by a society).[44]

For several years, the Debtor/Creditor Rights Committee of the Business Law Section of the State Bar has examined the Michigan exemption scheme, and since 2001, the Advisory Committee to the Civil Law and Judiciary Subcommittee of the House Civil and Judiciary Committee has indicated an interest in reviewing Michigan's exemption laws. If you would provide me with any comments, they would be appreciated and shared with members of these committees.[45]

NOTES

1. *Lilly v Schmock*, 297 Mich 513, 517, 298 NW 116 (1941).
2. *General Electric Co v Levine*, 50 Mich App 733, 213 NW2d 811 (1973); *In re Trickett*, 14 BR 85, 86–87 (Bankr WD Mich 1981); *In re Grosslight*, 757 F2d 773, 776 (6th Cir 1985); *see* Bienenfeld, *Creditors v Tenancies by the Entirety*, 1 Wayne L Rev 105 (1955). *Grosslight* and *Trickett*, while acknowledging the ability of an individual debtor to exempt entireties (real) property, deal with the question of the right of a creditor holding a joint claim to attach entireties property. In such cases, a creditor, or

a bankruptcy trustee acting on behalf of joint creditors, may preserve its rights against entireties property.

3. *United States v Craft*, 122 S Ct 1414 (2002). For a discussion of the case, *see* Paul L. B. McKenney, *Tax Matters: Whose House Is It Anyway?*, MI Bus LJ, Summer 2002, at 7, and Paul H. Steinberg, *Hot Issues in Consumer Bankruptcies*, Bankruptcy Nuts & Bolts at 2-2 (ICLE 2002).

4. There are numerous statutory exemptions in Michigan, including a $3,500.00 homestead exemption and a $750.00 personal property exemption allowed by Mich Const 1963, art 10, §3. The primary provision for protection of personal property is MCL 600.6023. *See, e.g.,* insurance proceeds and disability benefits, MCL 500.2207 and 500.4054; workers' compensation, MCL 418.821; crime victims' compensation awards, MCL 18.362.

5. *Ludwig v Brunner*, 203 Mich 556, 559,169 NW 890 (1918).

6. *Hart v Hart,* 201 Mich 207, 214–215, 167 NW 337 (1918).

7. *Lober v Dorgan,* 215 Mich 62, 64, 183 NW 942 (1921).

8. *Id.* at 68.

9. *Wait v Bovee,* 35 Mich 425 (1877).

10. *Lober v Dorgan, supra* note 6, at 68; *see In re Peterson's Estate*, 239 Mich 452, 454, 214 NW 418 (1927).

11. *Scholten v Scholten,* 238 Mich 679, 683, 214 NW 320 (1927).

12. *See Commissioner v Hart,* 76 F2d 864, 865–866 (6th Cir 1935).

13. *De Young v Mesler*, 373 Mich 499, 506, 130 NW2d 38 (1964).

14. *Id.* at 506–507.

15. 11 USC 522(b)(1).

16. 11 USC 522(b)(2)(A).

17. 11 USC 522(b)(2)(B).

18. 11 USC 522(c).

19. Fed R Bankr P 4003(a).

20. Fed R Bankr P 4003(b).

21. Fed R Bankr P 4003(c).

22. 11 USC 704.

23. *McMahon v Holland*, 260 Mich 246, 248–249, 244 NW 462 (1932); *American Nat'l Bank & Trust Co v Modderman*, 37 Mich App 639, 195 NW2d 342 (1972).

24. *American Nat'l Bank & Trust Co,* 37 Mich App at 642. In that case, however, the trial court had ruled that the creditor had not overcome the presumption of one-half ownership.

25. MCL 487.703.

26. *See State of Michigan, Department of Treasury v Comerica Bank,* 201 Mich App 318, 326, 506 NW2d 283 (1993).

27. *Supra* note 1.

28. *See Churchill, Joint Bank Accounts: One Size Doesn't Fit All,* 78 Mich Bar J 292 (1999), at 295, fn.3: "But, money in a couple's joint bank account which originated from the sale or rental of real estate owned by the entirety, may likewise be owned by the entirety; *Muskegon Lumber & Fuel Co v Johnson*, 338 Mich 655, 62 NW2d 619 (1954) and *SNB Bank and Trust v Kensey,* 145 Mich App 765, 378 NW2d 594 (1985)." This is consistent with the right of spouses to protect proceeds derived from entireties real property discussed in the previous section.

29. *People's State Bank v Reckling*, 252 Mich 383, 233 NW 353 (1930); *American State Trust Co v Rosenthal*, 255 Mich 157, 237 NW 534 (1931); *Bankers' Trust Co v Humber*, 264 Mich 71, 249 NW 454 (1933).

30. *Charter Twp of Pittsfield v Saline*, 103 Mich App 99, 302 NW2d 608 (1981); *Brooks v Gillow*, 352 Mich 189, 89 NW2d 457 (1958); *In re Plymouth Glass Co*, 171 F Supp 650 (ED Mich 1957).

31. In the case of *Hendricks v Wolf,* 279 Mich 598, 602, 273 NW 282 (1937), the court held that a land contract vendor's interest was a personal property interest that did not come within the statutory phrase "other evidences of indebtedness." The court relied on the earlier case of *Commissioner v Hart,* 76 F2d 864 (6th Cir 1935), in which the court assumed, but did not decide, that a land contract came within the phrase "other evidences of indebtedness." *Hendricks* held that the interest was protected nonetheless: "Notwithstanding that land contract interests are for certain purposes deemed to be personal property, it has been the general understanding and construction of the law for many years that the right of survivorship exists with respect to land contract interests if the property was originally held as an estate by the entirety." *Commissioner v Hart* at 866.

32. *See Papp v Brownlee*, 361 Mich 501, 503, 105 NW2d 430 (1960); *Battjes Fuel & Building Material Co v Milanowski,* 236 Mich 622, 624, 211 NW 27 (1926).

33. John G. Cameron, Jr., *Michigan Real Property Law: Principles and Commentary, 2002 Cumulative Supplement to Volumes 1 and 2* at 148 (ICLE 2002).

34. MCL 565.357(2).

35. *Kuklish v Wohleben*, 349 Mich 24, 84 NW2d 535 (1957).

36. *Theisen v Theisen*, 27 Mich App 356, 183 NW2d 373 (1970).

37. *Jahn v Regan,* 584 F Supp 399, 409 (ED Mich 1984).

38. *Id.*

39. *Reves v Ernst & Young*, 494 US 56, 60–61 (1990).

40. *Shapiro v Nicoloff,* Civ. Case No. 01-CV-71591-DT (ED Mich 9/25/01) (Hon. Patrick J. Duggan) (unpubl.).

41. *Theisen v Theisen, supra* note 36.

42. *Shapiro v Nicoloff, supra* note 39, quoting from *Department of Treasury v Comerica Bank,* 201 Mich App 318, 325, 506 NW2d 283 (1993).

43. MCL 600.6023(1)(d).

44. MCL 500.8181.

45. The author would also appreciate any "war stories" or other published or unpublished opinions on personal property exemptions under Michigan law.

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The Farm Security and Rural Investment Act of 2002

by Kevin C. Condon and William E. Penn

Introduction

The Farm Security and Rural Investment Act of 2002 (FSRI), which governs federal farm programs for the next six years, was signed into law on May 13, 2002.[1] The FSRI is the first major update of farm programs by Congress since it passed the Federal Agriculture Improvement and Reform (FAIR) Act of 1996. What is the significance of understanding the FSRI? As with many federal statutes and programs, navigating the farm subsidy program eligibility requirements and regulations can be as difficult as canoeing through quicksand. When violations occur, the results can be costly for the farmer, with sanctions ranging from loss of payments to cancellation of contracts to criminal charges. Therefore, it is more important than ever that attorneys who represent the producers receiving subsidies understand FSRI. The only way to adequately represent your farmer clients is to immerse yourself in the highly technical aspects of the act. This article is only the tip of the iceberg and is intended to alert you to some of the bill's provisions. The article first summarizes certain farm subsidy payment programs, namely direct payments, counter-cyclical payments, marketing assistance loans, and loan deficiency payments, and the payment limitations that apply to those programs. It briefly discusses several other issues dealing with farm program payments.

Payment Programs

To receive payments on crops covered by the program, a producer enters into annual agreements for crop years 2002 to 2007. What type of payments will you encounter when you represent a producer?

Direct Payments

Under the 1996 legislation, producers who had "contract acres" received production flexibility contract (PFC) payments, also known as AMTA payments. Under FRSI, direct payments replace PFC payments.

Counter-Cyclical Payments

Counter-cyclical payments (CCPs) under FRSI replace the market loss assistance payments (MLAs) of the past. CCPs are designed to provide producers with a safety net when market prices of covered commodities drop below a certain level. Payments are based on historical production and are not tied to current production. The term *covered commodity* is defined as wheat, corn, grain sorghum, barley, oats, upland cotton, rice, soybeans, and other oilseeds.[2] For both direct payments and CCPs, the producer has to establish the base acres by electing one of two methods by which the base acres of all covered commodities of the farmer are to be determined. Under option one, the producer takes the sum of the four-year (1998–2001) average of acreage planted on the farm to covered commodities (including oilseeds) for harvest, grazing, haying, silage, or other similar purposes, and any acreage on the farm that the producers were prevented from planting during the 1998 through 2001 crop years to covered commodities because of drought, flood, or other natural disaster, or other conditions beyond the control of the producers, as determined by the Secretary of Agriculture. (herein referred to as "the Secretary").[3]

Under option two, use the sum of the following: contract acreage used to calculate the 2002 payment authorized by the 1996 act for the covered commodities on the farm plus the four-year average of eligible oilseed acreage on the farm.[4] Oilseed acres may not exceed the difference between the four-year average of planted and prevented planted acreage for all covered commodities and the total contracted under the 1996 act.[5]

If the producer fails to make the election or fails to notify the Secretary of the election made in a timely manner, as required, the producer is deemed to have made the election described in option two to determine base acres for all covered commodities on the farm.[6] The election made applies to all covered commodities on the farm.[7]

For the purpose of determining a four-year acreage average, the Secretary must not exclude any crop year in which a covered commodity was not planted.[8] In cases involving acreage that was prevented from being planted and was devoted to another

commodity, the producer may elect the commodity to be used for that crop year in determining the four-year average.

As was the case under FAIR, the Secretary must provide for the establishment of a payment yield for each farm and for each covered commodity.[9] For direct payments, covered commodities, excluding oilseeds, will be treated the same as under the 1996 act if the yield was already established under that act.[10] If no yield has been established, the Secretary must establish an appropriate yield considering similar farms.[11] For oilseeds, the Secretary is to determine the actual yield for planted acres during the 1998 to 2001 crop year, excluding years in which oilseeds are not planted.[12]

For CCPs, if the producer retained the 1996 act's contract acres as base acres, the CCP yield is the same as the direct payment yield. If the producer elected to update base acres, the producer has a onetime opportunity to partially update the CCPs.[13] The selection is to be made at the same time as the selection of basic acres.[14] The act further directs the method of updating the yield.[15]

Calculation of Direct Payments and CCPs

In calculating direct payments, multiply the payment rate (in the act) by the payment acres times the payment yield.[16] The payment acres are 85 percent of the base acres. The payment rates used to make direct payments with respect to covered commodities for a crop year are as follows:

- wheat: $0.52 per bushel
- corn: $0.28 per bushel
- grain sorghum: $0.35 per bushel
- barley: $0.24 per bushel
- oats: $0.024 per bushel
- upland cotton: $0.0667 per pound
- rice: $2.35 per hundredweight
- soybeans: $0.44 per bushel
- other oilseeds: $0.0080 per pound[17]

CCPs are calculated by multiplying the payment rate by the payment acres times the payment yield (which may be different from the direct payment yield). The payment rate is determined by subtracting the effective price[18] from the target price. For purposes of the 2002 and 2003 crop years, the target prices for covered commodities are as follows:

- wheat: $3.86 per bushel
- corn: $2.60 per bushel
- grain sorghum: $2.54 per bushel
- barley: $2.21 per bushel
- oats: $1.40 per bushel
- upland cotton: $0.7240 per pound
- rice: $10.50 per hundredweight
- soybeans: $5.80 per bushel
- other oilseeds: $0.0980 per pound[19]

Timing of Payments

For the 2002 crop year, direct payments are to be made as soon as practicable after enactment.[20] In the case of each of the 2003 through 2007 crop years, payments are to be made on or after October 1 of the calendar year in which the crop of the covered commodity is harvested.[21] Producers may elect to receive an advance payment of up to 50 percent in any month beginning on December 1 of the calendar year before the calendar year in which the crop is harvested through the month within which the direct payment would otherwise be made.[22] If a producer on a farm that receives an advance direct payment for a crop year ceases to be a producer on that farm, or the extent to which the producer shares in the risk of producing a crop changes before the date the remainder of the direct payment is made, the producer is responsible for repaying the Secretary the applicable amount of the advance payment, as determined by the Secretary.[23]

Payments for CCPs should be made as soon as practicable after the end of the 12-month marketing year for the covered commodity. Sections 1103(2)–(4) govern the timing and amounts of advance payments for CCPs. Producers on a farm that receive partial payments for a crop year must repay the Secretary the amount, if any, by which the total of the partial payments exceeds the actual CCP to be made for the covered commodity for the crop year.[24]

Before a producer on a farm may receive direct payments or CCPs with respect to the farm, the producer must agree, during the crop year for which the payments are made and in exchange for the payments, to comply with certain conservation,[25] wetland,[26] and production flexibility requirements,[27] as well as several other agency requirements.

The production flexibility rules of the 1996 act are retained. Generally, any commodity or crop may be planted on base acres of a farm.[28] The prior prohibition on planting fruits and vegetables remains[29] with the additional prohibition of planting wild rice.[30]

When violations occur, the results can be costly for the farmer, with sanctions ranging from loss of payments to cancellation of contracts to criminal charges.

Marketing Assistance Loans and Loan Deficiency Payments

Commodity loan programs allow producers of designated crops to receive a loan from

the government at a commodity-specific loan rate per unit of production by pledging production as loan collateral. The Farm Service Agency (FSA) administers the commodity loan programs with marketing loan provisions for wheat, rice, corn, grain sorghum, barley, oats, upland cotton, soybeans, other oilseeds, peanuts, mohair, wool, honey, small chickpeas, lentils, and dry peas. After harvest, a farmer may obtain a loan for all or part of the new commodity production. The loan must have a term of nine months beginning on the first day of the first month after the month in which the loan is made.[31]

The loan may be repaid at the lesser of the loan rate plus interest, or at a rate determined by the Secretary that will minimize forfeitures and costs to the government.[32]

Loan deficiency payments (LDPs) are available if the producer agrees to forgo obtaining a commodity loan.[33] The LDP is computed as the product of the payment rate and the quantity not put under loan.[34] The payment rate is the amount by which the loan rate exceeds the loan repayment rate.[35] LDP rates will be determined on the date of request for the LDP.[36]

Although the complex formulas and detailed rules may seem daunting, it is important to realize that most of your clients will already understand the basics, so a grasp of the terminology used previously is important in gaining their respect.

Payment Limitations

Like the PFC payments under the 1996 legislation, direct payments are limited to $40,000 per person for covered commodities. The limitations on CCPs are $65,000 per person for covered commodities, and the payment limitations for marketing loan gains and LDPs are $75,000 per person.[37] Additionally, for the 2003 to 2007 crop years, an individual or entity will not be eligible to receive direct payments, CCPs, marketing loan gains, LDPs, or conservation payments (not discussed here) if the average adjusted gross income of the individual or entity exceeds $2.5 million, unless not less than 75 percent of the average adjusted gross income of the individual or entity is derived from farming, ranching, or forestry operations, as determined by the Secretary.[38]

The three-entity rule is retained. Under the three-entity rule, an individual can receive a full payment directly and up to a half payment from each of two additional entities. Although the complex formulas and detailed rules may seem daunting, it is important to realize that most of your clients will already understand the basics, so a grasp of the terminology used previously is important in gaining their respect. Most of our agricultural clients tell us that they need an attorney who "understands ag."

Other Commonly Occurring Issues

You will also need to understand some of the more common issues that lead to the need for an attorney when dealing with farm programs. Two are briefly discussed here:

Person Determination

Direct and counter-cyclical payments are subject to dollar limitations per "person." The analysis of whether a "person" exists is relatively easy. One need simply ask, is the purported "person" an individual or one of the listed business organizations? In other words, is the purported "person" organized as anything other than a joint operation? The more difficult issue is whether any "person" is combined with another "person." Is the individual or entity a "separate person" or part of a "combined person"? If two persons are combined, the combined person is limited to one payment limitation. For example, if two individuals are treated as separate persons, they are eligible to each receive $40,000 under a direct payment contract for a total of $80,000. If those same two individuals are combined as one person, those two individuals may only receive a total of $40,000 between them.

Various rules exist that cause persons to be combined and not treated as separate persons. These rules include (1) the combination of any owner of an entity (i.e., a business organization other than a general partnership or joint venture) with the entity itself when the owner holds more than 50 percent of the entity;[39] (2) the combination of two or more entities if more than 50 percent of those entities are owned by the same two or more individuals or entities;[40] (3) the combining of a sole income beneficiary of a trust with the trust;[41] (4) the combining of a revocable trust with its grantor;[42] (5) except for certain specific exceptions, the combining of husbands and wives;[43] and (6) except for certain specific exceptions, the combining of a minor with the minor's parent.[44]

A natural inquiry when determining whether a person exists and whether any persons are combined persons is to ask the following: at what time is the person determination made? In other words, if a corporation is formed on December 31 of a particular year, is that corporation treated as a person under the payment limitation regulations for that year? Or, if an individual who previously owned 70 percent of a corporation sells 40 percent of that corporation on June 1, is that individual treated as a sep-

arate person from the corporation in the year of the sale? That question is answered by the regulation at 7 CFR 1400.100, a section of the regulation that is aptly titled "Timing for Determining Status of Persons." That regulation provides the following:

> the status of an *individual or entity* on April 1 of the applicable program or fiscal year, shall be the basis on which determinations are made in accordance with this part. . . . Actions taken by an *individual or entity* after the applicable status date . . . shall not be used to determine whether there has been an increase in the number of persons for the applicable program or fiscal year (emphasis added).[45]

As a result, if a corporation is formed after April 1, a minor achieves majority after April 1, a husband and wife are divorced after April 1, or a majority stockholder sells 40 percent of the corporation after April 1, the act of the corporation being formed, the birthday celebration of the minor, the final judgment of divorce being granted, or the sale of 40 percent of the corporation must not be used to determine whether there has been an increase in the number of persons for that program. The status, as of April 1 of that year, is the "picture in time" used to make the person determination.

Actively Engaged in Farming

Another common issue is whether the farmer is actively engaged in farming. Before 1989, the limitation of federal farm program payments was done solely by determining whether persons were combined or separate. However, beginning in crop year 1989, in addition to limiting federal farm program payments through the use of person determinations, a threshold eligibility test was employed by requiring that each person be determined to be actively engaged in farming before that person was eligible to receive the first dollar in certain federal farm program payments.[46]

In general, to be "actively engaged in farming," a corporation, limited liability company, or similar entity must make a significant contribution to the farming operation of capital, land, or equipment. In addition, its stockholders or members who together own at least 50 percent of the entity must, collectively, make a significant contribution of active personal labor or active personal management.[47] When corporations or other similar entities are members of a joint operation (i.e., a joint venture or general partnership) that conducts the farming operation, the joint operation itself can make the "significant contribution" of capital, equipment, or land. Each entity partner whose members make a significant contribution of active personal labor or active personal management is considered "actively engaged in farming."[48] In addition, the total contributions made by or on behalf of each person must be at risk and must be commensurate with such person's share of the profits and losses from the farming operation.[49]

In general, to be "actively engaged in farming," a corporation, limited liability company, or similar entity must make a significant contribution to the farming operation of capital, land, or equipment.

When Legal Assistance is Needed

It is not uncommon for producers to run into legal difficulties as a result of a violation of one or more of the many regulations controlling farm program payments. Your assistance will usually be sought after there has been a determination from the FSA that a violation has occurred. You may be asked to represent the client at county and state committee hearings, in appealing the final agency determination through the U.S. Department of Agriculture (USDA) National Appeals Division, and if necessary, in Federal District Court. The first step is to understand the farm program payments. Further information can be found throughout the USDA's Web site at www.usda.gov/.

NOTES

1. The text of the bill, now PL 107-171, can be found at http://thomas.loc.gov/.
2. FSRI 1001(4).
3. FSRI 1101(a)(1)(A).
4. FSRI 1101(a)(1)(B).
5. FSRI 1101(a)(2).
6. FSRI 1101(c).
7. FSRI 1101(d).
8. FSRI 1101(a)(3).
9. FSRI 1102(a).
10. FSRI 1102(b).
11. FSRI 1102(c).
12. FSRI 1102(d).
13. FSRI 1102(e)(1).
14. FSRI 1102(e)(2).
15. FSRI 1102(e)(3).
16. FSRI 1103(c).
17. FSRI 1103(b).
18. The sum of the higher of national average marketing price during the marketing year or national average loan rate and the direct payment rate. FSRI 1104(b).
19. FSRI 1104(c)(1). For purposes of each of the 2004 through 2007 crop years, the target prices for covered commodities are as follows:

•wheat: $3.92 per bushel
•corn: $2.63 per bushel
•grain sorghum: $2.57 per bushel
•barley: $2.24 per bushel
•oats: $1.44 per bushel
•upland cotton: $0.7240 per pound
•rice: $10.50 per hundredweight

•soybeans: $5.80 per bushel
•other oilseeds: $0.1010 per pound. FSRI 1104(c)(2).
20. FSRI 1103(d)(1)(A).
21. FSRI 1103(d)(1)(B).
22. FSRI 1103(d)(2).
23. FSRI 1103(d)(3).
24. FSRI 1104(f)(5).
25. FSRI 1105(a)(1)(A).
26. FSRI 1105(a)(1)(B).
27. FSRI 1105(a)(1)(C).
28. FSRI 1106(a).
29. FSRI 1106(b)(3)(A), (B).
30. FSRI 1106(b)(3)(C).
31. FSRI 1203(a).
32. FSRI 1204(a). The loan rates for nonrecourse marketing assistance loans can be found at FSRI 1202.
33. FSRI 1205(a)(1).
34. FSRI 1205(b).
35. FSRI 1205(c).
36. FSRI 1205(e).
37. FSRI 1603(a).
38. FSRI 1604.
39. 7 CFR 1400.101(a).
40. 7 CFR 1400.101(b).
41. 7 CFR 1400.103(a).
42. 7 CFR 1400.103(c).
43. 7 CFR 1400.105.
44. 7 CFR 1400.106.
45. 7 CFR 1400.100.
46. *See generally* preamble to proposed rule, 53 Fed Reg 11,474 (April 6, 1988).
47. 7 USC 1308-1(b)(2)(B); 7 CFR 1400.201.
48. 7 USC 1308-1(b); 7 CFR 1400.201, 1400.203, and 1400.204.
49. 7 CFR 1400.201(d).

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Case Digests

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Contract Law—Claims in Equity—Clean Hands Doctrine

In *Rose v Nat'l Auction Group, Inc,* 466 Mich 453, 646 NW2d 455 (2002), the court held that plaintiffs were barred as a matter of law by the clean hands doctrine from bringing their equitable claims of fraud and misrepresentation in connection with a false-bidder scheme during an auction. Defendant auctioneers assured plaintiffs that the property would obtain the desired price of $850,000 at auction. During the auction, however, it was clear that the property would not bring such a price, so plaintiffs agreed to use a false bidder. Even with the use of a false bidder, however, the desired price was not met. Plaintiffs then sued the auctioneers, alleging that defendants induced plaintiffs into surrendering their contractual right to withdraw the property from the auction by initiating the false-bidder scheme.

In reaching its decision that the clean hands doctrine barred plaintiffs' claims, the supreme court noted that plaintiffs claimed to be victims of fraud, but by agreeing to the false-bidder scheme, plaintiffs themselves defrauded the bidders who had expected a no-reserve auction. The court emphasized it is undisputed that the use of a false bidder without the honest bidder's knowledge at an auction is contrary to public policy. The court dismissed the significance of plaintiffs' contention that they were unaware that use of a false bidder was illegal: "While it is appropriate for a party to secure the services of an expert for advice about legal, technical, or complex matters, we see no reason that the explicit or implicit advice of such an expert should allow a party to violate basic ethical norms that are obvious to any sentient person." *Id.* at 466–467.

Antitrust Law—Michigan Antitrust Reform Act—Private Actions—Monopolization

In *A&M Supply Co v Microsoft Corp,* No 236598, 2002 Mich App LEXIS 1247 (August 27, 2002), the court ruled that plaintiff did not satisfy its burden of proving that a class action would be a superior way to resolve this dispute and did not put forth a viable method for proving actual damages on a class-wide basis, which Michigan law requires of a plaintiff in an indirect-purchaser suit brought as a class action. Plaintiff sought to hold Microsoft liable to consumers who purchased Windows operating systems and Internet Explorer software for alleged damages attributable to Microsoft's monopolistic posture and antitrust violations in Michigan. Wayne County Circuit Court granted plaintiff's motion to certify the class. The court of appeals agreed with defendant's argument that plaintiff failed to satisfy the "pass-on" requirement necessary to certify a class.

The court began its analysis by explaining the instant action, which is an indirect or pass-on action in which the plaintiff is one or more steps removed from the direct purchaser, essentially purchasing the product after it has changed hands through middlemen. In an indirect action, plaintiff must prove that each class member sustained an injury by demonstrating two factors: first, plaintiff must show that the prices defendant charged the direct purchasers were consistently higher than the prices it would have charged in a competitive environment (the "overcharge" requirement); second, plaintiff must prove that the overcharge, or some portion thereof, passed through the chain of distribution to indirect purchasers (the pass-on requirement). The court ruled that the trial court erred in concluding that A&M satisfied the pass-on requirement and thus clearly erred when it certified the class. The court noted, however, that MCR 3.501(B)(3)(e) permits the named plaintiff to maintain its action against defendant, relying on individualized proofs.

Labor and Employment Law—Discrimination—Sexual Harassment—Hostile Work Environment

Jager v Nationwide Truck Brokers, Inc, Nos 226007, 228672, 2002 Mich App LEXIS 1197 (August 9, 2002). Plaintiff was employed with a technology company and an employment service. Through an employee lease agreement, she was assigned work with a trucking company (NTB) as a log entry clerk. According to plaintiff, her supervisor began making unwanted sexual advances toward her, including sending her sexually explicit electronic mail "pop-up" messages, repeatedly asking her to go out with him, and telling her that she smelled good. Plaintiff told certain fellow employees about the supervisor's conduct and talked to another supervisor about possibly transferring to his department. After plaintiff left work at NTB, she contacted an attorney who sent a letter to the president of NTB, notifying NTB of the harassment. Plaintiff was given paid leave, as she requested, and the supervisor was placed on suspension pending the outcome of an investigation. NTB, the technology company, and the employment service investigated and were unable to substantiate plaintiff's allegations. Thereafter, NTB invited plaintiff to return to work at NTB, but indicated that plaintiff would not have any contact with the supervisor, either directly or indirectly. Plaintiff declined NTB's offer and filed a complaint alleging discrimination in violation of Michigan's Civil Rights Act, which was dismissed on summary disposition.

The appellate court affirmed the dismissal of plaintiff's claim of quid pro quo sexual harassment because plaintiff did not show that any adverse job action was taken against her. Plaintiff offered no evidence that her supervisor made any decisions affecting her employment that related to her submission to or rejection of his sexual advances. The appellate court also ruled that the trial court correctly dismissed plaintiff's claim of hostile environment sexual harassment because, although plaintiff complained to a manager, she did not complain to a manager with sufficient authority to effectuate change in the workplace. Plaintiff's claim failed because NTB was not notified of the sexual harassment until it received the letter from plaintiff's attorney and thereafter suspended the

supervisor, provided plaintiff with paid leave, and conducted a prompt investigation.

Contracts—UCC Article 2—Breach, Repudiation, and Excuse

In *American Bumper & Mfg Co v Transtechnology Corp,* No 229616, 2002 Mich App LEXIS 1119 (July 26, 2002), plaintiff failed to give defendant proper notice of breach as required by the UCC and therefore was not entitled to any remedy. The bumper manufacturer (plaintiff) entered into an agreement with the vehicle manufacturer for front bumpers. The supplier (defendant) provided the U-nuts that the bumper manufacturer would use to fasten the bumpers to the bumper assemblies. The vehicle manufacturer notified the bumper manufacturer regarding problems with the U-nuts. Rather than allowing the supplier to attempt to cure the defect, the bumper manufacturer recommended purchasing the U-nuts from another supplier and simply canceled the contract. The bumper manufacturer initially notified the supplier that there was a problem with the U-nuts, but never notified the supplier that they were in breach. Once the parties investigated the problem with the U-nuts, the bumper manufacturer determined that the supplier was not at fault.

The court ruled that the notice given by the bumper manufacturer did not satisfy the policies underlying the UCC's notice provision, nor did the bumper manufacturer's conduct satisfy the UCC's standard of commercial good faith. Plaintiff was barred from any remedy, including the non-UCC remedy of indemnification.

Contracts—Contract Interpretation—Parol-Evidence Rule—Tortious Interference with Employment Relationship

In *ADR North America, LLC v Agway, Inc*, 303 F3d 653 (6th Cir 2002), the court, applying the parol-evidence rule, ruled that the parties' last agreement superseded all earlier ones; therefore, plaintiff's claims of breach of contract and tortious interference with an employment relationship failed. Defendant cooperative contracted for plaintiff to provide consulting services to return defendant's retail arm to profitability. The parties negotiated several documents, including the "Proposal," the "ADR Standard Terms and Conditions of Business" (the terms), which prohibited the solicitation of ADR personnel, and later, the "Supply Agreement" and the "Confidentiality Agreement." The supply agreement stated that it constituted the entire agreement between the parties. After defendant hired one of ADR's employees, plaintiff filed suit in the federal district court, which awarded defendant summary judgment.

The appellate court upheld the lower court's ruling. The court noted that only the terms contained a provision forbidding the hiring of ADR personnel. To prove that defendant's hiring of plaintiff's employee constituted a breach, plaintiff had to show that the terms were part of the parties' agreement. The court rejected both lines of reasoning plaintiff proposed to prove that the terms constituted part of the agreement. Plaintiff's first theory was that the proposal and terms comprised the initial agreement and that the subsequent signed documents—the confidentiality agreement and the supply agreement—were signed "amendments" to the contract. Alternatively, plaintiff contended that the supply agreement was ambiguous and only could be understood by reference to the proposal and terms. Citing *Archambo v Lawyers Title Ins Corp,* 466 Mich 402, 646 NW2d 170, 176-77 (2002), the court pointed out that under the parol-evidence rule, prior agreements cannot contradict the terms of a document meant to be the final and complete expression of the parties' agreement. The only exception to this rule is in cases of fraud or when an agreement is obviously incomplete "on its face"; plaintiff did not allege fraud and could not prove the supply agreement was obviously incomplete "on its face." Regarding the claim of tortious interference with an employment relationship, the court held that plaintiff did not produce sufficient evidence to show that defendant actively solicited plaintiff's employee to sever the relationship.

Contracts—Choice of Law—Contacts Requirement

In *Mill's Pride, Inc v Cont'l Ins Co*, 300 F3d 701 (6th Cir 2002), the court determined that Ohio law should apply to plaintiff's claim that defendant breached a commercial general liability policy by refusing to pay defense and indemnification costs related to an underlying trademark infringement action. Plaintiff, who purchases, manufactures, and sells furniture, has business entities that include a Connecticut corporation with its principal place of business in West Palm Beach, Florida, an Ohio limited partnership with administrative offices in West Palm Beach, and an Ohio manufacturing facility. Defendant, whose home office is located in Chicago, Illinois, issued plaintiff a commercial general liability policy, which did not contain a choice of law provision. Ameriwood Industries International Corporation brought the underlying trademark infringement action lawsuit against plaintiff when Ameriwood discovered that plaintiff was selling furniture identical in appearance to Ameriwood's line of children's furniture under another mark. In response to plaintiff's claim of breach, defendant contended that it had no duty to pay because plaintiff failed to comply with the policy requirements, in particular, the provision requiring plaintiff to cooperate with and to get consent to settle from defendant. Under Ohio law, notification is a condition precedent to coverage, whereas under Michigan law, the insurer must prove prejudice by the lack of timely notice. The district court applied Michigan law because the occurrence giving rise to the claim arose in Michigan. The parties thereafter resolved all factual and legal disputes except for the issue regarding the appropriate choice of law.

The appellate court began by noting the well-established rule requiring a federal court in a diversity case to apply the substantive law of the state in which the court sits, *Erie RR Co v Tompkins*, 304 US 64, 78, (1938), including the forum state's law regarding choice of laws. The court noted that because this action was brought in federal court in Michigan, Michigan's choice-of-law rules

apply. The supreme court's most recent treatment of choice-of-law rules in contract disputes is *Chrysler Corp v Skyline Indus Svcs, Inc,* 448 Mich 113, 528 NW2d 698 (1995). *Chrysler* adopted the balancing-of-factors approach in the Restatement (Second) of Conflict of Laws §188(2), when, as here, the contract contains no choice-of-law provision. The factors to be balanced are the place of contracting; the place of negotiation of the contract; the place of performance; the location of the subject matter of the contract; and the domicile, residence, nationality, place of incorporation, and place of business of the parties. Here, the court concluded that three of those contacts—the place of negotiation, the place of performance (at least with respect to the issue of plaintiff's duties to defendant), and the place of business of the parties—pointed to Ohio, whereas no factors pointed to Michigan. The appellate court therefore reversed the lower court's order and remanded for further proceedings.

Contract Law—Unconscionability

In *Lucre, Inc v ADC Telecomms,* File No 1:02-CV-343, 2002 US Dist LEXIS 15421 (WD Mich August 16, 2002), the court dismissed all of plaintiff Internet service provider's claims of breach of contract, breach of warranties, fraudulent misrepresentations, and innocent misrepresentations against defendant equipment supplier. Plaintiff and defendant signed an "Evaluation Agreement" for defendant to provide telecommunications equipment and software to plaintiff for a 90-day trial period. Defendant's proposal stated that the equipment would have multifrequency functionality (which it did not), but the agreement did not so state. On discovering the equipment did not contain this feature, plaintiff filed suit.

The court rejected plaintiff's assertion that, despite the integration clause, the parties' contract was not defined solely by the agreement but was "a contract within a contract." The integration provision communicated the parties' intent to incorporate all contract terms in the agreement. Plaintiff responded that even if the agreement alone constituted the parties' contract, the limitation-of-liability clause was unconscionable. The court found no evidence of unconscionability; plaintiff could not prove its essential element—unfair surprise or oppression—as the limitation-of-liability provision was clear and unambiguous. In addition, the court ruled that plaintiff could not recover on its tort claims because recovery was precluded by Michigan's economic-loss doctrine.

Alternative Dispute Resolution—When Dispute Is Subject to Arbitration

In *Denali Flavors, Inc v Marigold Foods, LLC,* 214 F Supp 2d 784 (WD Mich 2002), the court denied defendant's motion to stay proceedings and compel arbitration. Plaintiff licensor brought claims of trademark infringement and unfair competition/false designation against the former licensee (defendant), alleging that defendant failed to use best efforts in selling licensed products and marketed "knock off" ice cream. Defendant filed a demand for arbitration relating to plaintiff's claims for breach of contract; however, plaintiff's complaint contained no claim for breach of contract. The parties' agreement contained an arbitration clause but did not specifically name arbitrators, although it did provide a mechanism for determining the arbitrators.

When considering a motion to stay proceedings and compel arbitration under the Federal Arbitration Act, a court has four tasks: first, it must determine whether the parties agreed to arbitrate; second, it must establish the agreement's scope; third, if federal statutory claims are alleged, it must consider whether Congress intended those claims to be nonarbitrable; and fourth, if the court concludes that some, but not all, of the claims in the action are subject to arbitration, it must determine whether to stay the remainder of the proceedings pending arbitration. The parties did not dispute that they had entered into a binding agreement to arbitrate. Plaintiff asserted, however, that it did not agree to arbitrate the trademark infringement claims. The court agreed, noting that the parties' arbitration clause addressed disputes relating to royalties and sale of the licensed products, whereas the instant claim involved something specifically not within the contemplation of the licensing agreement: the manufacture of knock-off brands. The licensing agreement implicitly, if not explicitly, proscribed such conduct, but did not contemplate addressing infringement claims through arbitration.

Antitrust Law—State Unfair Competition Common Law

In *Donnelly Corp v Reitter & Schefenacker USA, LP*, No 1:00-CV-751, 2002 US Dist LEXIS 15205 (WD Mich August 13, 2002), the court granted plaintiff's request for trial bifurcation and held that allegations in defendants' counterclaim stated a cognizable claim under Michigan unfair competition law. Plaintiff's complaint for patent infringement alleged that defendants' manufacture, use, sale, and offering for sale to customers of lighted interior rearview mirrors infringed three of plaintiff's patents. Defendants denied the infringement claim and brought a Michigan common law unfair competition counterclaim, alleging that plaintiff (1) obtained the patents by fraud and inequitable conduct; (2) brought the instant, allegedly baseless patent infringement action; (3) publicized the pending action to defendants' customers and advised defendants' customers that defendant would be unable to supply the rearview mirrors because they infringed plaintiff's patents.

Plaintiff contended that Michigan's common law unfair-competition claim extends only to trademark violations, in particular those violations known as "palming off," and does not encompass claims for bad-faith assertion of patent actions. The court rejected plaintiff's argument because plaintiff could not prove that defendants' allegations would not support state common law unfair-competition claims. Also, other state cases have allowed similar unfair-competition claims, and federal law apparently does not preempt such a claim. In the interests of justice, the court granted plaintiff's order to bifurcate the proceedings into two separate trials—the first trying issues relating to the patent infringement claim and the sec-

ond trying issues pertaining to the antitrust and unfair-competition counterclaims and the patent misuse defense.

Corporations—Shareholder Derivative Action—Breach of Fiduciary Duties—Business Judgment Rule

In *Salsitz v Nasser*, 208 FRD 589 (ED Mich 2002), the court dismissed a shareholder derivative action in which plaintiff alleged that defendants, current and former corporate directors and officers, breached their fiduciary duties, among other things. Plaintiff disagreed with defendants' decision to mount a computerized ignition system, known as a thick film ignition (TFI) switch, directly onto the engine block, despite the switch's propensity to fail and shut down the engine if overheated.

A shareholder of a corporation may bring a legal action on behalf of that corporation if, among other things, the plaintiff (1) was a shareholder at the time of the transaction complained about and (2) first has sought to obtain the action desired from the directors of the corporation, i.e., has made a "demand" on the corporation's board of directors (Rule 23.1 of the Federal Rules of Civil Procedure). The court held that plaintiff's claims could go forward only if the complaint created a reasonable doubt regarding whether defendants' decisions resulted from a valid exercise of business judgment. Even if the defendants did not properly exercise business judgment, they could be held liable only if the complaint sufficiently alleged bad faith, illegal conduct, or a conscious disregard of known risks. Mere gross negligence was insufficient. The court ruled that plaintiff could not prove that the decision to continue mounting the TFI module on the engine block was not the product of a valid exercise of business judgment. In fact, the complaint acknowledged that a "heated dispute" took place within the company, that the board was well informed of the ongoing debate, and that the board was periodically updated regarding efforts to identify more precisely and rectify the problem. Regarding the defendants' decision to install a certain allegedly defective tire on cars manufactured by the corporation, the court held that defendants' failure to track the tires' safety record did not constitute a sufficient reason to hold defendants liable in their personal capacities.

Contracts—Tortious Interference—Third-Party Beneficiary Theory

In *Thomas v Galt Enters,* No 01-CV-10384-BC, 2002 US Dist LEXIS 10977 (ED Mich June 20, 2002), the court ruled that plaintiff marketer successfully pleaded a claim for tortious interference with a business expectancy but did not put forth successful claims of breach of contract based on third-party beneficiary theory and defamation. Defendant contractor (API) sold after-market service contracts to automobile purchasers. API retained the agent (Galt) to solicit automobile dealerships, which would offer API's service contracts to its customers. Galt then contracted with plaintiff marketer to actually market the contracts in the field. When API and Galt allegedly failed to perform their obligations under their respective contracts by refusing to supply company forms, supplies, instructions, and certificates to plaintiff and to customers, plaintiff filed suit. (Plaintiff later dropped the tortious-interference claim against API.)

The court ruled that plaintiff sufficiently alleged an intentional interference, that is, an unjustified instigation of a breach of contract by Galt. In addition to failing to perform its contractual obligations, Galt's conduct revealed an intent to eliminate plaintiff as a servicing agent and increase its own net revenue. Regarding the third-party beneficiary claim, at oral argument, plaintiff was unable to identify in the contract between API and Galt a promise that Galt made for the benefit of any third-party beneficiary, specifically a "subagent," as individuals in plaintiff's position are known. API and Galt's contract plainly could not have contemplated a promise for the benefit of the plaintiff in his individual capacity, because that contract was negotiated more than seven years before Galt hired the plaintiff as a subagent. Therefore, the court ruled that plaintiff failed to state a claim for relief based on third-party beneficiary theory. The court also dismissed plaintiff's defamation claim.

Trademark Law—Infringement—Entitlement to Injunctive Relief

In *Carrier Great Lakes v Cooper Heating Supply, Inc*, Case No 4:01-CV-189, 2002 US Dist LEXIS 10417 (WD MI June 5, 2002), the court allowed plaintiff's claims under the Lanham Act to go forward, rejecting defendant's assertions that remedies under the act are limited to registrants of the trademark, and plaintiff was not a registrant of the mark The term *Carrier* is a registered trademark; plaintiff is a licensee and distributor of Carrier heating and cooling products. Plaintiff asserted that it was the exclusive licensee and distributor in Carrier's Michigan region and objected to Cooper's advertisements directed at Michigan customers falsely suggesting that Cooper was an authorized Carrier dealer. Cooper asserted that it was a sublicensee of TEC, a licensed Carrier agent in Illinois, and that the licensing agreement authorized Cooper to sell Carrier equipment in nine counties, including counties in southwest Michigan.

Cooper argued that plaintiff failed to state a claim under the Lanham Act because 15 USC 1114 states that "the remedies given to the owner of a right infringed under this Act . . . shall be limited" to seeking an injunction if defendant is an innocent printer of infringing matter or an innocent media source. Cooper argued that because plaintiff was not the registrant of the trademark at issue, plaintiff was not entitled to seek redress under the Lanham Act. The court disagreed, interpreting the statute as limiting the relief available to a plaintiff such as this plaintiff when defendant is an innocent printer or an innocent media source. The court noted that Cooper's allegations did not lead to a finding that Cooper qualified as this type of defendant, and even if they did, plaintiff still would be entitled to seek an injunction. The court also noted that although section 1114 authorizes a civil remedy for registrants, it does not reduce the availability of civil remedies for other parties.

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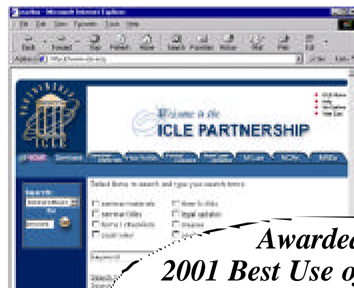

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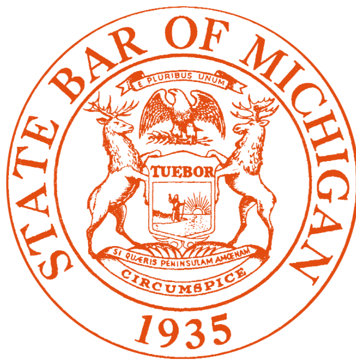

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