STATE BAR OF MICHIGAN
BLS
BUSINESS LAW SECTION

The Michigan Business Law JOURNAL

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

MISSION STATEMENT

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

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

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BUSINESS LAW SECTION

July 2006

Dear Business Law Section Member:

Welcome to another fantastic issue of the *Michigan Business Law Journal*. We are extremely proud of this publication and thankful for the efforts of our authors. This issue features articles written and solicited by the Section's Uniform Commercial Code Committee. We'd like to thank Patrick Mears, Chair of the Committee, for his efforts in coordinating this issue's submissions. Topics discussed in this issue include contractual supply disputes in the automotive industry, enforcement of shrink-wrap and click-wrap agreements under the UCC, enforcement of commercial finance lease agreements, proving economic duress in Michigan, and proving future lost profits for new businesses in the post-*Daubert* era. Our regular columns also feature useful information.

It is my sincere hope that you will participate in Section programs and become involved in Section activities. The Section leadership spends much time planning programs and activities that we hope our members will find informative and useful in their practice. Your ideas and suggestions are always welcome. Feel free to contact any of the Section leaders listed on the Web site for more information. The Section has a number of active committees and directorships that are always looking for new members. Please contact any of the Committee or Directorship Chairpersons listed on our Web site if you are interested in becoming involved.

Mid-Year Meeting and Business Law Institute. The Section's 18th Annual Mid-Year Meeting and Business Law Institute was held on June 2 and 3, 2006, at the Soaring Eagle Casino & Resort in Mt. Pleasant. It was an overwhelming success and we are thrilled that so many Section members were able to take advantage of the event. Next year's event will be held on June 1 and 2, 2007, at Boyne Mountain. Please mark your calendars now and plan to attend the Mid-Year Meeting and Business Law Institute. It promises to be an informative and worthwhile experience.

Annual Meeting. The Section will hold its 2006 Annual Meeting on September 26, 2006, at 5:00 pm at the Hotel Baronette in Novi. Details of the activities for the Annual Meeting event will be posted on our Web site as they develop. Please reserve a spot on your calendar for this great event.

Annual Scholarship Award. The winner of the Section's Third Annual Scholarship Award is Uwe Dauss of Wayne State University Law School. You can read Uwe's winning submission entitled "Stay or Proceed: What Effect Does an Arbitrability Appeal Have on the Proceedings in the Lower Court?" in this issue of the *Journal*. Uwe was presented with a $2,500 monetary prize at the Mid-Year Meeting and Business Law Institute event in June. The Section will hold its Fourth Annual Scholarship Award next year. The award is open to all law students enrolled in an ABA-accredited law school in Michigan. The purpose of the award is to promote law student involvement with and knowledge about the Section, as well as law student interest in business-related topics.

Business Boot Camp: Basic Training for Every Business Lawyer. The Section's award-winning Business Boot Camp program concluded in May. Planning is under way for Business Boot Camp II, which will begin in the fall of 2006. For more information, go to www.icle.org.

Business Law Journal. The *Business Law Journal* is published three times a year in conjunction with ICLE. As a Section member, you will receive the *Journal* by mail, and it is also available on our Web site. The *Journal* offers interesting and informative articles on topics of interest to business lawyers, including regular columns such as "Did You Know?" by G. Ann Baker and "Technology Corner" by Michael Khoury. If you are interested in submitting an article (or an idea for an article) to be considered for an upcoming issue, please contact Daniel Kopka at ICLE. If you have any other questions or comments about the *Journal*, please contact our Publications Director, Robert Wilson.

Stephen H. Schulman Outstanding Business Lawyer Award. The Section has established the Stephen H. Schulman Outstanding Business Lawyer Award. The Award, given annually, seeks to honor the Michigan business lawyer, who, over his or her career, consistently exemplifies the characteristics the Section seeks to foster and facilitate, namely: the highest quality of professionalism, the highest quality of practice, an unwavering dedication to service, and the promotion of ethical conduct and collegiality within the practice. Normally, the Award will be given to one attorney annually. However, the Section has decided to recognize four well-deserving individuals for 2006, the Award's inaugural year. We are proud to announce that this year's recipients are James C. Bruno, Hugh H. Makens, Cyril Moscow, and Martin C. Oetting. The Section will honor this year's recipients at the Annual Meeting in September. The Section will also hang a permanent plaque honoring the Award's recipients at the State Bar of Michigan headquarters in Lansing.

Small Business Forum. The Section has recently established a Small Business Forum, chaired by Cynthia Umphrey. The goals of the Forum are to create a bridge between business attorneys and the small business community; to provide resources and networking opportunities between attorneys, CPAs, lenders, investment bankers, financial professionals, and related advisers; to provide efficient, educational, and fun events; to create the perception of lawyers as valuable members of a business team; to improve the perception of Michigan as a good environment in which to do business; to help attorneys gain new tools and contacts to provide quality service to business owners; and to develop outreach opportunities to the business community. The Forum held a kickoff event on June 15 at the Community House in Birmingham. The event was a great success, with over 60 lawyers and others from the business community in attendance. For more information on the Forum, visit the Section's Web site, at www.michbar.org/business.

Finally, I'd like thank our officers—Michael Khoury, Mark High, and Diane Akers—as well as our members who have agreed to serve on our council, committees and directorships, for their efforts on behalf of the Section. We are extremely fortunate to have such talented and energetic people working on the Section's behalf. I thank you for your continued interest and support. I hope you will become as active as possible, and I encourage you to take full advantage of all the activities that the Section offers.

Sincerely,

Eric I. Lark, Chairperson 2005–2006

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Announcing the Launch of the State Bar's Practice Management Resource Center

As President of the State Bar of Michigan, I am proud to introduce a new membership benefit: the Practice Management Resource Center (PMRC). This program will assist members in effectively and efficiently managing the business component of practicing law. It is designed to help attorneys manage everything from outfitting an office with the latest software that integrates time accounting, billing, and account management, to effectively marketing one's practice.

The PMRC is accessible through the State Bar's Web site, at http://www.michbar.org/pmrc/content.cfm.

The PMRC contains different sections of information. The Resources section provides electronic access to articles, features, and forms on a variety of topics, such as business development, financial management, and calendaring and docket control. The Legal Software Directory contains links to dozens of vendors offering software applications to assist members in the day-to-day management of a law practice. And in the near future, a lending library will be available for members to search law practice management publications, tapes, CDs, and other resources. Members can then request those resources online or at the State Bar of Michigan Building, located at 306 Townsend Street in Lansing.

The PMRC also includes a Helpline, which is accessible by phone, at (800) 341-9715, or by email, at pmrcHelpline@mail.michbar.org. The Helpline is a confidential, informal service designed to quickly assist SBM members with practice management issues. Members accessing the Helpline can receive practical guidance, suggestions, referrals, and information on a variety of practice management topics from a practice-management adviser.

In addition to the Web site, the PMRC has an on-site Educational Center located in the Bar's Lansing headquarters. The Educational Center offers programs on a variety of topics, including hands-on software demonstrations on an informal, individual basis. For example, members and their staff can test legal software in such areas as case management, time accounting, billing, and calendaring functions. To ensure that members statewide can enjoy this new service, we are taking the program on the road to both Grand Rapids and Marquette. Bar associations interested in scheduling a program in their area should contact the PMRC Helpline.

The State Bar strives to be responsive to its members' needs. The PMRC was established in direct response to lawyers asking for help in keeping up with changes in technology, streamlining the way they practice, and enhancing the service they provide their clients. Many members in larger firms are simply trying to keep abreast of the tools available; others have undertaken career moves as a result of market changes or quality-of-life choices and are starting solo and small firms midway through their legal careers. The PMRC is designed with both sets of needs in mind, providing practical guidance and useful resources for everyone.

I invite you to visit our Web site, and to call or send an e-mail letting us know what you think.

Thomas W. Cranmer is President of the State Bar of Michigan.

THE PRACTICE MANAGEMENT RESOURCE CENTER

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DID YOU KNOW? By G. Ann Baker

Two Additions to FILEOnline Service

In March, the Corporation Division of the Michigan Bureau of Commercial Services expanded the online filing of corporation annual reports to include the 2006 domestic profit corporation annual reports. The 2006 nonprofit corporation annual report may be filed online after July 15, 2006. Submissions via the Internet have been increasing as the public has gained awareness of the new online options. The agency is now working with the Department of Information Technology to further expand online filing to include professional service corporations and professional limited liability companies (LLCs).

Corporation, LLC, and limited partnership documents may now be e-mailed as attachments to CDfilings@michigan.gov. Documents may be Microsoft Word, Excel, or PDF files. When a document submitted by e-mail is endorsed as "filed," the document and endorsement page are returned to the submitter by fax. Fees are paid using a credit card and a MICH-ELF filer account. A MICH-ELF cover sheet, BCS/CD 900, should be included with the document, along with an Expedited Service Request, BCS/CD 272, if expedited service is needed. For non-expedited documents, customers may submit their application for a MICH-ELF filer account with the document to be filed. First-time users, however, should obtain a MICH-ELF filer number before submitting a document for expedited service.

Credit Card Security

The Corporation Division has been working with the Department of Information Technology and the Department of Treasury and to make the credit card numbers of MICH-ELF filer accounts more secure. The entire credit card number is now encrypted, and the agency uses another number that is unrelated to the card number to complete filer transactions. If a credit card is declined, staff can verify all information except the card number. In May 2006, Michigan received an award from the International Association of Commercial Administrators for implementing a more secure credit card system.

The MICH-ELF program was also modified to simplify the fee-collection process and reduce the time it takes staff to complete a transaction.

When any of the filer information changes, customers should submit an update to their filer account. To avoid delays, information should be updated before a request for expedited service is submitted.

Restricted and Prohibited Words

Over the course of the last two years, the Corporation Division has been reviewing and updating the information used to determine whether particular words or phrases in an entity name are restricted or prohibited. Statutory cites and other information on the list were verified, and content was revised or deleted as needed. The Department of Information Technology used the revised list to update the name availability program used by Corporation Division staff. The name availability program will also be added to the Business Entity Search.

Links to applicable statutes have been added to the list of restricted words. The revised list is posted under "Publications" on the new Bureau of Commercial Services Web site. The URL is unchanged (http://michigan.gov/cis/0,1607,7-154-10557-25407--,00.html), but if you bookmarked "Business Entity Search" or other pages as favorites, those links will need to be updated. In addition to the links to related state and federal statutory provisions, the revised list contains internal links to related words and phrases.

The Restricted Words list may be used to determine whether a name selected by a client contains any words that may be restricted or prohibited by law. The links will provide quick access to the specific statutory restrictions and will be useful in helping clients select names that have a low probability of being rejected. The Bureau's list, however, does not include all of the words that may indicate or imply a purpose other than a purpose permitted by the articles of a particular entity.

After determining that the preferred name does not contain restricted or prohibited words, the Business Entity Search can be used to determine if another entity is using the same name. Searching the online database by entity name, excluding the required word (e.g., "Inc."), provides the quickest way to determine if a name is available; if a search is done on a name that contains one required word, identical names containing a different required word may not be displayed.

GAO Report on Corporations and Limited Liability Companies

Between October 2005 and February 2006, the Government Accountability Office conducted a Web-based survey in the fifty states and the District of Columbia about corporations and LLCs. The GAO submitted a report based on the survey results to the United States Senate's Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs. U.S. Senators Carl Levin (D-Michigan) and Norm Coleman (R-Minnesota) released the report to the public on April 25, 2006.

The survey collected information about the process of forming a corporation or LLC, methods for submitting documents, the number of entities formed, the benefits of forming corporations and LLCs, and the kinds of information that the states collect. The survey was conducted because of concerns about the use of "shell" companies and the criticism that some states collect only minimal information about corporation and LLC owners. The GAO found that most states do not collect ownership information for corporations or LLCs. It also found that, although states require statutory requirements to be

met before a document is filed, they do not verify the identity of company officials.

According to the GAO report, "Federal law enforcement officials are concerned that criminals are increasingly using U.S. shell companies to conceal their identity and illicit activities." The report indicates that officials would like more information about company owners. As Senator Levin said in a press release, "We ought to know who is behind U.S. companies doing business in our country, but right now we don't…. Today people have to supply more information to get a driver's license than to form a company."[1]

The full GAO report is available at http://www.gao.gov/new.items/d06376.pdf. An electronic supplement, including a link to the survey, is available at http://www.gao.gov/special.pubs/gao-06-377sp/index.html.

Acupuncture

On February 22, 2006, Governor Granholm signed Senate Bill 351, adding Part 165 to the Public Health Code[2] to create a board of acupuncture and provide for the registration of acupuncturists. The bill, Public Act 30 of 2006, is effective July 1, 2006.

New section MCL 333.16501(a) defines "acupuncture" as "the insertion and manipulation of needles through the surface of the human body at specific locations on the human body for the prevention or correction of disease, injury, pain, or other condition." MCL 333.16501(b) defines "acupuncturist" as "an individual who practices acupuncture and is registered, or otherwise authorized, under this part."

The Department of Community Health's Web site[3] indicates that acupuncturist registrations will not begin until the administrative rules have been developed and approved. The Department anticipates that the first applications and registrations will not occur before January 2008. As information about the new rules becomes available, the Department will post it online, at http://michigan.gov/mdch.

Attorney General Opinion number 4832, dated February 13, 1975, stated that acupuncture was within the practice of medicine. The Michigan Court of Appeals in *Cherry v State Farm Mutual Auto Insurance Co.,* 195 Mich App 316, 489 NW2d 788 (1992), held that acupuncture could only be performed by licensed physicians. Public Act 60 of 1999 amended MCL 333.16215(3) within the Public Health Code to specifically provide that a physician could delegate acupuncture to someone under his or her direct supervision.

Corporations and limited liability companies have not been permitted to be formed to provide acupuncture services to the public or to use a name that implies that they provide acupuncture services unless they are formed by a physician as a professional service corporation or a professional LLC. It is unclear at this time whether 2006 PA 30 is intended to permit a registered acupuncturist to provide acupuncture services directly to the public without supervision by a physician. The Bureau of Commercial Services will work closely with the Department of Community Health to clarify this issue. As further information becomes available, it will be posted at http://michigan.gov/corporations.

NOTES

1. Senate Committee on Homeland Security and Governmental Affairs, "Levin-Coleman Release Report—GAO Report Finds Anonymous U.S. Companies Pose Risk," press release, April 25, 2006, http://hsgac.senate.gov/index.cfm?Fuseaction=PressReleases.View&PressRelease_id=1234&Affiliation=C.

2. 1978 PA 368.

3. http://michigan.gov/documents/mdch_acupunturistannounce_151758_7.pdf.

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The Tax Increase Prevention and Reconciliation Act of 2005

Introduction

On May 17th of this election year, President Bush signed into law the Tax Increase Prevention and Reconciliation Act of 2005 (the Act), Pub L No 109-222. It will affect tens of millions of Americans in their individual capacities, as well as all of your clients who own interests in businesses via pass-through entities such as S corporations, LLCs, and other entities that are taxed as partnerships. The Act also contains very narrowly targeted provisions for corporations and for the international taxation of corporate entities. It is an unusual piece of legislation: the Act extends the provisions of this Administration's prior tax acts that were set to expire in 2008 or sooner, and it introduces some new and unrelated provisions.

Individual Provisions

Facing a political backlash from the millions of Americans set to pay the alternative minimum tax (AMT) for the first time, Congress increased the 2006 tax exemptions to $62,550 for married taxpayers and to $42,500 for unmarried individuals. Before the Act, those 2006 amounts would have been only $45,000 and $33,750, respectively. The Act also amended the non-refundable personal tax credits that may be claimed to the full extent of an individual's regular or AMT liability.

Before the Act, the current 15% rate cap on both non-corporate long-term capital gains and dividend income would have expired after 2008. The Act extends these reduced rates to 2010. This will be helpful for the tax community, where there had been considerable uncertainty about what would happen to those rates with a flip in party control of both houses of Congress and the presidency in 2008. Now, when planning for investments and the disposal of assets, one can expect that the current law will likely continue through 2010.

A related provision extends the period for a 0% tax on adjusted net capital gains that would otherwise have been taxed at 10% or 15% of ordinary income. Before the Act, this rule was to be in effect only during 2008. Under the Act, the 0% rate on such capital gains will be in place from January 1, 2008, through December 31, 2010.

Another related amendment addresses the interplay of AMT and adjusted net capital gain. A complicated series of provisions detailed in IRC 55 was designed to provide, effectively, that the 15% capital-gain rate cap would apply for AMT purposes as well as for regular income tax. These provisions would have expired at the end of 2008, but the Act extends them through 2010. Further, the current IRC section 179 expensing cap of $100,000 that was to have reverted back to $25,000 in 2008 is extended under the Act through 2010.

Paying for the Act

While taxpayers will likely enjoy these benefits, Congress must raise the revenue to pay for them. One solution likely to affect many Americans is that, beginning in 2006, the "Kiddie Tax" that applies to children under 14 will instead apply to all children under 18 years of age. Another change that will affect many individuals is the elimination, beginning in 2010, of the $100,000 modified AGI cap on Roth conversions. This is estimated to cost the Treasury Department about $447 million over the first five years, but to raise $6.432 billion over the subsequent ten years.

Under the Act, struggling taxpayers seeking an Offer-In-Compromise (i.e., settling payment of federal tax liabilities not in dispute for less than 100 cents on the dollar) will be required to make a payment up front for the Offer to be considered by the IRS. A payment of 20% is necessary for consideration of a lump sum offer. This is a radical departure from past practice, and it is expected to raise $1.9 billion.

Beginning in 2006, information reporting will be required for interest paid on tax-exempt bonds. This will enable the IRS to investigate whether a party with substantial interest income from tax-exempt bonds had income from capital transactions or high income in the past, such that the principal could have been acquired on after-tax income. Tax practitioners expect this to produce some interesting IRS examinations.

A controversial and complex set of new rules will require 3% withholding on many federal, state, and local government payments for services on property. There are complicated exceptions for welfare payments and needs or income-tested benefits, among others. The change is projected to raise $7 billion.

The Act also includes a number of other highly technical corporate provisions. The S corporation liberalization provisions were stricken from the bill in the Senate.

While many of this election-year tax legislation's provisions do not take effect for some time, one should become acquainted with the Act's provisions now. The extension of the historic low rates on dividends and capital gains for non-corporate taxpayers offers greater stability for investment and planning purposes. How long some of these extensions will last, however, may depend on the composition of the next Congress.

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By Michael S. Khoury and Arthur H. Siegal

End-of-Life Decisions (For Your Computer Equipment)

Introduction

The disposal of computer equipment has generated much discussion, controversy, and press in recent years. When advising your clients on the right way to deal with disposal issues, two areas deserve special attention: (1) the environmental effect of the physical disposal of the equipment, and (2) the software licensing, data privacy, and confidentiality issues surrounding the software and information that reside on the computer system's hard drive.

Environmental Liability Issues

Businesses and individuals have found many ways to deal with obsolete computer equipment. Solutions vary from the local garbage dump to passing down the equipment to others. However, the disposal of any asset that may have environmental liabilities associated with it should be addressed carefully.

The magnitude of the problem is significant. According to the United States Environmental Protection Agency, computers and mobile phones are being discarded at the rate of 130 million per year. "In addition to lead, electronics can contain chromium, cadmium, mercury, beryllium, nickel, zinc, and brominated flame retardants. When electronics are not disposed of or recycled properly, these toxic materials can present problems."[1] Proper recycling and disposal of electronic waste has become imperative. The days of disposing of these assets in landfills or of shipping them to foreign destinations are hopefully coming to an end.

Disposal of any item that includes hazardous substances can give rise to liability pursuant to the Comprehensive Environmental Response, Liability and Compensation Act (also known as CERCLA or Superfund)[2] and its state-law counterparts. If the volumes are significant enough, liability under the cradle-to-grave hazardous waste management statutes found in both federal and state laws can also result in liability. These laws have broad provisions that may impose liability with little opportunity for defense. Proper recycling and disposal is key to ensuring that the substances in the electronics do not wind up in the environment, and that the business doing the disposing does not wind up in court.

Businesses have adopted a number of approaches to properly recycling and disposing of obsolete computer equipment. Some address the problem as part of the acquisition process, while others wait until it is time to dispose of the assets.

Equipment Leasing

While equipment leasing has normally been thought of as a financing vehicle, the fact that the assets are returned to the lessor at the end of the lease term also provides an easy option for companies looking to pass on the disposal obligations to a third party.

Resale of Computer Equipment

Another option, although not logistically desirable for large businesses, is to sell or give away the equipment at the end of its useful life. It is not uncommon to see equipment that has lived out its useful life for a business winding up in the home office of a person who does not need a powerful network computer. Notebook computers are commonly sold on the secondary market, but desktop computers, monitors, and servers generally become obsolete and have no further use for others.

Contracting for Proper Disposal

One best practice often used by businesses is to contract for the proper disposal and recycling of computer equipment at the end of its useful life. There are both nonprofit and for-profit entities that will accept electronics for recycling, sometimes with a small charge. An important caveat to this process is that the user of the computer equipment should ensure that the disposal operator is actually going to perform what it has agreed to do, and not simply take the money and dispose of the equipment improperly.

Recycling

An exciting new trend is the introduction of manufacturer and retailer take-back programs similar to Michigan's Bottle Bill. Under these programs, manufacturers agree (or are obligated) to take back the products they produce or sell, and then are responsible for recycling and disposing of them. These programs may be free to the user or funded at the outset or back end. So far, several states (California, Maryland, Massachusetts, and Minnesota) have considered this approach or enacted pilot programs, but whether government-mandated programs will catch on or the private market will meet the needs of the business community remains to be seen. In either case, manufacturers should consider processes that will make recycling an easier and more desirable option.

Software and Data

Software and data that are stored on computer systems represent privacy, licensing, and confidentiality issues for the user company. For example, consider a personal computer that had the Microsoft Windows operating system installed at the factory and Microsoft Office installed at the company—based on a proper license acquired by the company—where it was used for tracking personnel and other confidential information.

Software Licensing Considerations

In this example, the software license for the operating system is probably licensed to that specific machine and cannot be installed on another computer without violating the license. The software for the MS Office application software, however, is likely licensed to the company for use on a specific number of machines it leases or owns. Allowing the computer to be

sold or removed from the company's possession with the software intact would probably violate the license agreement. Uninstalling the software from that computer would allow the company to install the Office software on a new computer, which is permissible under most enterprise licensing arrangements.

Data

Information stored on a company computer is often subject to a number of privacy and confidentiality considerations related to human resources, personal health, or financial information.[3] The data may also contain company proprietary or trade secret information, and ensuring their proper deletion is critical.

When discussing deletion of data, the novice computer user may think that finding the file and hitting "Delete" is sufficient. That is far from the truth. Deleting a file this way only deletes the information location on the hard drive (the storage device), while the actual data remain on the computer.

Destruction

If the computer is to be permanently retired from service, the best practice for the company is to ensure that the hard drive is properly erased or physically destroyed. A sledgehammer is also a good way to ensure that data cannot be recovered from the hard drive and that the software cannot be illegally used by another user.

Reuse Protections

If the company intends to maintain the usability of the equipment and resell or otherwise allow others to use it, there are two primary processes used. The first method is to completely "format" the hard drive, which essentially erases everything in storage. You can then reinstall the operating system software and any other software that was licensed just for that computer. The second method is to uninstall the software that is licensed to the company and delete any data stored on the computer. Then, the best practice is to use a tool to write over the data and uninstalled software so that they cannot be accessed later. In each of these methods, other users can use the physical computer without data or software, or perhaps just the operating system software. This protects the company from the breach of information privacy or release of proprietary information, or the illegal use of software in violation of the company's license.

NOTES

1. United States Environmental Protection Agency, "eCycling," http://www.epa.gov/ecycling.

2. 42 USC 9601 et seq.

3. Such as the Health Insurance Portability and Accountability Act of 1996 (HIPAA) or the Gramm-Leach-Bliley Act (GLB).

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Contractual Supply Disputes in the Automotive Industry: Lessons Learned

By Thomas S. Bishoff, Benjamin W. Jeffers, and Laura C. Baucus

Introduction

This is a familiar scenario for attorneys representing players in the automotive industry: You receive an urgent phone call from your client, an automotive supplier whose customers are Tier 1s and Original Equipment Manufacturers (OEMs),[1] explaining that its own supplier is threatening to stop shipments of a key component part within two days unless your client agrees to pay a steel surcharge on top of the existing contract price. An interruption in supply would be devastating: the supplier is the sole source for the part, and in this just-in-time industry your client only keeps a couple of days' worth of inventory on hand. Such an interruption could shut down your client's manufacturing process and possibly its customers' operations as well. Your client believes that the price in the agreement is fixed, with no legal justification for a demand to raise it. The supplier, meanwhile, has stated that dramatic increases in the cost of steel have left it with no choice but to demand a price increase. While it is willing to absorb some of the raw-material cost impact, the supplier would lose money on every part it sells unless it passes along the rest. The supplier justifies its demands under several legal theories, including section 2-615 of the Uniform Commercial Code (UCC), MCL 440.2615, which deals with commercial impracticability. The supplier adds that the documents comprising the parties' contract are sufficiently unclear that they insulate the supplier from claims that its demand constitutes a breach.

In an industry in which long-term supply relationships are the norm, such supply disputes have become common. Adverse market conditions have created an environment in which suppliers are willing to breach contracts and threaten interruptions in shipments unless buyers accede to their demands. Buyers in turn are faced with what a judge in a recent opinion aptly described as a "Hobson's choice"—to accept the price increase or face the prospect of a devastating cessation in shipment.[2] This article will describe eight lessons learned from such disputes and provide tips for lawyers on how to guide clients through them.

Lesson 1: Sellers have significant practical leverage, even when they may have a weaker legal position.

Buyers typically hold the bargaining power at the onset of a contractual relationship, and they will use that power to force sellers to accept their standard contract terms and conditions. Such terms often require sellers to supply the particular part through a set termination date or for the life of the part or the "program."[3] Part prices are fixed, and suppliers are not permitted to unilaterally adjust them for any reason, including an increase in production costs. However, although buyers appear to be legally in control, in reality the sellers enjoy a great deal of leverage when it comes to negotiating supply disputes in the automotive industry. There are at least two reasons for this.

First, the stakes are extremely high. Because of the sole-source supply and just-in-time delivery systems used in the automotive industry, a seller's threat to stop shipments leaves a buyer with few options. Comparable parts generally are not available on the open market, and it can take months or even years to validate a new seller's production of the same or similar parts through the industry standard Production Part Approval Process (PPAP). Acceding to the seller's demands may be the only viable way to prevent a costly business disruption and ensure a safe source of supply. Sellers know that buyers are stuck in a difficult position.

The second reason that buyers lack leverage is that time is of the essence when a seller threatens to stop shipments, and obtaining an immediate court order compelling continued performance is not always easy. Buyers must file a lawsuit and seek injunctive relief, first in the form of a temporary restraining order (TRO) and then through a preliminary

injunction.[4] The burden on the moving party is high, particularly when it seeks so-called "mandatory" injunctive relief.[5] The moving party must demonstrate, among other things, that it will suffer irreparable harm if the court does not grant the injunctive relief and that it has a substantial likelihood of prevailing on the merits.[6]

The ability to demonstrate irreparable harm, i.e., harm that cannot be remedied by money damages, at first seems obvious. The buyer can argue that unless the court issues an injunction and orders the seller to continue shipping goods, the buyer and its customers will have to shut down their plants, causing massive and incalculable damage. Several Michigan courts have recognized the potential harm to buyers that can result from a sole-source, just-in-time seller not shipping parts,[7] and they have granted preliminary injunctions.[8]

Because of the sole-source supply and just-in-time delivery systems used in the automotive industry, a seller's threat to stop shipments leaves a buyer with few options.

Not all courts, however, agree that irreparable harm exists. Buyers may have the ability to pay the increased price demands "under protest,"[9] only to later sue the seller to recoup the difference between the contract price and the new price. Having the practical ability to maintain its source of supply means that a buyer can prevent the very harm that it otherwise claims would be irreparable.

This argument convinced the court in *ThyssenKrupp Fabco Corp v Heidtman Steel Products, Inc.*[10] to deny a request for a preliminary injunction. Because the buyer had "not shown that it was unable to presently bear the cost requested" by the seller, and because the seller was willing to ship at the higher prices, the court found that the threatened harm might not come to pass. The buyer argued that without a preliminary injunction it would be forced to "finance all of its suppliers who demand prices above what their contracts specify." The court was unmoved, however, finding that this was not, in fact, the situation and that this "parade of horribles" had not occurred.[11]

In short, buyers face uncertainty when developing a legal strategy, because obtaining an injunction is not guaranteed. This very lack of certainty when the buyer needs it most may dissuade some buyers from pursuing their short-run legal options.

Lesson 2: Paying the demanded price increases under protest and suing later to recoup the money can be effective if buyers are patient and pick their battles.

Paying the seller's demanded price increase under protest may be the only way to ensure continued supply in the short term. A recent decision confirms that buyers can, in fact, get their money back if they pursue this strategy. In *Chainworks, Inc v Webco Industries,*[12] defendant was a supplier of steel tubing. Despite the existence of a fixed-price supply agreement, defendant demanded steel surcharges from plaintiff due to the dramatic rise in the cost of raw materials. Plaintiff acceded to the demands but expressly stated that it was doing so "under duress and reserv[ing] all rights and remedies."[13] Near the expiration of the parties' contract, plaintiff withheld from its final payment the difference between the prices it had paid under protest and the prices stated in the contract. Plaintiff then filed a declaratory judgment action seeking an order confirming that its behavior had been appropriate. Defendant filed a counterclaim, asserting that it was justified in seeking the price increase and that plaintiff had legally "agreed" to the new prices. Defendant relied on MCL 440.2207 (battle of forms) and 440.2615 (commercial impracticability).

The court disagreed with each of defendant's arguments and granted plaintiff summary judgment on its claims and defendant's counterclaim. The court found that the contract contained fixed prices, that the mere demand for price increases constituted a breach of the contract, and that plaintiff's payment under protest did not amount to an "acceptance" of the new terms.[14] Following a long line of Michigan and federal cases, the court also rejected defendant's argument that financial concerns constituted sufficient grounds to rely on the defense of commercial impracticability.[15] Noting that a "deal is a deal" and that defendant had breached it, the court wholly endorsed plaintiff's legal position. The *Chainworks* case, therefore, provides a road map for buyers who have little choice but to pay price increases under protest and who do not wish to give up their legal rights to recover the money at a later time.

Lesson 3: Buyers should shape the facts early in a pricing dispute.

There are several pre-litigation steps that can make a significant difference in a pricing dispute. Once a seller has threatened to stop shipments, buyers should send a letter seeking adequate assurances that the seller will perform. The letter should explain that the buyer considers the mere demand to increase prices and the threat to stop shipments to be a breach of the parties' contract, and it should solicit the seller's rationale for its position. The letter should also note that the buyer has no other source of supply, and that the seller's threatened actions would cause extraordinary consequences, including irreparable harm both to the buyer and its customers.

Such a letter is important for two reasons. First and foremost, seeking assurance may effectively be a prerequisite to suing for anticipatory repudiation under UCC 2-609.[16] If the buyer eventually needs to seek a TRO, then it likely will do so before the seller actually stops shipments and, depending on the circumstances, bringing a claim for anticipatory repudiation may make more sense than a breach of contract claim. Second, it is likely that the buyer's letter will provoke a written response. Regardless of what justification the seller may give for its position, if the seller simply acknowledges in writing that it has threatened to stop shipments, it will have provided the buyer with a valuable piece of evidence for when it goes to court.

Lesson 4: Buyer's counsel should be prepared to act quickly.

As the lawyer for the buyer facing the shutdown, time is of the essence when you receive the phone call from your client. If the seller is serious about its threats, your client may need to seek a TRO in a matter of hours or days. To be prepared to do this quickly, attorneys should keep on file a list of questions they can e-mail their clients as soon as they learn that a supplier dispute is brewing. Thus the lawyer can quickly identify or obtain the following:

- the documents that make up the contract, e.g., purchase orders, nomination contracts, letters of intent, invoices, releases, and terms and conditions;
- a description of the parts at issue and how they are used by the client's customers, including any facilities that will be affected if there is a cessation of shipments;
- the number of days' worth of inventory the client has of the parts at issue;
- confirmation that the parts are delivered on a just-in-time basis, that the supplier is a sole-source supplier, and that the parts are unique;
- the length of time it would take to get a new supplier to make the same parts, i.e., the PPAP time for the parts at issue;
- all communications between the parties concerning the dispute;
- the name of the individual (usually the purchasing manager) who has sufficient contract knowledge to sign an affidavit and verify a complaint.

At a minimum, being able and willing to go to court immediately will give the buyer some measure of leverage in negotiating a resolution to the supply dispute with the seller.

Lesson 5: Insist on clarity in the contractual terms to avoid disputes in the first place.

Sometimes, both parties to an automotive industry contract will sign a detailed written supply agreement that contains unambiguous terms. More often in this industry, however, the contract will consist of multiple documents that are exchanged over a period of time and that are not signed by anyone. Unfortunately, ambiguity in the contract documents can be fatal to a short-term litigation strategy, because clarity usually favors the party that wants to enforce a contract in court, particularly where the moving party seeks a TRO and a preliminary injunction. While a "battle of forms" theoretically can be litigated successfully over the course of a lawsuit about damages, such a dispute will usually lessen one's chances of proving that the moving party has a substantial likelihood of prevailing on the merits and will thus weaken the ability to obtain injunctive relief in the short run. The lesson here is right out of Contracts 101: To reduce the likelihood of a dispute during the course of performance, the parties must in the beginning clearly state their intentions in writing. They then must monitor the contractual relationship to ensure that there are no unintended modifications or waivers. Even the most desperate seller may pause before threatening to stop shipments if it cannot proffer a colorable story that the contractual relationship allows for its actions.

Once a seller has threatened to stop shipments, buyers should send a letter seeking adequate assurances that the seller will perform.

Lesson 6: One-sided contracts may not be the answer.

While the buyer may insist on clarity in a contract, it may also be tempted to include its own terms and conditions, with buyer-friendly language and provisions. However, this may create unintended problems. Consider, for example, a contract that purports to bind the seller but that simultaneously gives the buyer unilateral discretion to terminate the deal at will. Such provisions are common in requirements contracts, and they make some sense because the buyer might not know how many products it will need or for how long, since it is subject to the whims of its customers. However, these provisions are potentially unfair to the seller, which will have incurred start-up and investment costs that it might not be able to recoup if the contract is terminated prematurely. Unfortunately, there is no certainty that Michigan courts will enforce a requirements contract that allows the buyer to unilaterally terminate the relationship.

Being able and willing to go to court immediately will give the buyer some measure of leverage in negotiating a resolution to the supply dispute with the seller.

For example, in *General Motors Corp v Paramount Metal Products Co*,[17] defendants argued that GM's purchase orders were unenforceable as requirements contracts because GM had the right to terminate the purchase orders at will. The court disagreed. It ruled that the contracts were enforceable and were not "unconscionable" as long as GM exercised "good faith" in performing and in deciding to terminate.[18] It appears that the court felt that GM truly intended to perform and buy all of its requirements from the buyer and that a change in circumstances provoked the termination.[19] This was a decision in favor of buyers: the court enforced the parties' deal as is, showing that it clearly understood how business is conducted in the automotive industry.

In contrast, the Michigan Court of Appeals in *Acemco Automotive v Olympic Steel Lafeyette, Inc.*[20] held that a supply agreement between an automotive supplier and its steel supplier was unenforceable because it contained no set quantity to be purchased; instead, the amount would be as requested by the buyer in periodic releases. The court held that the contract was not a requirements contract, even though the contract documents used the word "blanket" and a previous decision by the court of appeals held that a "blanket order" satisfied the "quantity" requirements of the UCC.[21]

A court may also refuse to decide the issue of whether an enforceable contract exists and leave the matter to a jury. In *Schefenacker Vision Systems, USA, Inc v Depco International Inc*,[22] because quantities were set by releases and the buyer could terminate at any time, the court denied a motion for summary judgment and ruled that there was an issue of fact as to whether the contracts were requirements contracts.

The *Acemco* and *Schefenacker* decisions reveal the risks of relying on terms and conditions that allow only the buyer to terminate. To mitigate these risks and obtain a result more in line with the *Paramount* decision, buyers should consider the following:

- establishing a track record of good-faith purchases from the seller before considering termination;
- adding a provision in the terms and conditions that gives the seller time to match pricing if the buyer finds better pricing elsewhere and wants to terminate for that reason;
- including a minimum quantity amount in the contract, with no guarantees beyond that. Thus, if the buyer decides to terminate, a court can rely on the fact that the buyer promised to buy something and that its obligations were not simply illusory;
- making sure that the terms and conditions give the seller the right to make a claim for work in progress and raw material purchases in the event that the buyer terminates.

Lesson 7: Commercial impracticability rarely justifies the seller's actions.

At least one issue in these supplier disputes seems relatively settled: the "commercial impracticability" defense rarely works.[23] Courts in Michigan have uniformly rejected the argument that an increase in raw material prices alone justifies a seller breaching a fixed-price contract. The *Chainworks* case, discussed above, is the most recent example.[24] Indeed, noted commentators White and Summers, in their treatise on UCC law, state that (1) courts have favored buyers on this issue; (2) in their view, "a seller should never be excused from its obligations because of cost increases;" and (3) "an increase in price, even a radical increase in price, is the thing that contracts are designed to protect against."[25]

Lesson 8: Educate your client in advance.

Ideally, lawyers should help their clients understand even before disputes arise how these issues tend to play out. For example, giving your client's purchasing department personnel a short tutorial on how UCC 2-207 (the "battle of forms") works will help them spot issues before they become problems, such as when the other party attempts to incorporate its own terms and conditions into an agreement. Because memories fade and employees leave, clients should also get into the habit of documenting a contractual dispute in correspondence with the other side and creating a record of the issues. Having a written record of your client (1) objecting to the other side's position, (2) giving notice of its own position, and (3) advising the other side of potential breaches will be invaluable if and when the dispute lands on your desk. If litigation is unavoidable, then you as the attorney will be ready to proceed much faster if the client is aware of the issues.

Conclusion

The number of supply disputes over the last several years has risen largely because of the increased cost of raw materials. Even if the markets for steel, resin, and oil were to stabilize, however, these disputes would likely continue. Recent press reports reveal a trend toward downsizing the number of component suppliers that Tier 1s and even OEMs will use,[26] and faced with a lack of future business from a given buyer, a seller might be more willing to bite the hand that had previously fed it.

Litigation, however, is not inevitable. If your clients are knowledgeable about the issues that arise in these supply disputes, they will be in a better position to manage their contracts and personnel in a way that minimizes the risks. Likewise, if their lawyers are ready to react to disputes at a moment's notice, they can help develop a strategy that best matches the client's business objectives. Whether through litigation or arrangements to pay surcharge demands "under protest," it is possible to help a client ensure the continuation of supply while protecting its rights to later recoup improper surcharges or price demands.

NOTES

1. In the context of the automotive industry, an OEM refers to a company that manufactures and assembles vehicles for sale to dealers and customers, such as General Motors Corporation, Ford Motor Company, and DaimlerChrysler Corporation. Tier 1, Tier 2, and Tier 3 suppliers refer to various levels of suppliers that manufacture products in the automotive industry supply chain. A company that sells goods directly to an OEM is considered a Tier 1 supplier, a company that sells goods to a Tier 1 supplier is a Tier 2 supplier, and a company that sells goods to a Tier 2 supplier is referred to as a Tier 3 supplier.

2. *See Chainworks, Inc v Webco Indus,* No 1:05-CV-135, 2006 US Dist LEXIS *25 (WD Mich Feb 24, 2006).

3. The life of the part ends when the OEM terminates production of the vehicle model in which the part is incorporated or when the part is no longer needed due to engineering changes in the vehicle. In the context of the automotive industry, "program" is a general term used to define a group of major automotive components manufactured and assembled by an OEM, incorporating various products from downstream suppliers.

4. *See* MCR 3.310.

5. *See L&L Concession Co v Goldhar-Zimner Theatre Enters, Inc*, 332 Mich 382, 51 NW2d 918 (1952).

6. *See Fruehauf Trailer Corp v Hagelthorn*, 208 Mich App 447, 449, 528 NW2d 778 (1995).

7. *See, e.g., Kelsey-Hayes Co v Galtaco Redlaw Castings Corp,* 749 F Supp 794, 798 n7 (ED Mich 1990) ("A supplier's failure to make scheduled shipments may have immediate and dramatic consequences…. Thus, a breach of contract in the automotive industry may be more coercive than in other industries"). *See also In re Autostyle Plastics, Inc,* 216 BR 784 (Bankr WD Mich 1997).

8. *See, e.g., Intertec Sys, LLC v Multimatic, Inc,* No 04-CV-73661 (ED Mich Oct 14, 2004) (citing potential shutdown of Ford and Mazda plants if plaintiff did not obtain component parts from defendant); *Key Safety Sys, Inc v Proto Gage, Inc*, No 2004-4173-CK (Macomb Circuit, Oct. 29, 2004) (citing the "domino effect" that could ensue throughout the automotive industry if plaintiff did not obtain parts).

9. *See* MCL 440.1207 (allowing parties to "assent" to a demand made by the other party without waiving their legal rights).

10. No 04-74331 (ED Mich Jan 18, 2005).

11. *Id.* at *9.

12. No 1:05-CV-135, 2006 US Dist LEXIS 9194 (WD Mich Feb 24, 2006).

13. *Id.* at *6.

14. *Id.* at *9–17.

15. *Id.* at *18–23.

16. MCL 400.2609.

17. 90 F Supp 2d 861 (ED Mich 2000).

18. *See id.* at 873–874.

19. *See id.* at 875 (citing *Cardinal Stone Co, Inc v Rival Mfg Co*, 669 F2d 395 (6th Cir 1982) (enforcing termination clause under Ohio's version of the UCC)).

20. No 256638, 2005 Mich App LEXIS 2656 (Oct 27, 2005) (unpublished).

21. *See id.* at *12 (distinguishing *Great Northern Packaging Inc v General Tire & Rubber Co*, 154 Mich App 777, 787, 399 NW2d 408 (1986)).

22. No 03-71183 (ED Mich May 17, 2004).

23. *See* MCL 440.2615 (setting forth the defense).

24. *See Chainworks,* 2006 US Dist LEXIS 9194 at *18–23. *See also Karl Wendt Farm Equip Co v International Harvester Co*, 931 F2d 1112, 1117 (6th Cir 1991) (applying Michigan law; holding that defendant could not assert defense of impracticability to excuse its performance

Courts in Michigan have uniformly rejected the argument that an increase in raw material prices alone justifies a seller breaching a fixed-price contract.

under a dealership agreement notwithstanding expected losses of over $2 million a day, a drop in the company's standing on the Fortune 500 list from 27 to 104, and possible impending bankruptcy); *USX Corp v International Minerals & Chems Corp*, No 86 C 2254, 1989 US Dist LEXIS 1277 (ND Ill Feb 7, 1989) (applying Illinois law; no evidence that decline in price of ammonia or natural gas was non-occurrence that was a basic assumption on which the contract was based); *Eastern Air Lines, Inc v Gulf Oil Corp*, 415 F Supp 429 (SD Fla 1975) (increase in oil prices insufficient to excuse performance); *Publicker Indus, Inc v Union Carbide Corp*, No 74-2185, 1975 US Dist LEXIS 14305 (ED Pa Jan 17, 1975) (substantial increase in the cost of ethylene, the major cost element of ethanol, did not excuse performance); 4 *Anderson, Uniform Commercial Code* § 2-615:69, 644 (1997) ("A seller's supply difficulties do not excuse the seller's performance by virtue of UCC 2-615 where supply difficulties were or should have been within the contemplation of the seller and no reallocation for this potential problem was made by the contract").

25. *See* 1 White and Summers, *Uniform Commercial Code* 4th ed, § 3-10, 172–173 (1995).

26. *See, e.g., Delphi Will Slash 2,850 Suppliers*, Automotive News, March 13, 2006 (reporting on Delphi's purported plans to cut its supplier base to 750 core vendors).

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Enforcement of Shrink-Wrap and Click-Wrap Agreements Under the UCC: Mutual Assent is Pivotal

By Joseph P. McGill and Jill Lynn Zyskowski*

Introduction

This article discusses the significant common law contract requirement of "mutual assent" as applied to mass-market "shrink-wrap" and "click-wrap" agreements. In today's fast-paced world, over 100 million people use the Internet, many of them to buy and sell a vast array of items. While Article 2 of the Uniform Commercial Code (UCC) governs the sale of "goods," it was created over fifty years ago, and its application to online transactions and the sale of "non-goods," including the computer industry's license agreements, has resulted in unpredictability.

Prior Efforts to Standardize

In an attempt to rectify this and keep commerce running smoothly, the American Law Institute (ALI) and the National Conference of Commissioners on Uniform State Laws (NCCUSL) joined forces more than ten years ago to create a uniform body of law governing non-tangible information licenses and mass-market, non-negotiable service contracts, commonly known as "shrink-wrap" or "click-wrap" agreements.[1] The groups proposed a new addition to the UCC: Article 2B, "Law of Licensing of Information," which has been the subject of much debate and criticism.

The NCCUSL continued this effort without the ALI and created the Uniform Computer Information Transactions Act (UCITA). The UCITA's intention was to provide uniform law for software license contracts, online databases, information in digital form, and other intangible products. On July 29, 1999, the NCCUSL sent the UCITA to the state legislatures,[2] but only Virginia and Maryland have adopted it. The act was criticized by a group appointed by the American Bar Association's Board of Governors and seems destined to be virtually ignored as a potential for uniform enforcement among the states.[3]

Thus, at this time there is still some confusion and unpredictability with respect to the enforcement of shrink-wrap and click-wrap agreements. The issue of "mutual assent," however, remains the key to any contract.[4]

Shrink-Wrap and Click-Wrap: What Are They?

A "shrink-wrap" agreement appears in the documentation that comes inside a package. Computer software, for example, is often sold in cellophane shrink-wrap, with the details of the license agreement enclosed in the package. As such, the terms of the agreement are not accessible to the consumer until after the package is opened. This often creates debate and uncertainty as to whether there is mutual assent to the "shrink-wrapped" terms. Regardless of the item or product for sale, mutual assent to the terms is necessary to form an enforceable contract.

In "click-wrap" agreements, the terms of the agreement are displayed on the computer screen and may be read by the prospective consumer at his or her leisure. Thus, many courts have found that a legally enforceable contract is formed when the consumer manifests assent to the terms of the agreement by clicking the mouse on a "Buy" or "I accept" icon on the screen.

Shrink-wrap and click-wrap agreements are becoming increasingly common in mass-market transactions. The terms of the agreement are typically determined by the seller, usually a business entity of some type, leaving the buyer essentially without any bargaining power. The offer is made in a "take it or leave it" manner, in which the buyer must accept and agree to all terms or not buy or use the product being offered. Unlike the traditional, individualized party-to-party contracts, the terms here are not negotiated or bargained for between the parties. However, this does not mean that mass-market

** Mr. McGill wishes to acknowledge the efforts of Jill Zyskowski, formerly a senior associate with Foley, Baron & Metzger, PLLC, whose assistance greatly contributed to the completion of this article.*

contracts lack mutual assent: the buyer still has the power to reject the offer outright and not enter into a contract, or to accept all terms of the offer and thus establish mutual assent to a legally enforceable contract.

Precedent for Enforcing Shrink-Wrap and Click-Wrap Agreements Using the UCC

The Seventh Circuit case of *ProCD, Inc v Zeidenberg*[5] is the seminal precedent for the enforcement of shrink-wrap agreements. In this case, ProCD sold software packages wrapped in plastic wrap, with a notice on the outside indicating that there was a license enclosed imposing usage limitations. One such restriction was that the software was not to be used for commercial purposes. Defendant Matthew Zeidenberg purchased ProCD's software from a retail outlet and violated the shrink-wrap license agreement by reselling the information contained in the software.

Adhesion contracts, wherein the buyer has no power to bargain for the contract terms, may still be enforceable under the UCC.

The court determined that this was an issue of contract regarding the sale of a good and, therefore, the common law of contracts and the Uniform Commercial Code applied.[6] Pursuant to UCC 2-204(1), "[a] contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract." The Seventh Circuit thus determined that the software vendor, ProCD, had a broad right to invite acceptance of its offer in a specified manner. Because ProCD required payment upfront but offered Zeidenberg the chance to read the agreement and return the software if he did not accept the terms, the sale was not only reasonable but also a legally acceptable manner of forming a valid and enforceable contract for a mass-market commercial transaction. This "payment first, terms later" type of transaction for the sale of mass-market goods has been commonly accepted as an efficient way to do business and is used, for example, in the sale of insurance, airline tickets, or medications that contain package inserts providing warnings and other terms and conditions. Such contracts are routinely enforced under the UCC.[7]

Adhesion contracts, wherein the buyer has no power to bargain for the contract terms, may still be enforceable under the UCC if the buyer has an opportunity to read the agreement terms and either accept the goods and the terms of the contract or reject the terms and return the goods. In *ProCD,* the shrink-wrap agreement was upheld as valid and enforceable under the UCC because Zeidenberg had the opportunity to read the agreement and return the software if he did not accept the terms.

In *iLAN Systems, Inc v NetScout Service Level Corp,*[8] the court found that the click-wrap agreement was enforceable, even though its terms were not part of a preexisting purchase order. Plaintiff iLAN purchased defendant's sophisticated software system to use in its business of helping other companies monitor their computer networks. iLAN argued that the purchase order associated with the transaction permitted it to rent, rather than sell, the software to customers; however, NetScout argued that the click-wrap license agreement was contained in the software itself.[9]

The court decided the case based on the UCC, even though the purchase was of a *license* to use the software, rather than a *good*, because the UCC "best fulfills the parties' reasonable expectations."[10] Using UCC 2-204, the court determined that "iLAN manifested assent to the [click-wrap] license agreement when it clicked on the box stating 'I agree,' so the agreement is enforceable."[11] Furthermore, as an alternative ground for its decision, the court found that the additional terms of the click-wrap agreement were enforceable under UCC 2-207[12] because the purchaser was a merchant who implicitly accepted those nonmaterial terms by clicking on "I agree."[13] In short, a contract is no less a contract simply because it is entered into via a computer.[14]

Limitations of Shrink-Wrap and Click-Wrap Agreements

At the forefront of traditional contract law is the notion of a "meeting of the minds."[15] This can be problematic for shrink-wrap agreements because there is no opportunity for negotiation of the terms and the terms are not viewable until after payment.

In *Step-Saver Data Systems, Inc v Wyse Technology*,[16] Step-Saver purchased 142 copies of the Multilink Advanced program between August 1986 and March 1987 from creator TSL. Details of quantity, price, and shipping terms were communicated between the entities via telephone conference and memorialized in a written purchase order sent by Step-Saver to TSL. In return, TSL shipped the order along with a written invoice, which contained terms identical to Step-Saver's purchase order. "No reference was made during

the telephone calls, or on either the purchase orders or the invoices with regard to a disclaimer of any warranties."[17] On the package of each program copy, however, was a "box-top" license agreement that contained five additional terms, including a disclaimer of "all express and implied warranties except for a warranty that the disks contained in the box are free from defects." The box-top agreement also stated that "[o]pening this package indicates your acceptance of these terms and conditions."[18]

The court determined that the parties' actions (shipment of products, acceptance of shipment, and payment) demonstrated that both parties understood there to be a contract. Thus, the issue was not whether a contract existed but whether the box-top terms were part of that contract.[19] The court further found that "[i]n the absence of a party's express assent to the additional or different terms of the writing [i.e., the box-top terms], section 2-207 provides a default rule that the parties intended, as the terms of their agreement, those terms to which both parties have agreed."[20] Thus, the contract only contained those terms that both parties agreed on via their phone calls, purchase orders, and invoices, and, therefore, the box-top agreement terms did not become part of the contract.

Almost a decade after this case, the United States District Court in *Klocek v Gateway, Inc*[21] used UCC 2-207 to reach a similar decision that additional terms found in the packaging of the purchased computer were not accepted by the purchaser and therefore not enforceable contract terms. The court had found that the parties' conduct, plaintiff's payment, and defendant Gateway's shipment of a computer clearly demonstrated that there was a contract between the parties for the sale of a computer.[22] The court further found that Gateway did not inform plaintiff that the contract transaction was conditioned on plaintiff's acceptance of the additional terms enclosed in the computer's packaging.[23] Thus, pursuant to UCC 2-207, without non-merchant plaintiff's express agreement to those additional shrink-wrap terms, such terms did not become part of the parties' contract.

In *Specht v Netscape Communications Corp,*[24] visitors to defendant's Web site could initiate the download of the desired software by simply clicking on the box labeled "Download." "The sole reference … to the License Agreement [on the "Download" page] appears in text that is visible only if a visitor scrolls down through the page to the next screen."[25] Defendant Netscape failed to make it a requirement for a Web site visitor to view and "click" assent to the license agreement before downloading the software.[26] Therefore, the court concluded that the parties never reached mutual assent to the agreement terms and that no contract was formed.[27]

The lesson from these cases is that to be enforceable, shrink-wrap and click-wrap agreements—like any other contract terms—must be mutually accepted by the parties. "[Mutual] assent may be registered by a signature, a handshake, or a click of a computer mouse transmitted across the invisible ether of the Internet. Formality is not a requisite; any sign, symbol or action, or even willful inaction, as long as it is unequivocally referable to the promise, may create a contract."[28]

Conclusion

Predictability is the hallmark of the UCC. For more than half a century, it has been an indispensable part of the U.S. economy. Adopted by all fifty states, the Code successfully controls the sale of goods throughout this nation. However, it does not stand alone: by its own terms it depends on non-Code law, specifically traditional contract law, to fill in the gaps. Together, contract law and UCC Article 2 have governed the sale of goods in a uniform and predictable manner for decades, but the heavy onset in today's economy of the sale of non-goods—i.e., computer software, technology industry licenses, and information products—combined with electronic transactions conducted via the Internet, have brought confusion and uncertainty to sellers and buyers alike. While the legalities of mass-market non-goods and electronic transactions are far from settled, mutual assent is still critical to *any* contract.

The strongest argument against the application of the UCC to non-goods transactions is that Article 2 was specifically drafted for the "sale of goods." Although by strict definition non-goods do not apply, for the time being the UCC can offer those transactions the same uniformity and predictability it provides for the sale of goods. Electronic transactions, whether for tangible goods or for information-based non-goods, can and should be subject to the same key requirements as any traditional contract: offer, acceptance, consideration, *and* mutual assent.[29] The traditional purposes and policies of the UCC—

Traditional contract law focuses on the notion of a "meeting of the minds." This can be problematic for shrink-wrap agreements, because there is no opportunity for negotiation of the terms, which are not viewable until after payment.

"(a) to simplify, clarify and modernize the law governing commercial transactions; (b) to permit the continued expansion of commercial practices through custom, usage and agreement of the parties; (c) to make uniform the law among the various jurisdictions"[30] — are just as important to transactions involving "non-goods" or electronic transfers as they are to the "sale of goods."

Furthermore, with the enforcement of contracts concerning mass-market non-goods or electronic transfers (i.e., shrink-wrap and click-wrap agreements) comes the concern that powerful sellers will completely control the terms of the agreements and that, with no input from the buyers, the terms will enable unfair practices and unconscionable terms. However, this concern can be dealt with in the same manner as any sales agreement under the long-standing UCC Article 2.

Electronic transactions, whether for tangible goods or information-based non-goods, can and should be subject to the same key requirements as any traditional contract: offer, acceptance, consideration, and mutual assent.

Instead of labeling shrink-wrap and click-wrap agreements as evil monsters created by the software industry to entrap the unwary buyer, they should simply be accepted by consumers as an effective means for conducting mass-market sales in an efficient and timely manner. Without such agreements, the cost of doing business would be much higher, effectively pricing many items (computer software, digital information, etc.) out of the range of the average consumer. Furthermore, without such agreements the convenience of shopping from home and the luxury of browsing countless stores and brand-name items via the Internet would be greatly restricted.Without shrink-wrap and click-wrap agreements, the economy's growth based on online transactions could be effectively impeded.

Although not perfect, the courts are making a valid attempt to use the UCC to give the sale of non-goods and electronic transactions the same uniformity across the nation and predictability for sellers and buyers alike that traditional transactions for the sale of tangible goods have enjoyed for years. In the end, the golden rule for enforceable contracts for the sale of non-goods and electronic transactions is mutual assent between sellers and buyers, as has been the case for decades with the sale of tangible goods.

NOTES

1. Robert L. Oakley, "UCC Article 2B: Some Preliminary Comments on a New Issue for the Library Community" (presentation, 131st Membership Meeting, Association of Research Libraries, Washington, DC, Oct 16, 1997), *available at* http://www.arl.org/arl/proceedings/131/Oakley.html. *See also* Holly K. Towle, *UCC Article 2 Amendments: A Defective Product and a Flawed Process,* 20 Legal Backgrounder 7 (2005).

2. American Library Association, *UCITA 101: What You Should Know About the Uniform Computer Information Transactions Act* (2002), *available at* http://www.arl.org/info/frn/copy/ucita101.html.

3. Steven Robinson, *Security Concerns in Licensing Agreements, Part One: Clickwrap and Shrinkwrap Agreements* (July 4, 2002), *available at* http://www.securityfocus.com/infocus/1602.

4. "[T]he elements of a contract include offer and acceptance, consideration, and *mutual assent* to terms essential to the formation of a contract." 17 CJS Contracts § 2 (1999) (emphasis added).

5. 86 F3d 1447 (7th Cir 1996).

6. *Id.* at 1450.

7. *Carnival Cruise Lines, Inc v Shute,* 499 US 585 (1991) (the Court found that cruise line passenger's contract ticket delivered after payment was made was reasonable, and that the terms, specifically the forum-selection clause, were enforceable).

8. 183 F Supp 2d 328 (D Mass 2002).

9. *Id.* at 330.

10. *Id.* at 332.

11. *Id.* at 336.

12. UCC 2-207 states that "(1) A definite and seasonable expression of acceptance or a written confirmation which is sent within a reasonable time operates as an acceptance even though it states terms additional to or different from those offered or agreed upon, unless acceptance is expressly made conditional on assent to the additional or different terms. (2) The additional terms are to be construed as proposals for addition to the contract. Between merchants such terms become part of the contract unless: (a) the offer expressly limits acceptance to the terms of the offer; (b) they materially alter it; or (c) notification of objection to them has already been given or is given within a reasonable time after notice of them is received."

13. *iLAN,* 183 F Supp 2d at 336–338.

14. *See Forrest v Verizon Communications, Inc,* 805 A2d 1007 (DC 2002).

15. *See, e.g., Rory v Continental Ins Co,* 473 Mich 457, 490 n84, 703 NW2d 23 (2005).

16. 939 F2d 91, 95-96 (3rd Cir 1991).

17. *Id.* at 96.

18. *Id.* at 97.

19. *Id.* at 98.

20. *Id.* at 99.

21. 104 F Supp 2d 1332 (D Kan 2000).

22. *Id.* at 1337.

23. *Id.* at 1341.

24. 150 F Supp 2d 585 (SDNY 2001).

25. *Id.* at 588.

26. *Id.*

27. *Id.* at 595.

28. *Id.* at 587.

29. *See* note 4.

30. Henry D. Gabriel and Linda J. Rusch, *The ABCs of the UCC: (Revised) Article 2: Sales* (2004).

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The Enforcement of Commercial Finance Lease Agreements: A Basic Look at an Established Rule

By John F. Fleming

Background

Article 2A of the Uniform Commercial Code (UCC) was first adopted in Michigan in 1992 and is set forth at MCL 440.2801 et seq.[1] Attempting to establish a model of contractual fairness in personal property leases that is consistent with the UCC in general, its basic underlying rule is that "[a] lease contract imposes an obligation on each party that the other's expectation of receiving due performance will not be impaired."[2] The UCC sets forth an ideal of a contract situation in which the parties are presumed to be capable of understanding the nature of the transaction and of acting according to the terms of the agreement in good faith. The same ideal is contained in Article 2A, which is particularly enforced with respect to commercial financial leases by imposing strict burdens on the parties. For instance, upon acceptance of the equipment, the lessee is locked into repaying the lessor, regardless of the condition of the items acquired and often regardless of the lessor's conduct. A more complete understanding of the finance lease arrangement in general, and of Article 2A in particular, reveals the reasons behind some of the seemingly strict provisions of this part of the UCC.

The Commercial Finance Lease Arrangement

The typical commercial finance lease is nothing more than a financing tool for the lessee to acquire items, such as equipment, for use in its business operations. The relationship consists of a three-party transaction between a lessor, a lessee, and an equipment supplier, with the relationship between the lessee and the supplier just like any other purchase transaction: the lessee contacts the supplier, identifies the items to be acquired, and often sets the terms of purchase. The entire transaction is concluded between the supplier and the lessee, except for the payment of the purchase price, which is handled by the lessor. In most cases, the lessor has no further obligations; it is not in the business of supplying equipment, or of advising a prospective lessee about the operations of its business or the selection of equipment. The lessor's only role is to provide funds.

While the finance lease is a method of financing the acquisition of equipment or goods, it is unlike a traditional financing arrangement in that when the lessor pays the purchase price, usually directly to the supplier, it takes title to the equipment. While the lessee has controlled the transaction up to this point by selecting the supplier, identifying the items to acquire, and agreeing to the price, the lessor becomes the owner of the equipment for lease back to the lessee.

The limited role of the lessor is generally set forth in a written lease agreement (although a lease contract can be established by any method that demonstrates an intent to enter into a lease).[3] To acknowledge that the lessee has exclusive control over the selection of the supplier and the equipment and that the lessor has no part in that process, finance lease agreements generally include provisions similar to the following:

> Lessor has not manufactured, distributed, or supplied the equipment that is the subject of this lease agreement and is not responsible for the delivery, repair, or maintenance of this equipment. Lessee acknowledges that it has selected the equipment on terms it considers appropriate from a supplier it has selected at its own discretion.

Obviously, the lease will also contain the terms under which the lessee is entitled to possess the equipment, including the term and the agreed-upon monthly rental rate. At the conclusion of the lease, the lessee may have an option to purchase the equipment from the lessor for a price that is usually established at the beginning of the lease term. As with a traditional lender, the lessor under a finance lease rarely undertakes a warranty obligation of any kind. In fact, the lease agreement generally will disclaim all warranties, including implied warranties such as the warranty of merchantability and fitness for

a particular purpose, with the inclusion of a provision similar to the following:

> Lessee has leased the equipment strictly on an "as-is" basis. Lessor has not made any representations or warranties of any kind related to the equipment, and expressly disclaims any and all warranties with regard to the equipment, including, without limitation, any implied warranties, whether of merchantability, fitness for a particular purpose, or any other warranty.

Closely related to this disclaimer are provisions that make the lease terms absolute and unconditional on the lessee's acceptance of the equipment. The lease agreement will usually provide that the lessee unconditionally and irrevocably agrees to pay all rent specified in the lease, regardless of the condition of the equipment—which may fail at its essential purpose or not function at all—with a provision similar to the following:

> Lessee has the absolute and unconditional obligation to pay all rent and other payments under this agreement when such payments are due without any deduction or right of setoff, and regardless of any claim, including any claim that the equipment is not merchantable or fit for an intended use or purpose. Lessee's obligations under this lease become irrevocable and independent upon acceptance of the equipment. Lessor's right to receive the rent and other payments due under this agreement shall be free from all defenses, setoffs, rights of counterclaim, and any other condition whatsoever.

The typical commercial finance lease is nothing more than a financing tool for the lessee to acquire items, such as equipment, for use in its business operations.

The main reason for limiting the lessor's liability for the condition of the leased equipment is that, in reality, it has no control over the equipment's condition. The lessor is not in the business of manufacturing or supplying equipment, and the lessee generally has the exclusive responsibility for selecting the equipment and its supplier. Any problems with the equipment must be resolved between the lessee and the distributor, supplier, or equipment manufacturer. As indicated above, the lessor is merely the source of funds to purchase the equipment.

By removing the lessor from the initial part of the transaction, Article 2A releases the lessor from nearly all liability to the lessee and requires the lessee to repay the lessor almost without exception. This arrangement is designed to provide the lessor with the assurance that it will be repaid for the equipment that it has purchased on behalf of the lessee. The lessee also has the advantage that, theoretically, there will be more funding sources and more favorable terms (such as 100 percent financing) available when there is a virtual guarantee of repayment. The effect of Article 2A, then, is that a lessor should be able to enforce its agreement with the lessee when it has complied with the requirements of the statute.

The Statutory Framework

To qualify as a finance lease, a transaction must first be a true lease, not a security interest disguised as a lease.[4] Article 2A defines a finance lease arrangement by identifying the characteristics of the transaction. First, the lessor must not be involved in the selection of the equipment and cannot be the manufacturer or supplier of that equipment.[5] This is the primary basis for eliminating the lessor's liability to the lessee for the condition of the equipment. The lessor may own and possess the equipment, but under MCL 440.2803(g)(ii), if it had no involvement in the selection of the supplier and the equipment, it cannot be held liable if the lessee chose defective goods.[6]

For the transaction to qualify as a finance lease, the lessee also must receive a copy of the contract under which the equipment was obtained.[7] This is not a problem when the lessee has negotiated the terms directly with the supplier. However, there are circumstances in which the lessee is not aware of the final purchase price and the lessor wants to keep that information from the lessee. In this case, the lessor may provide a written statement of the terms of purchase that are relevant to the lessee, such as warranty rights and disclaimers from the manufacturer.[8] The statute also provides specific terms for construing the lease agreement if there is ambiguity with regard to a particular issue, such as whether there has been an offer or acceptance or if a party has waived a right under the lease.[9] In all respects, a lease agreement that complies with the statutory requirements will be valid and enforceable between the parties according to its written terms.[10] This is not a novel rule of law but is in fact consistent with the general and well-established principles related to the construction and enforcement of unambiguous contracts.[11]

Except in very limited circumstances, the lessor has no liability to the lessee.[12] This

means that the lessor does not guarantee that the items can be used for any purpose that the lessee might intend, or that the equipment will even function properly.[13] Unless modified by the contract, the entire risk of loss of the equipment is imposed on the lessee.[14]

To provide some protection to the lessee, any warranty rights that the manufacturer, distributor, or supplier may have promised automatically pass to the lessee. If there are any defects of any kind in the equipment, the lessee must deal with the manufacturer, distributor, or supplier directly; except in very limited circumstances, the lessor will not be liable in this regard.[15]

The real heart of commercial finance lease agreements is associated with this limitation of liability and derives from MCL 440.2937(1), which provides that "the lessee's promises under the lease contract become irrevocable and independent upon the lessee's acceptance of the goods." A provision to this effect does not need to be included in a lease agreement; however, to ensure that a lessee is aware of the finality of its obligations under the lease, most agreements contain a clause or two expressly stating that once the goods are accepted, the lease cannot be revoked and the lessee's obligation to pay rent is without condition or qualification. In effect, the lessee has no claim of any kind against the lessor.[16]

There are limited circumstances in which the lessee can avoid liability under the lease. Defects in goods and equipment malfunction will not affect the lessee's obligations under the lease. These obligations can only be avoided when the lessor fails to deliver to the lessee the items subject to the lease or otherwise repudiates the contract, or if the lessee properly rejects or revokes acceptance of those items.[17] However, even these limited defenses can be waived—in addition to any other rights that may be available in Article 2A—and most commercial lease agreements will include such a clause that should effectively eliminate all liability a lessor has to a lessee.[18]

The key to enforcement of the lease rests on whether the lessee has accepted the equipment identified in the contract. As noted above, upon acceptance, the lessee's obligation to pay rent becomes irrevocable. Once that obligation is irrevocable, the agreement is "(i) effective and enforceable between the parties ... and (ii) not subject to cancellation, termination, modification, repudiation, excuse, or substitution without the consent of the party to whom the promise runs."[19] The parties are left with the bargain they have struck, and it is to be enforced according to the terms they have expressed.

The lessee is able to reject a nonconforming delivery of the equipment, provided that the defect "substantially impairs the value" of the equipment and the lessor is "seasonably" notified.[20] While the statute does not identify the circumstances in which a defect may substantially affect the equipment's value, it should presumably be a serious defect that makes the equipment essentially worthless to the lessee. In any event, the lessee has the specific obligation to set forth a particular reason for rejection that can be determined upon a reasonable inspection.[21] It is probably insufficient to reject a delivery of equipment by making some vague statement like "the equipment does not work properly." Once the lessee has had an opportunity to inspect the equipment and fails to reject it, the equipment is deemed to be accepted.[22] As a result, many leases will contain a clause in which the lessee specifically states that it has had the opportunity to inspect the equipment and is accepting it in its current condition:

> Lessee acknowledges and agrees that it has received the equipment subject to this agreement, has had an adequate opportunity to inspect that equipment, and that it is accepting the equipment in its as-is condition.

Once the equipment is accepted, the lessee must pay rent according to the terms of the agreement, without modification or condition.[23] The lessee may only revoke acceptance of the equipment subject to a finance lease if acceptance of a nonconforming delivery was induced by some assurance of the lessor.[24]

As with any other contract, a default occurs when a party fails to perform as agreed.[25] The lease contract itself can indicate what constitutes a failure of performance; in addition, Article 2A sets forth specific elements of default.[26] The typical default is the lessee's failure to pay rent when due. With the strict requirements of the statute, the failure to pay rent obviously violates the basic rule set forth in MCL 440.2931(1), in which each party is prohibited from doing anything to impair the expectations of the other party. This failure also violates the basic provisions of the lease under which the lessor expected payment.

In the event of default, the lessor has a number of remedies. A lease agreement generally will identify these remedies, such as the right to accelerate the remaining balance due under the agreement or to impose

The lease agreement will usually provide that the lessee unconditionally and irrevocably agrees to pay all rent specified in the lease, regardless of the equipment's condition.

certain penalties and additional interest. Additional damages, such as costs of collection, including attorney fees, are generally included, along with the right to recover the equipment subject to the agreement. Liquidated damages are also permitted if they are reasonable under the circumstances. All of these remedies are considered to be cumulative, and the lessor need not elect one specific remedy over another.[27] The idea is to ensure that the lessor is made whole in the event of a default. A notice of default is not necessary, unless required by contract or as otherwise set forth in the UCC.[28] This probably arises from the rational belief that a lessee who is not paying its rent is already aware that it is not complying with the contract terms.

The key to enforcement of the lease rests on whether the lessee has accepted the equipment identified in the contract.

The basic premise behind these rules is that contracting parties are free to develop whatever agreement they believe is appropriate under the circumstances, which is consistent with the Michigan Supreme Court's decisions affirming the rights of parties to develop contractual arrangements without interference.[29]

Conclusion

In the commercial finance lease context, it is important to recognize the unconditional right, except in very limited circumstances, that a lessor has to receive payment. Since the lessor is not involved in the process of obtaining the equipment or choosing the supplier, this unconditional right—which may seem harsh at first glance—serves to protect it. The lessee, on the other hand, is in the best position to know what equipment it needs for its business and is thus the party selecting the equipment and supplier. The lessee is usually also in the best position to ensure that the products it obtains are consistent with its needs and that those products function properly. It can also best deal with the supplier if the equipment proves to be defective. In this arrangement, the lessee is busy conducting its business by obtaining equipment, and the lessor is focused on its job of providing funds. Article 2A of the UCC allows both parties to carry out their respective functions.

NOTES

1. Article 2A provides rules related to both consumer and commercial lease arrangements. Consumer leases are transactions that relate solely to the lease of goods to an individual "primarily for a personal, family, or household purpose, if the total payments to be made under the lease contract ... do not exceed $25,000.00." MCL 440.2803(e). Different rules apply to consumer leases, which are designed to protect the consumer from overreaching or seemingly unfair lease provisions. Note, for example, the prohibitions related to forum selection clauses in MCL 440.2806, or the treatment of unconscionable contract clauses in MCL 440.2808. The discussion in this article relates to the application of Article 2A in the commercial finance lease context.

2. MCL 440.2931(1).

3. MCL 440.2854. The traditional concepts of the statute of frauds and the parol evidence rule will apply, however. For instance, to be enforceable under Article 2A, a lease must be in writing or have total lease payments of less than $1,000.00. MCL 440.2851. In addition, the terms of a written agreement cannot be contradicted by evidence outside the contract. MCL 440.2852.

4. In this case Article 9 applies, and the lessor will be required to follow the provisions of that statute to perfect its interest in the equipment and secure repayment.

5. MCL 440.2803(g)(i).

6. *See* MCL 440.2803, UCC Comment g.

7. MCL 440.2803(g)(iii)(A).

8. MCL 440.2803(g)(iii)(D).

9. *See, e.g.,* MCL 440.2856, .2857.

10. MCL 440.2901.

11. As identified in, for example, *Wilkie v Auto-Owners Ins Co*, 469 Mich 41, 62, 664 NW2d776 (2003).

12. The circumstances in which a lessor may be liable to a lessee arise in connection with express warranties, such as a specific promise from the lessor to lessee, or if a description of the goods subject to the lease (whether by way of a statement in the agreement, or the provision of a sample of the goods) is made a part of, and is a basis for, the agreement. MCL 440.2860. In addition, Article 2A establishes that the lessor warrants that the lessee may possess and use the items subject to the lease without interference from any third party. MCL 440.2861. It is possible for the lessor to create a warranty through course of dealing between the lessor and lessee. MCL 440.2862(3).

13. MCL 440.2862, .2863.

14. MCL 440.2869.

15. MCL 440.2859; *see also* MCL 440.2937, UCC Comment 1.

16. *See* MCL 440.2937, UCC Comment 5.

17. MCL 440.2958.

18. *See* MCL 440.1102(3). A written waiver in this regard generally states that the lessee is precluded from asserting any of the rights or pursuing any of the remedies that are otherwise available in UCC 2A-508–2A-521. There has been some criticism from courts outside this jurisdiction relating to the enforcement of such a waiver if the lessee has been induced into entering a contract through fraud. *See Eureka Broadband Corp v Wentworth Leasing Corp*, 400 F3d 62, 70 (1st Cir 2005).

19. MCL 440.2937(2).

20. MCL 440.2960.

21. MCL 440.2964.

22. MCL 440.2965.

23. MCL 440.2966(1); *see also* MCL 440.2937.

24. MCL 440.2967(1)(b).

25. *See, e.g., Blazer Foods, Inc v Restaurant Props*, 259 Mich App 241, 245–246, 673 NW2d 805 (2003).

26. MCL 440.2951(1), 440.2958–.2982.

27. All of these remedies are authorized under the act. *See* MCL 440.2954, .2973. In addition, any remedies that are set forth in the contract, whether specified in the act or not, can be recovered. MCL 440.2953(1), (4).

28. MCL 440.2952.

29. *Wilkie*, 469 Mich at 62–63.

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Proving Economic Duress in Michigan: Will a Gun to the Wallet Ever Be Enough?

By Mark A. Aiello and Jason Menges

Introduction

One of the core principles taught in every first-year contracts class is that, to be enforceable, contracts must be the result of the exercise of free will. Accordingly, it is generally accepted that if a contract is not entered into voluntarily but is instead the result of duress, it is void or voidable. In the rare case of contracts entered into under *physical* duress (i.e., a gun to the head) or illegal threat, the law is well settled that such contracts are void, and evidence of lack of assent is easily established. In the case of contracts entered into under *economic* duress (i.e., a threat based on financial consequences), courts in a significant number of jurisdictions have agreed that such contracts are voidable, although these courts have disagreed as to the type of coercive activity required to establish duress.[1]

With the recent economic downturn in Michigan, the rise in bankruptcy filings, and the declining state of the automotive industry in general, the potential for parties to claim economic duress is arguably greater than ever. This article will discuss the current state of the law in Michigan concerning economic duress, as well as recent cases illustrating the application of Michigan law in today's economic climate.[2]

Economic Duress as Applied by Michigan State Courts

Under Michigan law, duress "exists when one by the unlawful act of another is induced to make a contract or perform some act under circumstances which deprive him of the exercise of free will."[3] With respect to what constitutes an "unlawful act" sufficient to deprive a party of its "free will," however, Michigan law is not entirely clear. The Michigan Supreme Court has not spoken on the issue of economic duress in more than forty years, leaving the issue instead to the intermediate appellate courts.[4] In defining the scope of activity required to support a claim of economic duress, the primary guidance given by the Michigan appellate courts is that the activity must be "illegal" or "unlawful."[5] The courts' view has been explained as follows:

> [T]o succeed with respect to a claim of duress, [defendants] must establish that they were illegally compelled or coerced to act by fear of serious injury to their persons, reputations, or fortunes. "Fear of financial ruin alone is insufficient to establish economic duress; it must also be established that the person applying the coercion acted unlawfully."[6]

Furthermore, the courts have stated that "duress will not prevail to invalidate a contract entered into with full knowledge of all the facts, with ample time and opportunity for investigation, consideration, consultation, and reflection."[7]

Under this view, Michigan appellate courts have held the following situations, among others, insufficient to establish "illegal" activity necessary to support economic duress:

- when a party entered into a settlement agreement or release because it was pressured financially, but could not establish any illegal conduct;[8]
- when a plaintiff, who was in dire financial straits, agreed to accept less than the full amount owed to him by certain defendants in exchange for immediate payment;[9]
- when a defendant claimed duress based on having entered into contracts with the plaintiff merely because the plaintiff threatened to cease doing business with the defendant;[10]
- when a party claimed duress in entering into loan agreements because the agreements required the party to issue security agreements in connection with receiving funds, and the security agreements later were foreclosed;[11]
- when a defendant accounting firm conditioned its delivery of plaintiffs' original books and records on the execution of a

promissory note and guaranty for unpaid fees;[12]

- when an employee claimed that she signed an acceptance of an employee handbook under duress, yet continued to work for the employer for more than two years;[13] and
- when a plaintiff real estate investor executed a contract modification in connection with a loan agreement, which was required by the defendant bank as a condition precedent to closing the loan.[14]

Clearly, in Michigan today it is extremely difficult to establish economic duress as a defense to a contract.[15]

The Modern View of Economic Duress

The modern view of economic duress would potentially offer relief to parties who are forced to accept unwarranted price increases to ensure continuity of supply. Still, Michigan has yet to adopt this perspective.

The "modern view" of economic duress expressed in the Restatement (Second) of Contracts posits a more lenient standard,[16] identifying four categories of per se threats: (1) where the threatened act is, or would be, a crime or a tort; (2) where what is threatened is criminal prosecution; (3) where what is threatened is the use of civil process, and the threat is made in bad faith; and (4) where the threat is a breach of the duty of good faith and fair dealing under a contract between the parties.[17] The Restatement further identifies three additional threats that would be characterized as improper if the resulting exchange between the parties were not on "fair" terms: (1) where the threat would harm the recipient and would not significantly benefit the threatening party; (2) where the effectiveness of the threat is significantly increased by prior unfair dealing by the party making the threat; and (3) where what is threatened is otherwise a use of power for illegitimate ends.[18] The modern view has been adopted, albeit in sometimes confusing and piecemeal fashion, by numerous courts throughout the United States.[19]

Application of Economic Duress

As many Michigan industries, particularly the automotive industry, face low profit margins and rising costs, the issue of economic duress has become ubiquitous in the everyday transaction of business. For a large number of businesses today, the supply chain has become particularly vulnerable to demands for price increases from sole-source suppliers. Assuming that the supplier is contractually obligated to supply (and an entirely separate body of law has been and is developing regarding such obligations or the lack thereof), questions about duress have become commonplace.

The modern view would potentially offer relief to parties who are forced to accept unwarranted price increases to ensure continuity of supply. Still, Michigan has yet to adopt this perspective, despite Justice Levin's acknowledgment in his dissenting opinion in *Stefanac v Cranbrook Educational Community*[20] that the doctrine of duress has been "greatly expanded" since its initial origin and that Michigan law "may have lagged" behind the modern formulation. The divergence between our state supreme court's view and the modern view has sometimes led to inconsistent results among federal courts applying Michigan law.[21]

For example, in *Kelsey-Hayes v Galtaco,*[22] plaintiff successfully argued that it had entered into a contractual modification only under economic duress and, thus, sought to invalidate the modification. In this case, defendant supplied 100 percent of plaintiff's demand for certain metal castings, which it manufactured into brake assemblies that it sold to its customers. The parties initially operated under a fixed price agreement, but before the agreement's expiration defendant declared it would stop producing castings unless plaintiff agreed to two separate 30 percent price increases. Plaintiff claimed that if it did not accept the increases, it would cause its customers' assembly plants to shut down. Plaintiff ultimately agreed to the new prices but later refused to pay defendant the higher amounts.

In ruling on defendant's motion for summary judgment on the issue of duress, the court posited that "if the Michigan Supreme Court were to rule today, it would rule that economic duress need not stem from an 'illegal threat.'"[23] Applying the modern rule, the court held that "economic duress can exist in the absence of an illegal threat," and that plaintiff had produced sufficient evidence to support its economic-duress claim. In fact, Judge Cohn noted in a footnote that "[g]iven the changing nature of the automotive industry, Galtaco's actions are more likely to constitute duress."[24] The court also remarked that the scenario presented paralleled one of the illustrations set forth in Restatement (Second) of Contracts § 175.[25]

Likewise, in *General Motors Corp v Paramount Metal Products Co,*[26] another federal court was presented with a claim for

economic duress and cited with approval the earlier *Kelsey-Hayes* opinion. Defendant in *Paramount* contracted to supply all of plaintiff's seat requirements for a fixed period of time on a just-in-time basis, but later threatened to stop supplying the seat frames unless plaintiff agreed to pay an increased price for the product. Plaintiff agreed to the higher price but then obtained a substitute supplier and claimed duress as a basis for voiding the increase. The court, in applying *Kelsey-Hayes*, held that factual disputes remained regarding whether such coercion necessary to establish the defense existed.

In contrast, the United States Bankruptcy Court for the Northern District of Illinois in *In re National Steel Corp*[27] applied Michigan law to a factual scenario virtually identical to those presented in *Kelsey-Hayes* and *Paramount;* the bankruptcy court, however, declined to apply the modern view of economic duress. In this case, National Steel was the sole supplier of certain specialized steel to Hayes-Lemmerz International Inc. After National Steel filed for Chapter 11 bankruptcy protection, it refused to ship any more product to Hayes-Lemmerz unless the latter agreed to pay a higher price and to pay for shipments in advance rather than under the contracted payment terms of net forty-five days. Hayes-Lemmerz claimed that it agreed to do so but subsequently sought to invalidate the parties' new agreement under the doctrine of economic duress, stating that it had "no choice but to pay the increased price for the steel or suffer severe economic repercussions."[28]

The court in *National Steel* adhered to the traditional view of economic duress as articulated by the Michigan appellate courts and expressly declined to adopt the modern view espoused in *Kelsey-Hayes* and *Paramount*. Accordingly, the court concluded that Hayes-Lemmerz failed to prove that National Steel engaged in any "illegal" or "unlawful" conduct. The court also noted that, under Michigan law, merely "refusing to abide by the Contract falls short of proscribed duress," and that Hayes-Lemmerz "had full knowledge of all the facts and made the choice to pay the increased steel price rather than pursue other alternatives or avenues."[29]

Conclusion

On the one hand, application of the majority view of economic duress may open the door to increased litigation by parties attempting to invalidate agreements under what can be a murky analysis of what constitutes financial duress. Yet, Judge Cohn's observation in *Kelsey-Hayes*, made more than fifteen years ago, appears to be truer now than ever before, as the just-in-time inventory system prevalent in many of today's industries, including the automotive industry, makes businesses increasingly susceptible to demands that in other jurisdictions could constitute economic duress. The weighing of Michigan's policies against the ever-changing realities of commercial transactions may, at some point, justify a revisiting of the law on this issue.

In Michigan today, it is extremely difficult to establish economic duress as a defense to a contract.

NOTES

1. As one commentator has noted, "[v]irtually all contract duress cases are of [this type]." Alan Wertheimer, *Coercion* 30 (1987).

2. For a comprehensive historical discussion of the development of the economic duress doctrine in United States jurisprudence, see John P. Dawson, *Economic Duress—An Essay in Perspective,* 45 Mich L Rev 253 (1947); Robert L. Hale, *Bargaining, Duress, and Economic Liberty,* 43 Colum L Rev 603 (1943); John Dalzell, *Duress by Economic Pressure I,* 20 NC L Rev 237 (1942).

3. *Norton v Michigan State Highway Dep't,* 315 Mich 313, 319, 24 NW2d 132 (1946) (quoting *Hackley v Headley,* 45 Mich 569, 574–575, 8 NW 511 [1881]).

4. The last Michigan Supreme Court majority opinion addressing this issue with any degree of discussion was *Beachlawn Bldg Corp v City of St Clair Shores,* 370 Mich 128, 121 NW2d 427 (1963). In this case, plaintiff sought to recover certain "increased" fees that he paid in order to obtain building permits. Plaintiff claimed that the exacted fees were unlawful, and that they were paid only because he otherwise would have had to give up his business. The court concluded that plaintiff had produced sufficient evidence of economic duress and thus remanded the case for trial to determine the amount to which plaintiff was entitled. *Id.* (citing *Hackley*).

5. *See Farm Credit Servs, PCA v Weldon,* 232 Mich App 662, 682, 591 NW2d 438 (1998); *Enzymes of America v Deloitte, Haskins & Sells,* 207 Mich App 28, 35, 523 NW2d 810 (1994), *rev'd on other grounds,* 450 Mich 889, 539 NW2d 513 (1995).

6. *Farm Credit Servs* at 681–682; *Enzymes of America* at 35.

7. *Canjar v Canjar,* No 241387, 2003 Mich App LEXIS 2450 (Sept 25, 2003) (quoting *Payne v Cavanaugh,* 292 Mich 305, 308, 290 NW 807 [1940]).

8. *Norton,* 315 Mich at 313; *Stefanac v Cranbrook Educ Cmty,* 435 Mich 155, 458 NW2d 56 (1990); *Hungerman v McCord Gasket Corp,* 189 Mich App 675, 473 NW2d 720 (1991); *Canjar*; *WE Rozinak Props, Ltd v Leemon Oil Co,* No 226159, 2002 Mich App LEXIS 215 (Feb 19, 2002) (unpublished); *Frank v Henry Ford Health Sys,* No 201419, 1999 Mich App LEXIS 1338 (Mar 26, 1999) (unpublished).

9. *Hackley,* 45 Mich at 569.

10. *Andersons, Inc v Crotser,* No 226095, 2001 Mich App LEXIS 1797 (Nov 27, 2001).

11. *Farm Credit Servs,* 232 Mich App at 681–82; *Apfelblat v National Bank Wyandotte-Taylor,* 158 Mich App 258, 404 NW2d 725 (1987); *Barnett v International Tennis Corp,* 80 Mich App 396, 263 NW2d 908 (1978).

12. *Enzymes of America,* 207 Mich App at 28.

13. *Bobo v Thorn Apple Valley, Inc,* No 184775, 1997 Mich App LEXIS 3280 (Sept 2, 1997) (unpublished),

overruled on other grounds, 459 Mich 892, 587 NW2d 501 (1998).

14. *Quartell v Great Lakes Bancorp,* No 183368, 1996 Mich App LEXIS 515 (Dec 17, 1996) (unpublished).

15. From our review of the case law, it has been more than forty years since any Michigan appellate court has affirmed a finding of economic duress. *See Beachlawn,* 370 Mich at 128.

16. Restatement (Second) of Contracts §§ 174-177.

17. Restatement (Second) of Contracts § 176(1). The modern view of economic duress has been adopted in numerous states, including Ohio and New York.

18. Restatement (Second) of Contracts § 176(2). In the 25 years since the publication of the Restatement (Second) of Contracts, only a few courts have even mentioned Section 176(2). *See* Grace M. Giesel, *A Realistic Proposal for the Contract Duress Doctrine,* 107 W Va L Rev 443, 484 n237 (2005). Of those that have mentioned Section 176(2), very few have actually relied on it.

19. *See* Giesel 461–462 and accompanying notes. *See also Blodgett v Blodgett,* 551 NE2d 1249 (Ohio 1990) (citing modern view of Restatement [Second] of Contracts § 176).

20. 435 Mich 155, 194 n40, 458 NW2d 56 (1990).

21. Confusion over application of the economic duress doctrine is nothing new. Nearly sixty years ago, one commentator remarked, "the modern American law of duress reflects the convergence of several lines of growth, originally moving from sources quite distinct. The symptom of this convergence has been an increasing interplay and transfer of ideas. Its result has certainly not been a coherent body of doctrine, unified around some central proposition; on the contrary, the conflict and confusion in results of decided cases seems greater than ever before." Dawson, *supra* note 2. In light of this confusion, several commentators have made alternative proposals for the economic duress doctrine. *See* Giesel (proposing four suggested improvements to the duress doctrine); Oren Bar-Gill & Omri Ben-Shahar, *The Law of Duress and the Economics of Credible Threats,* 33 J Legal Stud 391 (June 2004) (proposing that traditional duress analysis, focusing on the subjective understanding of the threatened party, should be replaced with an analysis of the credibility of threat by the threatening party).

22. 749 F Supp 794 (ED Mich 1990).

23. *Id.* at 797 n5.

24. *Id.* at 798 n7.

25. The *Kelsey-Hayes* court cited Restatement (Second) of Contracts § 175 comment b, illustration 5: "A, who has contracted to sell goods to B, makes an improper threat to refuse to deliver the goods to B unless B modifies the contract to increase the price. B attempts to buy substitute goods elsewhere but is unable to do so. Being in urgent need of the goods, he makes the modification. *See* Uniform Commercial Code § 2-209(1). B has no reasonable alternative, A's threat amounts to duress, and the modification is voidable by B." 749 F Supp 798 at n8.

26. 90 F Supp 2d 861 (ED Mich 2000).

27. 316 BR 287 (Bankr ND Ill 2004).

28. *Id.* at 308.

29. *Id.* at 309–310 (citations omitted). *See also Truform, Inc v General Motors Corp,* Nos 01-4301, 02-3015, 2003 US App LEXIS 23555 *27–28 (6th Cir Nov 17, 2003) (unpublished) (holding that plaintiff failed to prove economic duress where the district court "was not convinced that [plaintiff] was deprived of its will by [defendant's] attempts to impose cost recoveries," because "[plaintiff] always had the ability to cease shipping parts," and "[plaintiff's] concern that it might go out of business was insufficient to establish economic duress").

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*Proving Future Lost Profits for New Businesses in the Post-*Daubert *Era*

By Ian B. Bourgoine and J. Douglas Peters

Introduction

Proving future lost profits for a new business poses a conundrum, because a new business has no track record upon which to predict such losses. Accordingly, some judges liken an expert's prediction of a new business's future lost profits to an astronomer testifying that the "sun revolves around the earth."[1] In the view of some courts, such experts should be precluded from testifying because their opinions do not rise above the level of unsupported speculation. An emerging trend in federal case law, however, suggests that experts can establish future lost profits with reasonable certainty and, thus, can provide valuable lost-profit testimony to the jury.

A History of Judicial Skepticism

Federal courts have always met an expert's prediction of future lost profits for a new or recently launched business with a raised eyebrow. Early judicial skepticism was based on the cardinal rule of contract damages that future damages must be proven with "reasonable certainty."[2] At the state level, however, this evolved into the common law "new business rule," which severely restricts or bars new businesses from obtaining lost profits as an element of damages.[3]

The new business rule holds that the hazards, contingencies, and uncertainties inherent in the operation of a newly established business preclude consideration of future lost profits as an element of damages.[4] Several states, including Alabama,[5] Georgia,[6] Maryland,[7] New Jersey,[8] New York,[9] Ohio,[10] Oklahoma,[11] Texas,[12] and Virginia,[13] have adopted this rationale and all but shut the courthouse doors to new businesses claiming future lost profits. If the plaintiffs filed their breach of contract or business tort cases in federal court, the *Erie* doctrine of 1938[14] required the court to apply the substantive law of the forum state to the case. By the middle of the 20th century, the new business rule made it virtually impossible to prove future lost profits for new businesses.[15]

Overcoming the New Business Rule

In General

Fortunately for plaintiffs, the new business rule has evolved over the past 20 years.[16] Some jurisdictions have relaxed or abandoned the rule,[17] while others have recognized enough exceptions to suggest the rule's demise.[18] Consequently, today's federal judicial landscape reveals a number of approaches that new companies can use to prove lost profits, regardless of how long they have been in business.

The Definition Approach

When a business first opens its doors, it can safely be labeled as new—but beyond that first day, "new" becomes a matter of opinion. In *GM Brod & Co, Inc v US Home Corp,*[19] the Eleventh Circuit wrestled with the question of how long a business must be operating before it can shed the new business label and thus be spared the effects of the new business rule. In this case, a property management company brought suit against a condominium developer for a breach of the property management contract and for U.S. Home's other unlawful acts.[20] G.M. Brod had only been in business for three months, yet the jury awarded it $956,000 in future lost profits.[21] On appeal, U.S. Home argued that it was the settled law of Florida that "proof of profits for a reasonable time anterior to the breach is required to establish lost profits," and that since G.M. Brod was a new business, future lost profits were too remote and speculative to be awarded.[22]

The Eleventh Circuit disagreed, reasoning that if a company like G.M. Brod operates for three months, it is not a "new" business.[23] Supporting this proposition, the court cited authorities where businesses were awarded future lost profits despite the fact that they had only been in operation for five or six months.[24] The court then cited with approval the Fifth Circuit's policy reasoning on the future lost profit dilemma:

> Particularly is the calculation of damages difficult when … there is

> no reliable track record to look back on. But uncertainty cannot end the efforts of the federal courts to redress the harm caused proprietors…. The wrongdoer must bear the risk of the uncertainty in measuring the harm he causes.[25]

As exhibited by the Eleventh Circuit's analysis here, federal circuits have narrowed the definition of what constitutes a new business. Further, the courts are willing to construe the uncertainty of a young business's future lost profits against the party that breached the contract or committed the tortious act.[26] Such an analysis defies the new business rule, which held that any uncertainty with regard to future lost profits must be construed against the plaintiff, not the defendant.[27] The reasoning set forth in *GM Brod & Co* challenges this proposition by recognizing a policy of lessening the burden placed on the plaintiff in proving lost profits.

Federal circuits have narrowed the definition of what constitutes a new business.

The Chain Store Approach

Likewise, when established businesses or chain stores open new business locations, the new business rule can be overcome. Lowe's Home Centers is one of the largest chain stores in the country. In 2004, it brought suit against General Electric,[28] alleging that G.E. was responsible for the environmental contamination of Lowe's property and that this contamination prohibited it from opening a new, significantly larger store on that lot. G.E. brought a motion for judgment as a matter of law with respect to Lowe's claim of future lost profits.[29]

The District Court denied the motion, reasoning that the new store was not a new business because Lowe's planned to sell in the new building identical products at identical prices to those sold at other locations.[30] The Eleventh Circuit did not decide the issue on appeal but instead certified the question to the Supreme Court of Georgia,[31] noting other jurisdictions that have carved out a chain store exception to the new business rule[32] and outlining several reasons why the Georgia Supreme Court should follow suit.[33]

The Experienced Management Approach

In *In re Merritt Logan,*[34] the Third Circuit engaged in a similar analysis about a company opening a second grocery store location.[35] Plaintiff Merritt Logan ran a small neighborhood grocery store before opening a large supermarket called Rancocas Thriftway. Unlike the chain store circumstances of *Lowe's Home Centers,* however, the plaintiff in this case was not simply going to sell the same products at the same prices in a new building. Accordingly, the court decided that it would not treat Rancocas Thriftway as simply a continuation of the small neighborhood store.[36] However, the court's analysis didn't end there.

The Third Circuit went on to review the track record of the store's managers, stating that "it does seem proper to us to consider Mr. Logan's years of overall experience in the retail food business" when deciding whether evidence of future lost profits should be allowed.[37] In the end, plaintiff's significant experience in the industry, coupled with the fact that Rancocas Thriftway had been in business for more than a year, led the court to hold that there was a sufficient financial track record upon which to calculate future lost profits.[38]

Merritt Logan was not the first case to engage in such an analysis. Other federal courts have similarly cited the track record of management personnel in allowing new businesses to offer evidence of future lost profits, despite the new business rule.[39] As a result, attorneys for young companies should not be quick to accept an opponent's definition of their business as "new." Courts have held that companies in business for as little as three months have a sufficient track record upon which to predict future lost profits. Moreover, even when the business is in its infancy, it may still prove future lost profits if its management has considerable experience in the industry.

The "Yardstick" Approach

The "yardstick" approach is a fourth judicially recognized method of overcoming the new business rule, and it has been used to predict future lost profits in everything from antitrust cases[40] to labor relations disputes[41] to breach of contract actions.[42] The approach does not require a new business to have a long operational history because it bases profit projections on the record of other established businesses that are closely comparable to the plaintiff's.[43] By studying the track record of these similar firms, the plaintiff's expert may project future profits even though the plaintiff's business has little or no profit history of its own.[44]

The case of *CA May Marine Supply Co v Brunswick Corp*[45] demonstrates that the yardstick approach is a legitimate tool for demonstrating lost profits in federal court. At the trial level, C. A. May brought suit against Brunswick for the wrongful termination of its franchise boat-engine dealership.[46] The issue on appeal concerned the amount of damages that C. A. May should recover as a result of not being able to sell engines to Brunswick. The Fifth Circuit recognized that "[w]here the business is new and the dealer goes out of business before he is able to compile an earnings record, the amount of lost profits is gauged by a 'yardstick' study of the business profits of a closely comparable business."[47] The court went on to hold that because C. A. May had a profit record, a study of this record was the more appropriate method for quantifying damages in this particular case.[48] However, the court made it clear that if the profit history had not been available, the yardstick approach would have been a legitimate means for projecting future lost profits.[49]

The Liquidated Damages Approach

Courts generally enforce contractual provisions that specifically set forth what liquidated damages will result in the event of a breach.[50] In these cases, the new business rule is no obstacle to recovery because proactive parties resolve the question of what amount of damages is appropriate or "reasonably certain" in the event of a breach in the contract. There is a significant likelihood that future lost profits will not be recoverable if a new business does not demand a liquidated-damages clause during contract negotiations and does not subsequently use one of the other approaches to overcoming the new business rule.

In *RMLS Metals, Inc v International Business Machines Corp,*[51] plaintiff was a new company with no operational track record that was thus subject to New York's new business rule.[52] Nevertheless, plaintiff sought future lost-profit damages arising from defendant's breach of contract,[53] arguing that even in the face of the new business rule, its future lost profits were not remote or speculative. Plaintiff cited the case of *Hirschfeld v IC Securities, Inc*[54] in support.

This reliance on *Hirschfeld,* however, was misplaced. In *Hirschfeld,* plaintiff had inserted the amount of anticipated damages into the contract.[55] As a result, the court reasoned that because the amount of damages was fixed and ascertainable by the plain language of the contract, those sums could be recovered, regardless of plaintiff's lack of a financial track record.[56] In *RMLS Metals,* on the other hand, plaintiff had no such contract clause, and consequently the court held that RMLS could not recover lost profits pursuant to the new business rule.[57]

The lesson here is simple: in states that rigidly apply the new business rule, new businesses should insert a liquidated-damages clause into their contracts until they can safely shed the new business label.[58] Then, if a contractual dispute arises, the business can ask the court to simply enforce the plain language of that clause.

With the emergence of these four approaches to overcoming the new business rule, the rule is no longer a major obstacle to predicting future lost profits with reasonable certainty. Still, these approaches are only half of the lost-profits battle today. The second half of the battle focuses on the qualifications and methodology of the plaintiff's damage expert, and whether that expert should be allowed to testify in front of a jury about the plaintiff's future lost profits.

How Lost-Profit Experts Pass *Daubert* Muster

Development of Standards

Before the U.S. Supreme Court's opinion in *Daubert*, judges had expressed their disappointment at what experts had become. One court expressed its displeasure this way:

> [Experts are] … the mere paid advocates or partisans of those who employ and pay them, as much so as the attorneys who conduct the suit. There is hardly anything, not palpably absurd on its face, that cannot now be proved by some so-called "experts."[59]

For an expert to testify in the courtroom of judge and legal scholar Learned Hand in the early 1900s, it had to be possible to test the expert's theory for reliability in the same way that one could test the laws of nature.[60] It is certainly a tribute to Judge Hand that almost a century after the publication of his article "Historical and Practical Considerations Regarding Expert Testimony," the judge's informal thoughts on expert testimony would be mirrored in *Daubert v Merrell Dow Pharmaceuticals*[61] and become the law of the land.

Daubert motions rarely challenge an expert's qualifications, as experts who satisfy the liberal standard of FRE 702 usually meet the qualification prong of the Daubert standard.

In states that rigidly apply the new business rule, new businesses should insert a liquidated-damages clause into their contracts until they can safely shed the new business label.

The petitioners in *Daubert* were minor children and their parents, who alleged that birth defects in the children had been caused by Dow's pharmaceutical Bendectin. At the trial level, the court dismissed the case based on Dow's submission of a "well-credentialed" expert affidavit that concluded that Bendectin does not cause birth defects.[62] Plaintiffs in turn presented eight experts who relied on animal studies, chemical structure analysis, and the unpublished "reanalysis" of previously published human studies to reach the conclusion that Bendectin does cause birth defects.[63] The trial court held that this evidence did not meet the "general acceptance standard"[64] for reliable expert testimony and, given the reliable testimony of Dow's expert, dismissed the case.[65]

On appeal to the U.S. Supreme Court, plaintiffs argued that the "general acceptance standard" was superseded by the enactment of Federal Rule of Evidence 702.[66] While the Court agreed, its holding was overshadowed as it proceeded to set out "helpful" factors that federal trial courts could review before admitting expert testimony under FRE 702. The list of factors includes the following:

- whether the expert theory can be tested
- whether the theory or technique has been subjected to peer review and publication
- whether there is a known or potential rate of error
- whether the theory has "general acceptance" in the relevant scientific community[67]

The purpose of these factors is to ensure scientific validity in expert testimony.[68] Just as fact witnesses can only testify to that which can be perceived by the senses, an expert witness can now only testify to that which can be tested for relevance and reliability.[69] The Supreme Court followed *Daubert* with two more decisions that clarified the federal judiciary's role as the gatekeepers of expert testimony: *General Electric v Joiner*[70] and *Kuhmo Tire Co v Carmichael*.[71] Together, these cases are known as "the trilogy."[72]

In *Joiner,* the Court held that the federal court should scrutinize an expert's underlying data, and if there is a gap between the data and the expert's conclusion, the court should exclude the expert's entire testimony.[73] In *Kuhmo,* the Court held that the *Daubert* standard applies to all experts, not just to those specializing in science.[74] Taken together, the trilogy demands that federal judges ask (1) whether the proposed witness is a qualified expert, (2) whether the proposed expert's testimony is reliable, and (3) whether the expert's testimony will assist the trier of fact.[75]

Whether the Expert Is Qualified

Because projecting future lost profits for a new business requires quantitative analysis, economists and accountants should be retained early in the litigation.[76] The standard qualification for economists is a PhD, while accountants should be CPAs. In both cases, the plaintiff's attorney should seek out experts who have superior academic credentials and a history of original research and publication.[77] Even so, *Daubert* motions rarely challenge an expert's qualifications, as experts who satisfy the liberal standard of FRE 702 usually meet the qualification prong of the *Daubert* standard.[78] In a recent bankruptcy case, for instance, a trustee who was not a CPA and who lacked many of the certifications and professional affiliations customary for accountants[79] was allowed to testify about reconstructive accounting because she had sufficient general accounting training and experience to be considered an expert under FRE 702.[80]

Whether the Expert Will Assist the Trier of Fact

Obviously, expert testimony must be relevant if it is to be admitted under *Daubert*. "Rule 702's 'helpfulness standard' requires a valid scientific connection to the pertinent inquiry as a precondition to admissibility."[81] In other words, the plaintiff's lost-profit expert's testimony must be tied to the issues raised in the case.[82] Not surprisingly, federal case law reveals that relevance is not a point of contention between the parties when it comes to the exclusion of experts before trial. Instead, the heart of the dispute is the reliability of the expert's testimony.

Whether the Expert's Testimony is Reliable

The breadth of federal case law discussing the reliability of the plaintiff's expert testimony on future lost profits is sobering.[83] Thus, it is essential for new businesses to be prepared for the expert's challenge even before that challenge is made. The most important preparation for a *Daubert* motion is to compare each step of the expert's methodology with the methodology presented in the peer-reviewed literature published at the time the expert opinion was formed. This way, when

the court subsequently evaluates the expert's opinion under the *Daubert* standard, the plaintiff is prepared to show that the expert's methodology has been (1) tested, (2) subjected to peer-reviewed publication, and (3) generally accepted in the relevant professional community.[84]

Fortunately, modern methodologies for forecasting business profits are sophisticated.[85] There is no one particular methodology or model that must be used to project future lost profits to satisfy *Daubert*; rather, it depends on the circumstances of the particular case. Regardless of which methodology is used, the Federal Judicial Conference has set forth several issues that can be addressed when seeking to quantify future lost profits:

- the plaintiff's economic position absent the harm compared to its actual economic position;
- the full economic and market consequences of the defendant's behavior, including price, supply, demand, and competition;
- the possible causes of the plaintiff's lost profits other than the defendant's breach of contract or wrongful acts, if any;
- the likely profitability of the new business given the lack of a track record.[86]

If the parties follow these guidelines, they should be able to rebut any suggestion that the lost-profit analysis by their experts is not reliable under *Daubert*.

The plaintiff in *Swierczynski v Arnold Foods Co*[87] followed this advice and defeated the defendant's *Daubert* motion, despite its unusual choice of lost-profit methodology. In *Swierczynski*, plaintiff was a bakery distributor that sued defendant, a bakery, for breach of contract, seeking lost profits.[88] Defendant moved to exclude plaintiff's lost-profit expert on the grounds that his testimony improperly used a "lost wages" approach to quantifying damages, and that the damage calculations were thus not reliable.[89] Plaintiff responded by arguing that the relationship between the parties and the objective circumstances of the market warranted the "lost wages" methodology, and that any challenge should go to the weight, not the admissibility, of the expert's testimony.[90] The *Swierczynski* court engaged in the *Daubert* analysis and held that since the expert's overall method for calculating future lost profits appeared to be valid, it did not fail the *Daubert* reliability standard.

The court made this ruling despite defendant's vigorous argument that a better methodology should have been used.[91] If defendant suggested a better method for quantifying lost profits, the court held that defendant could present that alternative during direct and cross-examination.[92] The importance of the court's refusal to hold that there is only one valid methodology per case cannot be understated. *Daubert* and its progeny do not hold that there is one correct method for quantifying lost profits.[93] They require only that the expert set forth a reliable methodology that is based on objective market forces.[94]

A second point of attack on the reliability of an expert's testimony focuses on the expert's underlying assumptions when making lost-profit predictions. Obviously, any expert who predicts future lost profits for a new business will have to make assumptions to project revenues into the future, and these assumptions will be vulnerable to attack. The key is that the attorney must ensure that any assumptions the expert makes are drawn from the plaintiff's evidence. Large or unrealistic profit projections that have little relationship to the plaintiff's evidence endanger the entire opinion, and the entire case.[95]

Main Street Mortgage, Inc v Main Street Bancorp, Inc[96] is an example of the correct response to an attack on an expert's underlying assumptions. Plaintiff in *Main Mortgage* brought suit against defendant for unfair competition[97] and retained a CPA named Kenneth Biddick to quantify lost-profit damages.[98] Predictably, defendant filed a *Daubert* motion to strike the expert, arguing that Mr. Biddick's testimony was not reliable because his lost-profit calculations were based on unrealistic assumptions.[99]

Mr. Biddick set forth three possible scenarios for predicting lost profits, based on a set of assumptions about what would have happened had defendant not engaged in unfair competition. The expert also addressed many of the other issues set forth in the Federal Judicial Conference's *Reference Manual*.[100] As a result, the expert's assumptions did not overreach but were instead supported by a variety of independent market factors.[101] The court recognized that there was nothing inherently wrong with plaintiff's expert basing his lost-profit projections on reasonable assumptions, and denied defendant's motion in its entirety.[102]

New businesses seeking to present unfettered lost-profit expert testimony to the jury can do so with proper preparation.

The analysis in *Main Street Mortgage* is sound. Contrary to popular belief, *Daubert* does not stand for the proposition that if an expert bases his or her opinion on assumptions, the opinion is per se unreliable. As the Supreme Court stated in *Kuhmo*, the expert's testimony need not be certain, but must be based on the same level of intellectual rigor that characterizes the expert's field.[103] According to Robert L. Dunn in his authoritative treatise *Recovery of Damages for Lost Profits*,[104] assumptions are part of predicting lost profits and should not be excluded if they are reasonable:

> Expert testimony is properly admitted when based on assumptions of fact supported by the evidence, even if the evidence is disputed. As long as there is some evidence to support the assumptions, and the opinion rests on an adequate foundation. The dispute is then for the trier of fact to resolve.[105]

Daubert and its progeny do not hold that there is one correct method for quantifying lost profits. They require only that the expert set forth a reliable methodology that is based on objective market forces.

The plaintiff's accountant or economist should not be excluded from the courtroom merely because his or her projections involve assumptions.[106] Assumptions are part of the "intellectual rigor that characterizes" accounting and economics when these fields are used to project future lost profits for any business.[107]

Accordingly, new businesses seeking to present unfettered lost-profit expert testimony to the jury can do so with proper preparation. First, each step of the expert's methodology should be validated by authoritative sources so that the court can be reassured that the expert's analysis has been tested, reviewed by his or her peers, and accepted in the professional community.[108] Second, the expert's opinion should fully address the issues raised by the Federal Judicial Center's *Reference Manual*. Third, the expert's assumptions must be conservatively drawn from the plaintiff's evidence. If these acts are performed at the same time that the expert's opinion is formed, the plaintiff can easily respond to attacks on the reliability of the expert testimony's, and *Daubert* will not be an obstacle to the recovery of lost profits.

Conclusion

Today, proving lost profits for new businesses is nothing like trying to prove that the "sun revolves around the earth." Modern accounting methods can test future lost-profit projections for reliability by considering independent market forces. Federal courts are more frequently questioning the rationale of the new business rule when new businesses can prove damages by adopting alternative approaches to quantifying lost profits. Judicial skepticism over the reliability of expert testimony in the courtroom will no doubt continue in the post-*Daubert* era. But the modern federal judicial landscape reveals that there is little reason that new businesses seeking to prove future lost profits should abandon possible claims out of the fear that they will be thwarted by the traditional new business rule.

NOTES

1. *Target Mkt Publ'g, Inc v ADVO, Inc,* 136 F3d 1139, 1143 (7th Cir 1998).

2. Restatement (Second) of Contracts § 352.

3. There is considerable confusion in the courts regarding the appropriate application of the new business rule. One court has suggested that the rule is simply a new label given to the normal burden of proof placed on plaintiffs in proving damages. *Fera v Village Plaza, Inc,* 396 Mich 639, 641–646, 242 NW2d 372 (1976). Other courts, however, believe it is a rule of law that actually raises the plaintiff's burden of proof to a higher evidentiary standard. *Schonfeld v Hilliard,* 218 F3d 164, 172 (2d Cir 2000) ("Therefore, evidence of lost profits from a new business receives greater scrutiny because there is no track record upon which to base an estimate").

4. *Larsen v Walton Plywood Co,* 390 P2d 677, 687 (Wash 1964).

5. *Taylor v Shoemaker,* 38 So2d 895, 899 (Ala Civ App 1948).

6. *Georgia Grain Growers Ass'n Inc v Craven,* 98 SE2d 633, 637–638 (Ga 1957).

7. *St Paul at Chase Corp v Manufacturers Life Ins Co,* 278 A2d 12, 37–38 (Md 1971).

8. *Weiss v Revenue Bldg & Loan Ass'n,* 182 A 891, 893 (NJ Super Ct App Div 1936).

9. *Kenford Co v County of Erie*, 67 NY2d 257, 260–261 (1986).

10. *Hickman v Coshocton Real Estate Co,* 15 NE2d 648, 650 (Ohio 1938).

11. *Dieffenbach v McIntyre,* 254 P2d 346, 349 (Okla 1953).

12. *Southwest Battery Corp v Owen,* 115 SW2d 1097, 1099 (Tex 1938).

13. *Mullen v Brantley,* 195 SE2d 696, 700 (Va 1973).

14. *Erie RR v Tompkins,* 304 US 64, 78 (1938) ("Except in matters governed by the Federal Constitution or by Acts of Congress, the law to be applied in any case is the law of the State").

15. *See* notes 5–14.

16. *See* Herman Forsecue Green, *Remedies—Lost Profits as Contract Damages for an Unestablished Business: The New Business Rule Becomes Outdated*, 56 NC L Rev 693, 695–696 (1979). Green discusses the origin and evolution of the new business rule and opines that the rule is outdated because of the growing sophistication of market analysis and business forecasting.

17. *Cope v Vermeer Sales & Serv,* 650 P2d 1307, 1309 (Colo Ct App 1982); *Cardinal Consulting Co v Circo Resorts, Inc,* 297 NW2d 260 (Minn 1980); *Universal Computers (Sys) v Datamedia Corp,* 653 F Supp 518, 525–527 (DNJ 1987) (All three cases reasoning that the

new business rule can be overcome if the plaintiff presents alternative evidence that profits were lost).

18. *Lowe's Home Ctrs, Inc v General Electric Co,* 381 F3d 1091, 1096–1097 (11th Cir 2004) (questioning whether a "new" chain store is a "new" business); *Lakota Girl Scout Council, Inc v Havey Fund-Raising Mgmt, Inc,* 519 F2d 634, 640–641(8th Cir 1975) (recognizing that despite the new business rule, a plaintiff may recover anticipatory lost profits when the profits were foreseeable to the defendant at the time of contracting); *Cates v Morgan Portable Bldg Corp,* 591 F2d 17, 21 n7 (7th Cir 1979) (noting that in cases where new businesses have obtained lost profits, the measure of damages can be based on the profits of other, similar businesses).

19. 759 F2d 1526 (11th Cir 1985).

20. *Id*. The wrongful acts included U.S. Home's tortious interference with the business relationship between G.M. Brod & Co. and the unit owners of the condominium hotel.

21. *Id.* at 1537.

22. *Id*. (citing *A&P Bakery Supply & Equip Co v Hawatmeh,* 388 So2d 1071, 1072 [Fla Dist Ct App 1980]).

23. *GM Brod & Co.,* 759 F2d at 1526.

24. *See Manufacturing Research Corp v Greenlee Tool Co,* 693 F2d 1037 (11th Cir 1982); *Heatransfer Corp v Volkswagenwerk, AG,* 553 F2d 964, 983 (5th Cir 1977).

25. *Lehrman v Gulf Oil Corp,* 464 F2d 26, 45 (5th Cir 1972).

26. *Id.*; *GM Brod & Co*, 759 F2d at 1537–1538.

27. *Schonfeld,* 218 F3d at 172.

28. *Lowe's*, 381 F3d at 1091.

29. *Id.* at 1096.

30. *Id*.

31. *Id*. at 1097.

32. *No Ka Oi Corp v National 60 Minute Tune, Inc,* 863 P2d 79, 84 (Wash 1993) (allowing proof of lost profits for new franchise); *Pauline's Chicken Villa, Inc v KFC Corp,* 701 SW2d 399, 401–402 (Ky 1985).

33. *Lowe's*, 381 F3d at 1097.

34. 901 F2d 349 (3d Cir 1990).

35. *Id*. at 356.

36. *Id*.

37. *Id.*

38. *Id*. at 357.

39. *Lee v Joseph E Seagram & Sons, Inc,* 552 F2d 447 (2d Cir 1977); *McDermott v Middle East Carpet Co Associated,* 811 F2d 1422 (11th Cir 1987).

40. *See, e.g.*, *Lehrman*, 500 F2d at 659.

41. *Iodice v Calabrese,* 409 F Supp 389 (SDNY 1976).

42. *Merritt Logan*, 901 F2d at 349; *GM Brod*, 759 F2d at 1526.

43. *GM Brod,* 759 F2d at 1538.

44. *Id*.

45. 649 F2d 1049 (5th Cir 1981).

46. *Id*. at 1050–1051.

47. *Id*. at 1053 (citing *Lehrman*, 500 F2d at 667).

48. *Id*. at 1054.

49. *Id*.

50. *See, e.g., Rattigan v Commodore Int'l Ltd,* 739 F Supp 167 (SDNY 1990); *Manufacturers Cas Ins Co v Shome Power Corp,* 157 F Supp 681 (WD Mo 1957); *Atel Fin Corp v Quaker Coal Co,* 132 F Supp 2d 1233 (ND Cal 2001).

51. 874 F Supp 74 (SDNY 1995).

52. *Id*. at 76.

53. *Id*.

54. 132 AD2d 332 (NY App Div 1987).

55. *RMLS Metals*, 874 F Supp at 77.

56. *Id.*

57. *Id*. at 78.

58. If a business inserts a lost-profits provision into a contract, the amount must be reasonably related to its anticipated losses or it will be viewed as a penalty and become void. *See, e.g., Easton Telecom Servs, LLC v Corecomm Internet Group, Inc,* 216 F Supp 2d 695, 698 (ND Ohio 2002).

59. *Keegan v Minneapolis & St Louis RR Co,* 78 NW 965, 966 (Minn 1899).

60. Learned Hand, *Historical and Practical Considerations Regarding Expert Testimony,* 15 Harv L Rev 40, 53 (1901). The U.S. Supreme Court even references Mr. Hand's thoughts on expert testimony in *Kuhmo Tire Co v Carmichael,* 526 US 137, 148–149 (1999).

61. 509 US 579 (1993).

62. *Id.*

63. *Id.*

64. This standard was set forth in *Frye v United States,* 293 F 1013 (DC App 1923).

65. *Id*.

66. FRE 702 states, "If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise."

67. *Daubert,* 509 US at 593–594

68. *Id*. at 590 n9.

69. *Id*.

70. 522 US 136 (1997).

71. 526 US 137 (1999).

72. Robert E. Hall and Victoria A. Lazear, *Reference Manual on Scientific Evidence, in* Reference Guide on Estimation of Economic Losses in Damage Awards 282 n5 (2d ed 2000).

73 *Id*. at 146.

74. It has been held that accounting is subject to the *Daubert* standard of admissibility. *See City of Tuscaloosa v Harcros Chems, Inc,* 158 F3d 548, 564 n17 (11th Cir 1998).

75. *In re Paoli RR Yard PCB Litig,* 35 F3d 717, 741–43 (3d Cir 1994). These prongs are commonly referred to as qualifications, reliability, and fit. The plaintiff's expert must satisfy the prongs by a preponderance of proof. *In Re TMI Litig,* 193 F3d 613, 633 (3d Cir 1999).

76. Retaining experts early in litigation is essential. In these cases, it is not enough for the expert to issue a report under Fed R Civ P 26. Rather, each step of the way, the expert must compare his or her methodology with authoritative sources and peer-reviewed publications to ensure that it has been reviewed and tested for reliability. This way, when the defendant files the *Daubert* motion, the plaintiff is fully prepared to demonstrate to the judge that the expert's analysis is not novel and can be shown to be scientifically valid.

77. Hall and Lazear.

78. *See, e.g., Casey v Ohio Med Prods,* 877 F Supp 1380, 1383 (ND Cal 1995) (admitting expert testimony based on education and experience); *Crowley v Chait,* 322 F Supp 2d 530, 538 (DNJ 2004) (admitting experts based on experience alone); *Elcock v Kmart Corp,* 233 F3d 734 (3d Cir 2000).

79. *In re Bonham,* 251 BR 113, 131–132 (Bankr D Alaska 2000).

80. *Id*.

81. *United States Info Sys, Inc v IBEW Local Union No 3,* 313 F Supp 2d 213, 226–227 (SDNY 2004) (citing *Daubert,* 509 US at 591–92).

82. *United States Info Sys.*

83. *See, e.g., Club Car, Inc v Club Car (Quebec) Imp Inc,* 362 F3d 775 (11th Cir 2004); *Chemipal Ltd v Slim-*

Fact Nutritional Foods Int'l, 350 F Supp 2d 582 (D Del 2004); *Lithuanian Commerce Corp v Sara Lee Hosiery,* 179 FRD 450 (DNJ 1998); *Real Estate Value Co v USAir, Inc,* 979 F Supp 731 (ND Ill 1997); *Albert v Warner-Lambert Co,* 234 F Supp 2d 101 (D Mass 2002).

84. These are the first, second, and fourth factors set forth in the *Daubert* opinion.

85. Green.

86. Hall and Lazear. The *Reference Manual* discusses many other issues that should be addressed as well.

87. 265 F Supp 2d 802 (ED Mich 2003).

88. *Id.*

89. *Id.* at 809. Plaintiff in *Swierczynski* was not a new business and did not face the new business rule. However, the court's holding did not rest on the track record. Rather, it was based on the fact that plaintiff used a recognized and valid methodology to quantify lost profits.

90. *Id.*

91. *Id.* at 810–811.

92. *Id.*

93. *Daubert*, 509 US at 579.

94. The "best" methodology is a matter of opinion. Under *Daubert*, the jury is to decide the better of two opposing, but reliable, methodologies.

95. *Matosantos Commercial Corp v SCA Tissue North America, LLC,* 369 F Supp 2d 191, 198 (DPR 2005); *Boucher v United States Suzuki Motor Corp,* 73 F3d 18, 21 (2d Cir 1996).

96. 158 F Supp 2d 510 (ED Penn 2001).

97. *Id.*

98. *Id.*

99. *Id.* at 515–517. One of the expert's scenarios involved the yardstick approach discussed above.

100. *Id.* at 515.

101. *Id.*

102. *Id.* at 514–516.

103. *Kuhmo*, 526 US at 152.

104. Robert L. Dunn, *Recovery of Damages for Lost Profits* (6th ed 2005).

105. Dunn at 610.

106. At least one court has been willing to admit that when it comes to proving future lost profits, "reasonable certainty" may not be a practical standard. "Once it is apparent that damages must be assessed so as to approximate the future profits of a business, a court and jury necessarily enter into the realm of the imprecise and the uncertain." *Lehrman,* 500 F2d at 671 n57.

107. *Kuhmo,* 526 US at 152.

108. Although the U.S. Supreme Court in *Daubert* provided that these factors are merely "helpful," there is little doubt that striving to satisfy these factors increases the plaintiff's chance of prevailing in a *Daubert* dispute.

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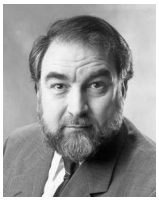

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*Stay or Proceed: What Effect Does an Arbitrability Appeal Have on the Proceedings in the Lower Court?**

By Uwe Dauss

Introduction

The federal courts are said to be divided over whether an appeal from the denial of a motion to compel arbitration stays the proceedings in the district court while the appeal is pending.[1] The question, though narrow, is not without practical impact: absent a stay, a party to an arbitration agreement may have to litigate a claim that should rightfully be arbitrated.[2] The federal circuit courts have issued seemingly conflicting decisions on this question: either an appeal from the denial of a motion to compel arbitration[3] does not stay the litigation in the district court,[4] or it does stay the proceedings as long as the appeal is not frivolous.[5]

Background

Arbitration is an alternative method of resolving disputes before a neutral body other than a court.[6] It is an old concept,[7] and while initially not well received by the courts[8–9] it has since become widely used.[10] This evolution accelerated, first for the federal courts and later for the state courts,[11] when Congress enacted the Federal Arbitration Act (FAA) of 1925.[12]

Section 2 of the FAA provides that agreements to settle disputes by arbitration "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."[13] Section 3 of the FAA requires that in "any suit or proceeding … upon any issue referable to arbitration … , the court in which such suit is pending … shall … stay the trial of the action until such arbitration has been had."[14] The goal is "to move the parties to an arbitrable dispute out of court and into arbitration as quickly and easily as possible."[15] To this end, a "court shall designate and appoint an arbitrator … as the case may require."[16] In summary, sections 2 through 5 of the FAA articulate a strong federal policy favoring arbitration[17] and envision the courts helping arbitration along.[18]

The courts, however, are only required to defer to arbitration "upon being satisfied that the issue involved … is referable to arbitration."[19] When a court, rightly or wrongly, finds an issue not to be referable to arbitration, the issue will likely be litigated.[20] While there is no doubt that questions of arbitrability are for the courts to decide,[21] the point only highlights the tension inherent in the FAA: the courts decide when to yield to arbitration, and there is no guarantee that they will get this right. If they get this wrong, the purpose of the FAA is thwarted.[22]

As originally enacted, the FAA did not contain special rules governing appeals.[23] Court decisions under the FAA were therefore appealable only according to the basic rules of federal appellate jurisdiction[24] and related doctrines.[25]

In 1988, Congress amended the FAA by adding special provisions governing appeals.[26] Section 16 of the FAA now allows for an immediate appeal of a district court's refusal to stay litigation pending arbitration,[27] to order arbitration to proceed,[28] or to compel arbitration.[29] At the same time, it prohibits interlocutory appeals from court orders that favor arbitration.[30] These added provisions raise the question of whether an appeal under section 16(a)(1)(B) or (C) from the denial of a motion to compel arbitration stays the proceedings in the district court.

The question was recently addressed in depth by the Tenth Circuit in *McCauley v Halliburton Energy Services Inc*.[31] In *McCauley*, the parties agreed that some of the claims were related to their employment relationship and were therefore arbitrable under Halliburton's dispute resolution program.[32] McCauley, however, contended that two other claims arose out of his work for Halliburton as an independent contractor.[33] The district court therefore partially denied Halliburton's motion to arbitrate all claims and ordered the parties to proceed to litigate the non-arbitrable claims. Halliburton appealed the issue

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of arbitrability and asked for a stay of the litigation pending appeal.[34] After the district court denied the requested stay, Halliburton moved the court of appeals to stay the litigation until the issue of arbitrability was decided.[35] This motion was the only subject of the circuit court's decision in *McCauley*.[36]

In accord with Halliburton's primary contention, the Tenth Circuit rested its decision on the divestiture principle.[37] The divestiture principle holds that

> a federal district court and a federal court of appeals should not attempt to assert jurisdiction over a case simultaneously. The filing of a notice of appeal is an event of jurisdictional significance—it confers jurisdiction on the court of appeals and divests the district court of its control over those aspects of the case involved in the appeal.[38]

Whether an arbitrability appeal requires a stay depends on the purpose and structure of the statute allowing for such appeals.

Despite some concern, the Tenth Circuit concluded that the divestiture principle applied to arbitrability appeals under section 16 of the FAA.[39]

The Seventh Circuit reached basically the same result in *Bradford-Scott Data Corp, Inc v Physician Computer Network*.[40] Here, too, the defendants sought to arbitrate the plaintiff's claims and moved the district court to stay discovery and trial pending arbitration.[41] The district court concluded the dispute was not arbitrable and refused to stay the trial proceedings.[42] Defendants appealed and asked the court of appeals to stay the trial pending appeal.[43] The court issued a stay because plaintiffs did not argue that the appeal was frivolous,[44] and because without a stay the point of arbitrability appeals under section 16(a) of the FAA would be largely defeated.[45] The Eleventh Circuit was persuaded by the Seventh Circuit's reasoning in *Bradford-Scott,* and in a factually similar case stayed the proceedings in the district court.[46]

The opposite result was reached by the appeals courts for the Second and Ninth Circuits in *Motorola Credit Corp v Uzan* and *Britton v Co-Op Banking Group*, respectively.[47] Both cases involved protracted litigation.[48] In addition, in *Motorola Credit* the stakes and mutual resentment among the parties were particularly high.[49]

In both *Britton* and *Motorola Credit*, the defendants had at some point in the litigation sought to compel arbitration and appealed the district courts' adverse decisions.[50] In both cases, the defendants argued that their filing of a notice of appeal from the district court's order denying their motion to compel arbitration had deprived the district court of jurisdiction to proceed to trial.[51] The trial courts had in each case refused to stay proceedings, finding that the defendants' push for arbitration was without merit.[52] Regardless, on appeal a stay of litigation had become moot because the district courts had meanwhile entered judgment against the defendants.[53] The Second Circuit held that, although defendants' appeal was not frivolous, the district court had retained jurisdiction to continue with the case in the absence of a stay.[54] The Ninth Circuit similarly concluded that absent a stay the district court was not barred from proceeding with the case on the merits.[55]

The cases described above all involve arbitrability appeals under section 16(a) of the FAA and were discussed in the same general terms of lower-court jurisdiction, yet the courts came down with seemingly conflicting results. These results call for an explanation.

Analysis

Even though the courts consider themselves split,[56] on closer inspection their dispute is a phantom: the courts on either side of the divide actually answered different questions. The analysis shows that the courts were facing procedurally different cases, and that the procedural differences account for the different outcomes. The analysis also shows that the divestiture principle is not dispositive of the issue. Rather, whether an arbitrability appeal requires a stay depends on the purpose and structure of the statute allowing for such appeals. The analysis concludes that in the right procedural setting, section 16 of the FAA leaves the courts little choice but to stay litigation while an arbitrability appeal is pending.

Due to the Different Procedural Postures of the Cases Before Them, the Courts Answered Different Questions

Procedurally, the cases before the Seventh, Tenth, and Eleventh Circuits were straightforward: the defendants had been sued in federal district court, moved the district court for arbitration, then appealed the district court's adverse decision.[57] As an immediate matter, the courts of appeals had to decide whether to stay the trial proceedings until they would

decide the merits of the appeal.[58] In each case the court issued a stay.[59] The question the courts had to answer was whether an appeal under section 16(a) of the FAA, generally and in the particular case, warrants a stay.

The cases before the Second and Ninth Circuits, on the other hand, were markedly different. There, by the time the courts decided the appeal, the district court had entered a judgment against the defendant.[60] The existence of a judgment rendered obsolete any earlier request for a stay,[61] and required the defendants to attack the judgments against them on jurisdictional grounds.[62] The defendants argued that their filing of a notice of appeal had divested the district court of jurisdiction, making the subsequent entries of judgment void.[63]

The Second and Ninth Circuits thus faced a much starker choice. Unlike the Seventh, Tenth, and Eleventh Circuits, the Second and Ninth Circuits were not asked to only temporarily halt litigation; rather, they were asked to undo trials that had meanwhile concluded in a final judgment.[64] The precise question before the Second and Ninth Circuits, therefore, was whether a district court's final judgment had to be vacated because of a previously filed arbitrability appeal, without any regard to the merits of that appeal.[65] This question is quite different from asking whether an arbitrability appeal must, or generally should, be followed by a stay of litigation.

The fact that the courts on either side answered different questions allows for a first conclusion. Nothing in their decisions precludes the Second or Ninth Circuits from granting a stay of litigation before the conclusion of the litigation in the district court.[66] Conversely, nothing in the decisions of the Seventh and Eleventh Circuits suggests that they would throw out a judgment because a notice of appeal had been filed. The Eleventh Circuit merely said that *upon motion,* proceedings in the district court *should* be stayed;[67] the Seventh Circuit issued its stay because continuation of proceedings in the district court would largely defeat the point of arbitrability appeals and erode the benefits of arbitration.[68] The purported circuit split thus turns out to be a split that wasn't quite there. Only the Tenth Circuit explicitly granted a stay *because* the district court was divested of jurisdiction.[69] It is, however, a mystery why a stay would be necessary when the divestiture principle already leaves the lower court without jurisdiction.[70]

The Divestiture Principle, Though Relevant, Does Not Control

The courts in each decision discussed the divestiture principle.[71] In *Britton* and *Motorola Credit*, the principle was presented by the appealing parties,[72] while in *Blinco* and *Bradford-Scott* it was invoked by the courts.[73] The *Bradford-Scott* court in particular took its approach voluntarily.[74] In *McCauley,* it was again the appealing party that advanced the principle as the basis for a stay of litigation.[75] These varying ways in which the divestiture principle ended up in the decisions suggest that the principle lent itself well to the relief sought by the appealing parties. However, that does not necessarily mean that the principle in fact governs the issue.

The divestiture principle was formulated by courts in order to prevent trial and appellate courts from simultaneously adjudicating the same issue.[76] As the Ninth Circuit noted, the appeals court would be dealing with a moving target if, after the filing of an appeal, the district court retained any power to adjudicate the very issue on appeal.[77] To be sure, the question of whether a claim must be arbitrated implicates the courts' jurisdiction to decide the merits of the claim.[78] But the question of arbitrability is legally severable and distinct from the merits of the underlying claim,[79] and the divestiture principle, where applicable, only divests the lower court of control over the issues presented on appeal.[80] Once impressed with the divestiture principle, though, it made sense for the courts to try to determine whether "the trial of a case on the merits is 'involved in' an appeal of an order denying arbitration."[81] The fact that the courts started out with the same principle but arrived at opposite conclusions allows us to infer that (1) there was something other than the divestiture principle at work, and (2) the divestiture principle itself is not so precisely outlined as to be controlling of the issue.[82] There is also no doubt that Congress could authorize or even require trial and appellate courts to consider the same issue at the same time.[83] The proper question, therefore, is what Congress intended to do when it enacted section 16 of the FAA.

The appeals court would be dealing with a moving target if, after the filing of an appeal, the district court retained any power to adjudicate the very issue on appeal.

While the preeminent concern in originally enacting the FAA was to enforce agreements to arbitrate, Congress's goal in passing the 1988 amendments was to increase the efficiency of the federal judiciary.

Legislative History, Statutory Interpretation, and Purpose of Section 16 of the FAA Generally Require a Stay of Litigation

Legislative History

Section 16 was added to the FAA as part of the Judicial Improvements and Access to Justice Act of 1988.[84] This Act amended a number of federal statutes with the overall purpose of improving the administration of justice and securing the "just, speedy and inexpensive determination of every action."[85] The Act was part of a decade-long effort by Congress to relieve the federal courts of an overload of cases and to curtail the spiraling costs of litigation.[86] To this end, Congress authorized an experimental pilot program of court-annexed arbitration as a possible means of quicker and less-costly dispute resolution that would reduce the burden on the federal judiciary.[87]

The legislative history of 9 USC 16 itself is brief and inconclusive. It states only that the new section on interlocutory appeals was added to chapter 1 of title 9 to improve the appellate process in the federal appeals courts with respect to arbitration.[88] Applied to the issue at hand, this summary of the legislative history nonetheless steers the discussion in one direction: Congress's goal was to reduce the involvement of the federal courts in civil litigation, and arbitration was seen as an alternative—a faster and less-expensive means of dispute resolution.[89] Therefore, while the preeminent concern in originally enacting the FAA was to enforce agreements to arbitrate,[90] Congress's goal in passing the 1988 amendments was to increase the efficiency of the federal judiciary.[91]

Thus, it may at first seem counterintuitive to provide for interlocutory appeals in an effort to reduce court involvement.[92] However, a successful arbitrability appeal would result in the referral of the case to arbitration, which in Congress's reasonable judgment would lead to a net reduction of court involvement in the adjudication of the case.[93] In addition, interlocutory appeals are designed to prevent an otherwise "final and irreparable effect on the rights of the parties."[94] By adding section 16 to the FAA, Congress expressed its view that litigation of an arbitrable claim would affect the rights of the parties in a way that cannot be undone in a later appeal.

In conclusion, the legislative history suggests that Congress would view it as the worst possible outcome if a dispute is both litigated *and* arbitrated because the trial court wrongly refused to submit a case to arbitration.[95] In accord with the Seventh, Tenth, and Eleventh Circuits, this outcome does not occur when an arbitrability appeal is generally followed by a stay of litigation. Therefore, this approach accurately reflects the congressional intent behind section 16 of the FAA.

This Inferred Congressional Intent is Supported by Statutory Interpretation

As a basic division, section 16 of the FAA provides that an appeal may be taken from various orders disfavoring arbitration while generally prohibiting appeals from orders favoring arbitration.[96] This division illustrates that while Congress did not want litigation to proceed at the expense of arbitration, it did not mind arbitration proceeding at the expense of litigation, even if a claim would later turn out to have been wrongly submitted to arbitration.[97]

Section 16(a)(1)(A) is the most instructive provision to illustrate how the entire section operates. Section 16(a)(1)(A) allows for an immediate appeal should a district court refuse to stay litigation after and despite finding the issue before it referable to arbitration.[98] A district court refusing to stay litigation would presumably move the case along, consistent with its view that no stay is required.[99] Counter to the purpose of the FAA and the federal policy favoring arbitration, this would result in a trial where arbitration is proper.

The significance of section 16(a)(1)(A) is then twofold. First, enactment of section 16(a)(1)(A) was necessitated by the U.S. Supreme Court decision in *Gulfstream Aerospace Corp v Mayacamas Corp*, which came down just half a year before Congress amended the FAA.[100] Before *Gulfstream*, a court order granting or denying a stay of the proceeding before it was considered an injunction and was therefore immediately appealable under 28 USC 1292(a)(1).[101] That understanding, going back to *Enelow v New York Life Insurance Co*[102] and *Ettelson v Metropolitan Life Insurance Co*,[103] was overruled in *Gulfstream*.[104] By enacting section 16(a)(1)(A), however, Congress promptly reinstated with respect to arbitration what had been the law before *Gulfstream*—that is, court orders denying to stay litigation in favor of arbitration were once again appealable.[105] The second significant element of section 16(a)(1)(A) is that the only issue involved in an appeal from the denial of a stay is whether litigation in the district court should proceed.[106] Therefore, because Congress cared so much to make the denial

of a stay appealable, the appeal itself must then necessarily entail a stay.[107]

This line of reasoning derived from section 16(a)(1)(A) applies with almost equal force to appeals from the denial to compel arbitration.[108] While technically the subject of such an appeal is something other than a trial on the merits, there appears to be no reason why one type of appeal should have a different effect on the trial court than the other.

The prime reason to provide the opportunity to appeal is the notion that the lower court's decision may have been wrong.[109] Appellate review serves to rectify such wrongs. In the context of arbitration, the potential wrong to be averted is that the parties would have to bear the burdens involved in litigation.[110] At the very least, federal policy would be furthered if a district court cannot proceed while an appeals court reviews matters of arbitrability, and the federal courts are generally required to apply federal statutes in such a way as to implement federal policy.

Since arbitrability appeals, therefore, generally warrant a stay of litigation but do not categorically divest the lower court of jurisdiction, it remains to be seen how much discretion the courts have to rule one way or the other.

Section 16(a) Neither Precludes All Nor Leaves Much Discretion to the Courts

There are two relevant points of certainty: (1) a court cannot refer to arbitration a claim the parties did not agree to arbitrate;[111] and (2) if a court finds a claim referable to arbitration, the court must stay the litigation, without any discretion in that regard.[112] Arbitrability appeals fall somewhere in between.

When taken at face value, section 16 of the FAA does not address the courts' discretion; however, section 16(b) contains a reference to 28 USC 1292(b),[113] which is crucial to the question at issue.

Section 1292(b) of title 28 allows for discretionary appeals from orders not otherwise appealable under that section. An appeals court may, at its discretion, take such an appeal if (1) the district court states in writing that its order involves a controlling question of law as to which there is substantial ground for difference of opinion, (2) an immediate appeal may materially advance the ultimate termination of the litigation, and (3) application for appeal is made to the appeals court within ten days after the district entered its order.[114] Section 1292(b) further provides that application for such an appeal "shall not stay proceedings in the district court unless the district judge or the Court of Appeals or a judge thereof shall so order."[115]

Read in context with section 16 of the FAA, section 1292(b) of title 28 means that Congress only placed in the discretion of the courts the question of (1) whether to take an appeal from an interlocutory order *favoring* arbitration, and (2) whether such an appeal should stay the proceedings in the district court. This shows that where Congress wants the federal courts to have discretion, it knows how to provide for it. It is also difficult to conceive that, absent an explicit grant by Congress, the federal courts should have the same discretion as to orders disfavoring arbitration as they have to appeals from orders favoring arbitration.[116]

As a result, section 16(a) of the FAA, while not necessarily precluding all discretion, can only be understood as leaving little discretion to the courts and generally requiring a stay of litigation.[117] In that sense, section 16 contains a mandate to the courts to use their discretion to further the federal policy in favor of arbitration.

In the Discretion of the Courts, Frivolous Appeals Do Not Require a Stay of Litigation

The Seventh, Ninth, Tenth, and Eleventh Circuits were concerned that if arbitrability appeals require a stay, litigation could be stalled by bringing frivolous appeals.[118] This concern grew out of the courts' heavy reliance in their analyses on the divestiture principle.[119] However, as shown above, that reliance was misplaced.[120] Under the more flexible approach formulated by the Seventh Circuit, a frivolous appeal would merely steer the appeals court's discretion toward denying a stay or disposing of the appeal summarily.[121]

Conclusion

The categorical application of the divestiture principle in *Britton* and *Motorola Credit* would have had the most unwelcome result of vacating judgments that for good reasons had been entered against the defendants. That result is not what Congress envisioned when it provided for immediate appeals of questions of arbitrability. Both *Britton* and *Motorola Credit* were thus correctly decided.

That said, the appeals courts for the Seventh, Tenth, and Eleventh Circuits were also correct in staying litigation pending the determination of the questions of arbitrability

Congress would view it as the worst possible outcome if a dispute is both litigated and arbitrated because the trial court wrongly refused to submit a case to arbitration.

before them. Arbitration is, by definition, an *alternative* means of dispute resolution—that is, alternative to litigation, and as long as it is unclear whether a claim should be arbitrated, litigation should not advance at the expense of arbitration. Rather, because Congress considered questions of arbitrability so important as to make them immediately appealable, such an appeal should generally stay the proceedings in the court below.

The correct approach, then, was laid out by the Eleventh Circuit in *Blinco v Green Tree Servicing* and is here recommended for widespread adoption. When a litigant files a motion to stay litigation in the district court pending the outcome of an arbitrability appeal, the district court should stay the litigation so long as the appeal is not frivolous.[122] If the district court denies the motion, the appellant may renew its motion for a stay in the appeals court.[123] If the appeals court determines that the appeal is not frivolous, then it should stay the litigation in the district court.[124] This approach best implements the congressional intent behind the Federal Arbitration Act, while at the same time giving the courts the flexibility to deny a stay of litigation in the proper circumstances. In our adversarial system of litigation, however, arguing the point of frivolity can and should be left to the parties.[125]

Section 16 of the FAA contains a mandate to the courts to use their discretion to further the federal policy in favor of arbitration.

NOTES

1. *McCauley v Halliburton Energy Servs, Inc,* 413 F3d 1158, 1160 (10th Cir 2005) ("Our sister circuits … are split"); *Motorola Credit Corp v Uzan,* 388 F3d 39, 54 (2d Cir 2004) ("Other circuits are divided on this question"); *Blinco v Green Tree Servicing, LLC,* 366 F3d 1249, 1251 (11th Cir 2004) ("The circuit courts that have considered the issue are split").

2. The prospect of arbitrating the same claim later is of little comfort: much of the appeal of arbitration lies in the degree to which it happens outside of court, and that degree would be irretrievably diminished. *Blinco*, 366 F3d at 1251–52; *Bradford-Scott Data Corp v Physician Computer Network,* 128 F3d 504, 506 (7th Cir 1997); *see also Lummus Co v Commonwealth Oil Refining Co,* 273 F2d 613 (1st Cir 1959) (staying discovery because "discovery would be affirmatively inimical to appellee's obligation to arbitrate, if this court determines it to have such obligation").

3. Arbitrability appeals such as this arise under section 16(a)(1)(A), (B), and (C) of the Federal Arbitration Act, 9 USC 1 et seq.

4. *Motorola Credit*, 388 F3d at 54; *Britton v Co-op Banking Group,* 916 F2d 1405, 1412 (9th Cir 1990); *see also Gutfreund v Weiner (In re Salomon Inc S'holders Derivative Litig),* 68 F3d 554, 556–57 (2d Cir 1995) (denying defendants' repeated motions for a stay).

5. *See McCauley*, 413 F3d at 1162–63; *Blinco*, 366 F3d at 1252–53; *Bradford-Scott*, 128 F3d at 506–07.

6. See the definitions of "arbitration" in *Black's Law Dictionary* 112 (8th ed 2004) and 28 USC 651(a) (2000).

7. Arbitration was known in medieval England and is even said to go back to ancient Greek civilization. *See* Gabriel Herrmann, *Note, Discovering Policy under the Federal Arbitration Act*, 88 Cornell L Rev 779, 783–84 (2003); Larry J. Pittman, *The Federal Arbitration Act: The Supreme Court's Erroneous Statutory Interpretation, Stare Decisis, and a Proposal for Change*, 53 Ala. L Rev 789, 790 n4 (2002).

8. Decisions of the U.S. Supreme Court contain numerous references to "the longstanding judicial hostility to arbitration agreements." *See, e.g., Gilmer v Interstate/Johnson Lane Corp,* 500 US 20, 24 (1991). On the other hand, the Court stated as early as 1855 that "[a]s a mode of settling disputes, [arbitration] should receive every encouragement from courts." *Burchell v Marsh,* 58 US 344, 349 (1855). *See also Scherk v Alberto-Culver Co,* 417 US 506, 511 (1974); *Southland Corp v Keating,* 465 US 1, 36 (1984), (O'Connor, J., dissenting) (emphasizing, respectively, the "desirability" and "worth[iness]" of arbitration as an alternative to litigation).

9. The initial hostility towards arbitration may go back to English courts, which "traditionally considered … arbitration agreements as 'ousting' the courts of jurisdiction, and refused to enforce such agreements for this reason." *Scherk* at 511 n4.

10. Arbitration clauses are nowadays part of many legal relationships, including employment, consumer transactions, and statutory claims. *See* Herrmann at 780 n3; Pittman at 791. Whether the modern ubiquity of arbitration clauses is a good development is beyond this Article, but certainly disputable. *See* Diane P. Wood, *The Brave New World of Arbitration*, 31 Cap U L Rev 383 (2003).

11. The U.S. Supreme Court later interpreted the FAA to mandate enforcement of arbitration agreements in state courts and to preempt any contrary state law. *Southland Corp*, 465 US at 10–17. The extension of the FAA to actions in state court was, and still is, subject to vigorous dispute. *See id.* at 21–36 (O'Connor, J., dissenting); Pittman at 863–74.

12. 9 USC 1–16. The FAA was originally enacted in 1925 as the United States Arbitration Act and then reenacted and codified in 1947 as title 9 of the United States Code. *Gilmer*, 500 US at 24.

13. 9 USC 2. The purpose of this section was to place arbitration agreements on equal footing with other contracts and make them enforceable on their terms. *Allied-Bruce Terminix Cos v Dobson,* 513 US 265, 271 (1995). *See also Volt Info Scis, Inc v Board of Trustees,* 489 US 468, 474 (1989) ("The FAA was designed to overrule the judiciary's longstanding refusal to enforce agreements to arbitrate" (quotations omitted)).

14. 9 USC 3 (capturing Congress's preference of arbitration over litigation, where the parties agreed to arbitrate). There are many reasons a party to an arbitration agreement would nonetheless seek recourse in court; the most common may be a genuine dispute whether a particular claim is subject to arbitration. *See, e.g.*, *McCauley*, 413 F3d at 1158. Because arbitration is based on consent, a party cannot be required to arbitrate a claim outside of the scope of the arbitration agreement. *See, e.g.*, *David L Threlkeld & Co v Metallgesellschaft, Ltd,* 923 F2d 245, 248 (2d Cir 1991).

15. *Moses H Cone Mem'l Hosp v Mercury Constr Corp,* 460 US 1, 22 (1983).

16. 9 USC 5. Other sections of the FAA addressing arbitration procedure and providing for confirmation or vacation of arbitrators' awards are not of primary concern for this article. *See* 9 USC 7, 9–13.

17. *See only Shearson/American Express v McMahon,* 482 US 220 (1987) ("The Arbitration Act establishes a federal policy favoring arbitration, requiring that the courts rigorously enforce arbitration agreements" (citations and quotations omitted)). *But see* Rita M. Cain, *Preemption of State Arbitration Statutes: The Exaggerated*

Federal Policy Favoring Arbitration, 19 J Contemp L 1 (1993); Herrmann.

18. *See*, *e.g.*, *Galt v Libbey-Owens-Ford Glass Co,* 376 F2d 711, 714 (1967) ("The policy of the Federal Arbitration Act is to promote arbitration to accord with the intention of the parties and to ease court congestion. All doubts are to be resolved in favor of arbitration. Whenever possible, the courts will use the Federal Arbitration Act to enforce agreements to arbitrate") (citations omitted).

19. 9 USC 3. Similarly, courts shall make orders compelling arbitration only "upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue." 9 USC 4.

20. For examples of district court decisions denying arbitration, which were overturned on appeal, see *Lenz v Yellow Transp, Inc,* 352 F Supp 2d 903 (SD Iowa), *rev'd*, 431 F3d 348 (8th Cir 2005); *Denney v Jenkens & Gilchrist,* 340 F Supp 2d 338 (SDN. 2004), *rev'd in part, vacated in part, and remanded*, *Denney v BDO Seidman, LLP,* 412 F3d 58 (2nd Cir 2005); *Hill v PeopleSoft USA, Inc,* 333 F Supp 2d 398 (D Md 2004), *vacated and remanded*, 412 F3d 540 (4th Cir 2005); *Faber v Menard, Inc,* 267 F Supp 2d 961 (ND Iowa 2003), *rev'd and remanded*, 367 F3d 1048 (8th Cir 2004); *Fazio v Lehman Bros,* 268 F Supp 2d 865 (ND Ohio 2002), *rev'd and remanded*, 340 F3d 386 (6th Cir 2003). In the preceding cases, 10 to 13 months passed between the district courts' decisions and the reversals by the courts of appeals—considerable time for the district courts to move litigation along. Similarly, when a court finds "the making of the agreement for arbitration" in issue, that issue would have to be litigated. *See* 9 USC 4.

21. *See AT&T Technologies, Inc v Communications Workers of America,* 475 US 643, 649 (1986) (reversing the lower courts' decisions to refer the question of arbitrability to arbitration) ("[T]he question of arbitrability … is undeniably an issue for judicial determination [u]nless the parties clearly and unmistakably provide otherwise").

22. *See Bradford-Scott*, 128 F3d at 506.

23. Federal Arbitration Act of 1947, 9 USC 1 et seq. (1947) (current version at 9 USC 1 et seq. (2000)).

24. 28 USC 1291, 1292.

25. *See, e.g.*, the *Cohen* exception to 28 USC 1291: *Cohen v Beneficial Indus Loan Corp,* 337 US 541, 546–47 (1949) (holding orders appealable "which finally determine claims of right separable from, and collateral to, rights asserted in the action, too important to be denied review and too independent of the cause itself to require that appellate consideration be deferred until the whole case is adjudicated"). Arbitrability determinations are separable from, and collateral to, the underlying claim and would therefore arguably come within the exception. *See Cone Mem'l Hosp*, 460 US at 8–10.

26. Title X, § 1019(a), Pub L No 100-702, 102 Stat 4671.

27. 9 USC 16(a)(1)(A).

28. 9 USC 16(a)(1)(B).

29. 9 USC 16(a)(1)(C).

30. 9 USC 16(b).

31. 413 F3d 1158 (2005). Interestingly, the court notes that, some sixteen years after enactment of 9 USC 16, the question was "a question of first impression in this circuit." *Id.* at 1160. Several other circuit courts do not appear to have ruled on the issue yet. The U.S. Supreme Court at least twice had the opportunity to accept a case involving the question, but chose not to do so. *See Snowden v CheckPoint Check Cashing,* 290 F3d 631 (4th Cir), *cert denied*, 537 US 1087 (2002); *Koveleskie v SBC Capital Mkts, Inc,* 167 F3d 361 (7th Cir), *cert denied*, 528 US 811 (1999).

32. *McCauley*, 413 F3d at 1159.

33. *Id.*

34. *Id.*

35. *Id.* at 1160.

36. The circuit court granted the motion. *Id.* at 1163.

37. *See id.* at 1160–63 (holding that "the district court was divested of jurisdiction by Halliburton's filing of its notice of appeal").

38. *Griggs v Provident Consumer Disc Co,* 459 US 56, 58 (1982).

39. *McCauley* at 1160. The court was concerned that the categorical application of the divestiture principle might invite frivolous appeals. Relying on its own precedents, the Tenth Circuit therefore limited its holding in *McCauley* to apply to non-frivolous appeals only. *See id.* at 1160–63.

40. 128 F3d 504 (7th Cir 1997).

41. *Id.* at 505.

42. *Id.*

43. *Id.*

44. *Id.* at 507.

45. *Id.* at 505–06. The Tenth and Seventh Circuit differed as to who may raise the question of frivolity. According to the Seventh Circuit, it is the party opposing the arbitrability appeal who must argue that the appeal is frivolous, in which case the appeals court may dismiss the appeal or affirm the district court summarily. *See id.* at 506. According to the Tenth Circuit, the district court as well as the appeals court may, without urging of a party, certify an appeal as frivolous. *See McCauley*, 413 F3d at 1161–62.

46. *Blinco*, 366 F3d at 1251, 1253.

47. 388 F3d 39 (2d Cir 2004); 916 F2d 1405 (9th Cir 1990).

48. The initial suit in *Motorola Credit* was filed in January 2002. *Motorola Credit Corp v Uzan,* 274 F Supp 2d 481, 491 (SDNY 2003). The appeal was decided on October 22, 2004. 388 F3d 39 (2d Cir). Two years and ten months may not seem extraordinary, if it weren't for a host of motions and numerous contempt orders, making up "the almost Dickensian history of this case." *Id.* at 48; 274 F Supp 2d at 492, 494–95. Litigation in *Britton* stretched over three years. *See Britton*, 916 F2d at 1407–09. There, too, the defendant was held in contempt, eventually resulting in a default judgment against him. *Id*.

49. In short, plaintiffs had lent the defendants $2.7 billion, who in turn pledged their company stock as security, then diverted the funds and devalued the collateral. *See Motorola Credit*, 388 F3d at 43–44.

50. *Britton*, 916 F2d at 1408; *Motorola Credit*, 388 F3d at 44–45.

51. *Britton*, 916 F2d at 1411; *Motorola Credit*, 388 F3d at 53.

52. *See Britton*, 916 F2d at 1407 (reversing the district court's finding that defendant had waived his right to arbitration); *Motorola Credit Corp v Uzan,* No 02 CIV 666, 2002 US Dist LEXIS 20712, at *1 (SDNY Oct 28, 2002).

53. A default judgment pursuant to Fed R Civ P 37 in *Britton*, 916 F2d at 1408–09, and a final judgment after a bench trial in *Motorola Credit*, 388 F3d at 46–47.

54. *Motorola Credit*, 388 F3d at 53.

55. *Britton*, 916 F2d at 1412.

56. *See* note 1.

57. *Bradford-Scott*, 128 F3d at 505; *McCauley*, 413 F3d at 1159–60; *Blinco*, 366 F3d at 1250.

58. *Bradford-Scott* at 505; *McCauley* at 1160; *Blinco* at 1250.

59. *See Bradford-Scott* at 507; *Blinco* at 1253; *McCauley* at 1160.

60. *Britton*, 916 F2d at 1411; *Motorola Credit*, 388 F3d at 53. Why those judgments issued while an interlocutory appeal was pending does not bear on the analysis here, but is nonetheless interesting: Litigation in both cases had been drawn out for years, due in significant

part to uncooperative defendants. The default judgment in *Britton* issued as a result of the defendant's continued refusal to comply with discovery. *See Britton*, 916 F2d at 1409. In *Motorola Credit*, the proceedings in the district court had not been stayed pending resolution of the appeal, and the district court had moved the trial forward at a brisk pace. 388 F3d at 45. Almost two years passed before the appeals court ultimately decided the arbitrability appeal. *See id*. at 39, 45 (arbitrability appeal filed on October 29, 2002, and decided on October 22, 2004). Whether the court of appeals was just busy or dragging its feet is open to speculation. The crucial fact in both cases is that by the time the courts decided on the appeal, the trial courts had entered judgment.

61. There is no litigation to be stayed when the case has concluded in a judgment.

62. *See Britton*, 916 F2d at 1411; *Motorola Credit*, 388 F3d at 53.

63. *Britton* at 1411; *Motorola Credit*, 388 F3d at 53.

64. Even though the judgment entered by the trial court in *Britton* was a default judgment, it operated as a final adjudication. *See Britton*, 916 F2d at 1410.

65. The Ninth Circuit correctly noted that no court of appeals had ever granted this kind of relief. *Motorola Credit*, 388 F3d at 54.

66. Notably, neither the Second nor the Ninth Circuit discussed 9 USC 16 in their decisions, but rather disposed of the appellants' argument in terms of the divestiture principle. *See Motorola Credit*, 388 F3d at 39 (containing no reference to 9 USC 16); *Britton*, 916 F2d at 1409 (merely referring to 9 USC 16(a)(1)(A) as the basis of jurisdiction to hear the appeal). Because the cases before them did not present the question of a stay, the Second and Ninth Circuits are not barred from issuing a stay should the question present itself.

67. *Blinco*, 366 F3d at 1251 (indicating that the court would grant a stay neither automatically nor under all circumstances).

68. *Bradford-Scott*, 128 F3d at 505–06. These reasons lose traction the moment litigation concludes in a judgment. It is therefore unlikely that the Seventh and Eleventh Circuits would feel obliged by their decisions in *Blinco* and *Bradford-Scott* to vacate a judgment that may have been entered before they decided the arbitrability appeal.

69. *McCauley*, 413 F3d at 1163.

70. *Cf. Bombardier Corp v Amtrak,* No 02-7125, 2002 US App LEXIS 25858 at *1–2 (DC Cir Dec 12, 2002) (ordering that the motion for a stay be denied as unnecessary "[b]ecause the appeal . . . divests the district court of jurisdiction over those aspects of the case on appeal … and the district court may not proceed until the appeal is resolved").

71. *See Britton*, 916 F2d at 1411; *Motorola Credit*, 388 F3d at 53–54; *Blinco*, 366 F3d at 1251; *Bradford-Scott*, 128 F3d at 505; *McCauley*, 413 F3d at 1160. For the most common statement of the principle, see note 39 and the accompanying text.

72. *See Britton*, 916 F2d at 1411; *Motorola,* 388 F3d at 53.

73. *See Blinco*, 366 F3d at 1251. The discussion was likely triggered by the other court decisions referenced there. In any case, the principle does not appear to have been forced on the court by the parties. *See* Appellant's Initial Brief, 2004 WL 3416646 (Apr 05, 2004); Appellees' Answer Brief on Appeal, 2004 WL 3416647 (May 04, 2004); Appellant's Reply Brief, 2004 WL 3416648 (May 27, 2004) (containing no reference to the divestiture principle).

74. *See Bradford-Scott*, 128 F3d at 505 ("We approach the subject from a different perspective…"). The Seventh Circuit wondered whether there was "any good reason why the district court may carry on once an appeal has been filed." *Id*.

75. *See McCauley*, 413 F3d at 1160.

76. *See Griggs*, 459 US at 58–59.

77. *Britton*, 916 F2d at 1411–12. *See also McClatchy Newspapers v Central Valley Typographical Union No 46,* 686 F2d 731 (9th Cir 1982) (holding that the district court lacked jurisdiction to amend its judgment while the judgment was on appeal).

78. Section 2 of the FAA requires courts to enforce arbitration agreements, and section 4 speaks of the "district court which, *save for such agreement*, would have jurisdiction." 9 USC 4 (emphasis added).

79. *See Cone Mem'l Hosp*, 460 US at 21; *Britton*, 916 F2d at 1412. *Cf. Bradford-Scott*, 128 F3d at 505.

80. *Griggs*, 459 US at 60.

81. *Motorola Credit*, 388 F3d at 53. The exact language varied from court to court: To the Ninth Circuit, "an appeal seeking review of *collateral orders* does not deprive the trial court of jurisdiction over *other proceedings* in the case," *see Britton*, 916 F2d at 1412 (emphasis added). In the view of the Seventh and Eleventh Circuits, litigation of the claim's merits in the district court is "the mirror image of the question presented" by an arbitrability appeal. *See Bradford-Scott*, 128 F3d at 505; *Blinco*, 366 F3d at 1251, *quoting Bradford-Scott*.

82. As a point in case, the U.S. Supreme Court stated the principle as "divest[ing] the district court of its control over those aspects of the *case* involved in the appeal." *Griggs,* 459 US at 58. The decision referred to for this proposition speaks of the "aspects of the *cause* involved in the appeal." *United States v Hitchmon,* 587 F2d 1357, 1359 (5th Cir 1979) (emphasis added). To say that "a federal district court and a federal court of appeals *should* not attempt to assert jurisdiction over a case simultaneously" (*Griggs* at 58; emphasis added) sounds more like a prudential admonition rather than an absolute bar. *But see Bradford-Scott*, 128 F3d at 505 (calling the principle "fundamental to a hierarchical judiciary").

83. Under the U.S. Constitution, Congress has the power "[t]o constitute tribunals inferior to the Supreme Court." US Const art I, § 8, cl 9. This includes the authority to regulate the jurisdiction, practice, and procedure of the federal courts. *See Keene Corp v United States,* 508 US 200, 207 (1993); *Mistretta v United States,* 488 US 361, 387 (1989).

84. *See* Pub L No 100-702, 102 Stat 4642 (1988).

85. *See* Table of Contents, HR Rep No 100-889, 100th Cong, at 1 (1988), *reprinted in* 1988 USCCAN 5982; *see also* the Purpose of the Legislation and Statement of Legislative History, *id*. at 22–23, *citing* Fed R Civ P 1. The vast majority of statutes amended are part of title 28 of the United States Code, governing the judiciary and judicial procedure. *See* Pub L No 100-702, 102 Stat 4642 (1988) ("An Act to amend title 28, United States Code….").

86. HR Rep No 100-889, 100th Cong, at 22-23 (1988).

87. *Id*. at 30–31. The then-experimental sections are now permanent. 28 USC 651–58.

88. HR Rep No 100-889, 100th Cong at 36 (1988) (delineating the statutory structure of the new provision on interlocutory appeals, but not relaying congressional purpose). Beyond this, specific deliberations to section 16 of the FAA, if any, do not appear to be reflected in the congressional record.

89. *See supra* note 86.

90. *Dean Witter Reynolds v Byrd,* 470 US 213, 221 (1985).

91. *See supra* note 86.

92. Interlocutory appeals are rightly reserved for exceptional circumstances, because they disrupt the regular trial proceedings. *See Cohen*, 337 US at 546 ("The purpose is to combine in one review all stages of the pro-

ceeding that effectively may be reviewed and corrected if and when final judgment results").

93. After arbitration, a case may still return to the court for confirmation, vacation, modification or enforcement of the arbitral award. *See* 9 USC 9–13.

94. *Cohen*, 337 US at 545.

95. This was the explicit conclusion of the Seventh Circuit in *Bradford-Scott*, 128 F3d at 506.

96. *Compare* FAA 16(a)(1)(A), (B), (C) with 16(b). That an appeal "may be taken" is not to be understood as giving the appeals court discretion whether to take such an appeal. The language reflects Congress's courteous way of creating appellate court jurisdiction where none existed before. Like interlocutory appeals based on 28 USC 1292(a), section 16(a) of the FAA creates an appeal of right, which must be taken if it is otherwise proper. *See Tidewater Oil Co v United States,* 409 US 151, 153 (1972).

97. The idea is that once arbitration has been had and resulted in an award, the award may be acceptable to the party that formerly sought litigation, so that the desire to litigate is exhausted and the case would not return to the courts, other than for enforcement of the arbitral award.

98. *See* FAA 3 and 16(a)(1)(A).

99. *See, e.g., Britton*, 916 F2d at 1412.

100. 485 US 271 (1988).

101. *Id*. at 279–82.

102. 293 US 379 (1935).

103. 317 US 188 (1942).

104. *See Gulfstream*, 485 US at 282–89.

105. 9 USC 16(a)(1)(A).

106. Here it is indeed the "mirror image." *Bradford-Scott*, 128 F3d at 505.

107. Otherwise, litigation would get under way for as long as it takes the appeals court to decide whether a stay is appropriate. This could take anywhere from 10 to 13 months, possibly more. *See supra* note 20. This illustration also shows the shortfalls of applying the divestiture principle: By its terms, the principle would only divest the lower court of jurisdiction to consider another motion for a stay.

108. FAA 16(a)(1)(B) and (C).

109. *United States v Arevalo,* 408 F3d 1233, 1238 (9th Cir 2005); *In re Emergency Beacon Corp,* 790 F2d 285, 288 (2d Cir 1986). Another reason, of course, is to employ lawyers.

110. *See* Blinco, 366 F3d at 1252 ("The arbitrability of a dispute … gives the party moving to enforce an arbitration provision a right not to litigate the dispute in a court").

111. *See Volt Information Scis*, 489 US at 474–75.

112. *See* 9 USC 3 ("[T]he court … shall … stay the trial of the action until … arbitration has been had"). *See also McMahan Sec Co LP v Forum Capital Mkts LP,* 35 F3d 82, 85–86 (2d Cir 1994), *citing Dean Witter*, 470 US at 218.

113. *See* 9 USC 16(b) (providing that an appeal may not be taken from decisions favoring arbitration "[e]xcept as otherwise provided in section 1292(b) of title 28").

114. *See* 28 USC 1292(b).

115. *Id.*

116. *See* 9 USC 16(b).

117. A prime case for not precluding all discretion is *In re Salomon*, 68 F3d at 554. In *Salomon*, the district court was initially quite willing to refer the case to arbitration. *Id*. at 556. However, the designated arbitrator (the NYSE) refused to arbitrate the dispute. *Id*. Even though the arbitration agreement could not be performed, the defendants kept demanding arbitration. *Id*. at 556–57. Staying the litigation under these circumstances would only have meant to be further "putting off the awful day." *Id*. at 557.

118. *Bradford-Scott*, 128 F3d at 506 ("That is a serious concern"); *McCauley*, 413 F3d at 1162 ("[W]e recognize the … legitimate concerns regarding … dilatory appeals").

119. *See supra* notes 73–83 and accompanying text.

120. *See id*.

121. *Bradford-Scott*, 128 F3d at 506.

122. *Blinco*, 366 F3d at 1253.

123. *Id*.

124. *Id.*

125. *See, e.g., Ingle v Circuit City,* 408 F3d 592 (9th Cir 2005) (sanctioning the defendant for filing a wholly meritless appeal from the denial of its renewed motion to compel arbitration).

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Case Digests

*Prepared by David J. Johnson**

Corporations—Constitutionality of Local Tax Credits and Abatements

In *DaimlerChrysler Corp v Cuno*, ___ US ___, 126 S Ct 1854 (2006), the State of Ohio and the City of Toledo gave property tax abatements and state franchise tax credits to defendant-petitioner to encourage the expansion of its Toledo plants. Plaintiff-respondent, representing a class of Ohio and Toledo taxpayers, sued in state court, alleging the tax breaks violated the Commerce Clause. Defendants removed the action to U.S. District Court. Plaintiffs wanted the action removed back to state court because they thought that they would not have standing in federal court, but the District Court declined, stating they had "municipal taxpayer standing." The District Court subsequently found that neither tax break violated the Commerce Clause; on appeal, the Sixth Circuit found that the state franchise tax credit violated the Commerce Clause.

The Supreme Court granted certiorari and ruled that the taxpayers did not have standing in federal court, and thus did not reach the constitutionality of either tax break in this opinion. The Court had previously denied federal taxpayer standing, since a taxpayer's interest "is shared with millions of others" and is too "minute and indeterminable" to give a "case or controversy" jurisdiction to federal courts. *Frothingham v Mellon,* 262 US 447 (1923). The Court held that this doubly applied to state taxpayer suits, since the burden is similarly minute and would put federal courts in the untenable position of "monitors of the wisdom and soundness" of state actions. The Court rejected an analogy to the standing granted to taxpayers suing on Establishment Clause grounds, saying that this was a special case. Then the Court noted that, although it has granted standing for municipal taxpayers to challenge illegal use of municipal funds, this does not give standing to challenge state franchise tax credits: even if the monies generated are redistributed to municipalities under state law and thus affect municipal budgets, this would still be a state decision. The Court also rejected plaintiff's arguments that the "supplemental jurisdiction" recognized in *United Mine Workers v Gibbs*, 383 US 715 (1966), allowing federal-question jurisdiction over one claim to authorize jurisdiction over a state-law claim "[deriving] from a common nucleus of operative fact," applied here.

Patent Law—Standards for Permanent Injunctive Relief

In *eBay Inc v MercExchange, LLC*, ___ US ___, 126 S Ct 1837 (2006), plaintiff-respondent alleged that it held the patent on an "electronic market designed to facilitate the sale of goods between private individuals by establishing a central authority to promote trust among participants." Plaintiff first sought to license its patent to defendant-petitioner, but failed to reach an agreement. Plaintiff then filed suit against defendant and won, but the District Court declined to give plaintiff permanent injunctive relief. The court of appeals for the Federal Circuit reversed, holding that it had a general rule to "issue permanent injunctions against patent infringement absent exceptional circumstances." 401 F3d 1323, 1339 (2005).

The Supreme Court held that the well-established four-factor test for permanent injunctions also applied to patent cases, thus overruling the Federal Circuit's "general rule." Under this test, a plaintiff must demonstrate (1) irreparable injury, (2) that remedies available at law such as damages are inadequate compensation, (3) that when balancing hardships to plaintiff and defendant an injunction is warranted, and (4) that an injunction does not harm the public interest. The granting of a permanent injunction under these criteria can only be overturned on appeal for abuse of the District Court's discretion. The Court held that the Patent Act does not contradict this test, as the Act expressly states that injunctions "may [be issued] in accordance with the principles of equity." 35 USC 283. While patents are given general property rights, including the right to exclude, 35 USC 261 and 154(a)(1), the enforcement of those rights is "subject to the provisions of this title." 35 USC 261. Thus, the enforcement includes the equity principles of 35 USC 283. Still, the Supreme Court remanded the case back to the District Court for a new decision, holding that the District Court did in fact abuse its discretion: it too broadly stated that a "willingness to license its patents" and a "lack of commercial activity in practicing the patents" automatically showed there could be no irreparable harm to plaintiff and vitiated the need for a permanent injunction. The Court stated that patent holders such as "university researchers" or "self-made inventors" might simply wish to license their patents, and not try to pursue on their own the capital needed to bring their inventions to market.

Contracts—Accord and Satisfaction—Negotiable Instruments

In *Hoerstman General Contracting, Inc v Hahn,* 474 Mich 66, 711 NW2d 340 (2006), defendants contracted with plaintiff to remodel their lakeside house. When various events caused delays and cost overruns, defendants informed plaintiff that they still wanted the house to be completed, despite the extra expense. Plaintiff orally agreed with defendants to continue work if defendants paid the additional costs. Plaintiff complied with defendants' extensive oral modifications to the plans, which he later compiled into a 10-page list. Despite plaintiff's flexibility, however, defendants "refused to agree in writing to any changes to the existing contract." Defendants paid plaintiff $125,000, which was more than the bid price, but plaintiff claimed it was still owed $32,750. Plaintiff offered to settle the lien and close the account for $16,910.79. Defendants countered

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with a check for $5,144.79. They wrote "final payment" on the check and accompanied it with a letter stating that this payment would waive the lien and close the account. Plaintiff deposited the check, crossing out "final payment" on an attorney's advice, and sued for the balance when defendants made no additional payments. Defendants asserted the affirmative defense of accord and satisfaction. The trial court awarded plaintiff $26,000, less $5,800 from a counterclaim by defendant. On appeal, the court of appeals ruled that "final payment" was not enough to inform plaintiff that deposit of the check satisfied the entire claim.

On appeal to the Michigan Supreme Court, the issue was whether an accord and satisfaction existed in this case. The court noted that an accord and satisfaction is a contract requiring a meeting of the minds of both parties. There have been two common-law lines of cases. The first holds that whether there was a meeting of the minds is a question for a jury. The second holds that the meeting of the minds "is implied as a matter of law by the acceptance of the offer," and any change to the accord, such as the crossing out of "final payment" by plaintiff, is thereby made irrelevant. The court ruled that MCL 440.3311 repudiated continuing to follow the first line of cases for accord and satisfactions involving negotiable instruments such as checks. The first part of an accord and satisfaction is a "good faith" (MCL 440.3103(1)(d)) tender to claimant as a full satisfaction of the claim. MCL 440.3311(1). The court held that defendants' accompaniment of the tender with a detailed, clear accounting of the costs and payment made was evidence of good faith. The second requirement is that the claim be un-liquidated or subject to a bona fide dispute. *Id.* The court held that because plaintiff performed extra work without a cost agreement, even if a part of the amount of the debt was conceded, the whole debt was treated as un-liquidated. The third requirement is that claimant must obtain payment of the obligation. *Id.* Plaintiff did so by depositing the check.

The question then became whether the claim was discharged. The court noted that a claim is discharged if (1) the instrument or accompanying written materials contain a conspicuous statement that it is tendered in full satisfaction of the claim (MCL 440.3311(2)); or (2) the claimant or claimant's agent knew that defendant tendered the instrument for that purpose (MCL 440.3311(4)). Here, plaintiff knew that defendant was attempting an accord and satisfaction, but erroneously thought, as did his attorney, that it was not valid under Michigan law. The Supreme Court noted that there is no statutory exception for a mistaken understanding of the law. In addition, the words "final payment" on the check and the language in the accompanying letter were sufficiently conspicuous to also qualify as a valid discharge under MCL 440.3311(2).

Contracts—Enforcement of Usurious Loans

In *Washburn v Makedonsky,* No 258769, 2006 Mich App LEXIS 1554 (May 9, 2006), plaintiff sued to recover unpaid principal and interest from defendant, who had signed as a guarantor a promissory note with an interest rate that was held to be usurious in the second of two previous cases. In 1995, defendant guaranteed for his sister a $40,000 promissory note payable to plaintiff. The note had an interest rate of 10%, with a monthly payment of $667; it also contained an acceleration clause that allowed the holder to demand immediate repayment of the entire debt if the debtor failed to make a payment within 30 days of its due date. Plaintiff later assigned the note to two different parties, and defendant's sister withheld payment until the proper holder was determined. In the first previous suit, plaintiff and the proper holders sued for back payments, which defendant's sister paid within 30 days. Plaintiff then brought an action seeking to accelerate the debt and receive unpaid principal and interest because of late payments during this dispute and on other occasions. The trial court refused to uphold the acceleration clause, and the court of appeals ruled that defendant's sister was entitled to attorney fees under MCL 438.32, since the interest rate on the note was usurious. However, the court of appeals ruled that defendant, as a guarantor of a usurious note, was not entitled to receive attorney fees.

In the current case, plaintiff sued to recover the alleged unpaid balance of the note, including principal, late fees, and interest, from defendant-guarantor, arguing that a guarantor is not entitled to a usury defense under MCL 438.32. The court of appeals affirmed the ruling of the trial court, holding that the plain language of MCL 438.32 prohibits a lender from recovering "any interest, any official fees, delinquency or collection charge, attorney fees or court costs" from a usurious note, whether from a guarantor or borrower. The language limiting the recovery of attorney fees from usurious lenders to "borrowers or buyers" elsewhere in the statute was absent here, and thus the Legislature intended the language in this section to be applied broadly against enforcement of usurious loan terms.

Contracts—Implied and Express Warranties—Car Dealer

In *Davis v LaFontaine Motors, Inc*, No 258434, 2006 Mich App LEXIS 1513 (May 4, 2006), plaintiff had purchased a Daewoo automobile from defendant LaFontaine Motors and brought suit for claims of breach of implied and express warranties after defendant refused to honor a service warranty on plaintiff's car. After the sale of the car to plaintiff, defendant ceased being an authorized Daewoo service operation, and plaintiff was referred to other Daewoo authorized service dealers for repairs. Later, all Daewoo dealers stopped doing warranty work after Daewoo declared bankruptcy. Plaintiff then filed suit against defendant, alleging breach of express and implied warranties, revocation of the contract, breach of good faith under the Uniform Commercial Code, MCL 440.1101 et seq., and violations of the Magnuson-Moss Warranty Act (MMWA), 15 USC 2301 et seq., the Michigan Consumer Protection

Act, MCL 445.901 et seq., and the Motor Vehicle Service and Repair Act, MCL 257.1301 et seq.

The court of appeals found for defendant on all of the counts. On the express warranty claim, the court of appeals held that the plain language of the vehicle purchase order only recognized the manufacturer's warranty and clearly disclaimed an express warranty on the part of the dealer. On the implied warranty claim, the court ruled that the disclaimer of implied warranties of merchantability was suitably conspicuous as defined in MCL 440.1201(10) and thus did not violate MCL 440.2314–.2316. The court further ruled that defendant did not violate section 2308 of the MMWA (i.e., implied warranties cannot be waived when written express warranties are provided), because defendant did not provide its own express warranty. Plaintiffs had also contended that the disclaimer was not valid, since it was not part of the vehicle purchase agreement and all terms governing the sale must be contained in a single document under the Motor Vehicle Sales Finance Act (MVSFA), MCL 492.101 et seq. The court, following *Pack v Damon Corp,* 320 F Supp 2d 545 (ED Mich 2004), held that the MVSFA only applies to enforcing claims contained within a subsequent installment contract, not warranty disclaimers only mentioned in the initial sales order.

Secured Transactions— Disposition of Options to Purchase

In *Fodale v Waste Management of Michigan, Inc,* No 253446, 2006 Mich App LEXIS 1502 (May 2, 2006), plaintiff had been assigned 10% of Eagle Valley Limited's assets and liabilities in a 1984 redemption agreement. This amount included proceeds from a 1983 agreement between Eagle Valley and defendant, in which Eagle Valley assigned the rights to a proposed landfill to defendant in return for 50% of the future profits; thus, after the 1984 redemption agreement, plaintiff would be entitled to 5% of the profits from this landfill. In 1987, defendant loaned plaintiff $250,000, with two options for recovery if plaintiff defaulted: an option to buy plaintiff's interest in profits from the landfill for $350,000 less any amount owed, and the 5% interest in profits itself as collateral. In 1998, after several missed payments and negotiated loan modifications increasing the amount owed to defendant, defendant notified plaintiff that it was going to exercise its option to purchase plaintiff's interest. Plaintiff sued in 2002, alleging a violation of Article 9 of the Uniform Commercial Code (UCC), MCL 440.9101 et seq., breach of the implied covenants of good faith and fair dealing, and unjust enrichment.

The court of appeals first ruled that the trial court erred in finding the parties were not bound by the former part 5 of Article 9 of the UCC, MCL 440.9501 et seq. (1979), which governed secured transactions (the court noted that part 6 from the newest revision went into effect in 2001; *see* MCL 440.9601 et seq.). Second, the court held that an option to purchase serves as an intangible "interest in personal property," and thus is collateral within the scope provision of Article 9, which is meant to apply broadly to secured transactions of all types. MCL 440.9102. The former part 5, which addressed the debtor's rights during the disposition of collateral, specifically applied to this case, since the termination of a debtor's rights in the collateral is a "disposition" within the meaning of Article 9.

The salient provision to this case from the former part 5 was that the contractual waiver of debtor's rights "to notice of disposition, a commercially reasonable disposition, and accounting of a surplus" was prohibited. MCL 440.9501(3). Ultimately, however, the court held that inaction by plaintiff on a duty imposed by MCL 440.9505(2) superseded these prohibitions. First, the court ruled that plaintiff did not receive an adequate notice of disposition, which may only be waived by the debtor in a written statement after default under 440.9501(3)(b) (1979), or if the collateral is "perishable … declin[ing] speedily in value … and of a type customarily sold on a recognized market." MCL 440.9504(3) (1979). Second, under the former part 5 (but not the current part 6), the price term of the option was not commercially reasonable, because it constituted a private sale without a provision for competitive public bidding. MCL 440.9501(3)(b) and .9504(3) (1979). Third, plaintiff did not have a right to any surplus from the sale, since the default rule is that the debtor is not entitled to the surplus unless the contract so specifies. MCL 440.9504(2) (1979). Fourth, the debtor must have an opportunity to redeem the collateral after default but before disposition. MCL 440.9506 (1979). Although the contract provisions did not violate this last statute, defendant's letter in 1998 disposing the option "effective immediately" did not give plaintiff reasonable opportunity to redeem this collateral. However, the court held that MCL 440.9505(2) (1979) superseded these violations, and defendant was entitled to ownership of the 5% interest. The 1998 letter stated that defendant accepted plaintiff's collateral in full satisfaction of plaintiff's debt, and plaintiff did not object within 21 days, which would have invoked the debtor's rights from the former part 5 and forced plaintiff to dispose of the collateral.

On plaintiff's remaining claims, the court of appeals found that the trial court did not err in finding a breach of the duty of good faith, because no independent right of action exists in the common law, and no factual evidence was given for a breach of any provision of the UCC. Any claims of unjust enrichment were precluded, because there was an express provision in the initial contract, as well as the fact that plaintiff had failed to pay on the loan several times and was a sophisticated businessman.

Employment Law— Vicarious Liability and Negligence

In *Brown v Samuel Whittar Steel, Inc,* No 256691, 2006 Mich App LEXIS 1285 (Apr 25, 2006), plaintiff was employed by defendant and was sexually assaulted on defendant's premises by another of defendant's employees. That employee, as part of a plea bargain, stipulated to the facts of the assault in the resultant criminal case. Plaintiff filed

a civil suit against defendant, arguing vicarious liability and negligence for the employee's assault and battery. The trial court first denied and then granted defendant's motion for summary judgment, ultimately holding that defendant was not responsible for the criminal acts of its employee, the assault having nothing to do with the interests of defendant's business.

On appeal, plaintiff's attorney conceded the issue of vicarious liability, leaving the issue of defendant's negligence. The court of appeals noted that generally there is no duty to protect someone against a third party's conduct. However, an employer has a duty to protect its employees against the intentional torts of another employee, if the employer knew or should have known of the employee's violent propensities. *Hersh v Kentfield Builders, Inc,* 385 Mich 410, 189 NW2d 286 (1971). Here, the employee who assaulted plaintiff had no history of violent acts, but plaintiff stated that defendant should have known of the employee's propensity based on what he said to plaintiff before the incident. Plaintiff reported to management "a number of sexually aggressive and predatory statements" made by the employee, although plaintiff admitted she did not feel a physical threat from the employee at that time. Thus, defendant would have had to be put on notice by the employee's mere words. The employee made his aggressive statements repeatedly and from a position of power as a foreman in defendant's plant. The court of appeals held that the language and circumstances here were sufficient that a jury could conclude that defendant knew or should have known of the employee's violent tendencies, and remanded the case to the trial court.

Single Business Tax—Video Distributor Is "Film Distributor" for Purposes of Tax-Base Calculation

In *Twentieth Century Fox Home Entertainment, Inc v Department of Treasury,* No 258664, 2006 Mich App LEXIS 940 (Apr 6, 2006), the court of appeals upheld a ruling by the Michigan Tax Tribunal that petitioner was a "film distributor" and thus was not required to add film producer royalty payments to its tax base. In 1997, respondent had asserted that petitioner owed over $500,000 under the Single Business Tax Act (SBTA), MCL 208.1 et seq., for the four tax years ending in June 1991 through July 1994. This was largely because petitioner should have added payments to motion picture producer Twentieth Century Fox Film Corporation (Fox Film) back to its tax base. Petitioner petitioned the Tax Tribunal, contending that (1) payments to Fox Film were not royalty payments; and (2) even if those were royalty payments, petitioner was a "film distributor," and according to 1996 PA 347 payments should not be added to its tax base. The Tax Tribunal ruled that the payments were royalty payments, but that they were exempt from the tax base because petitioner was a film distributor.

On appeal, respondent contended that a distributor of copyrighted motion pictures produced on videocassettes for private home entertainment was not a "film distributor" for purposes of MCL 208.9(4)(g)(VII). Petitioner's tax base accounting had undergone several changes in recent years with regard to the SBTA in response to 1993 PA 105 and *Field Enterprises v Department of Treasury,* 184 Mich App 153, 457 NW2d 113 (1990), which required film distributors to include in their tax base any royalties paid to film producers and to not deduct royalties paid to them by theater owners. MCL 208.9(7)(c). The court noted that the term "film distributor" was not defined by the SBTA, while "film" could apply either to the actual film used to project movies in theaters or to the "motion picture" itself. Under the plain language of the statute, the court noted that a distributor could pay royalties to a "film producer" for "motion picture films" but also for "program matter" and "signals" as well; accordingly, a "film distributor" need not be limited to distributors of motion pictures only on film. Although the legislative history indicates that 1993 PA 105 was meant to alleviate tax burdens on theater owners, and that 1996 PA 347 was meant to alleviate the shift of that burden to film distributors, the court held that this legislative history was not enough to overcome the plain statutory meaning. Finally, although it may seem unfair that the result of this ruling would allow film distributors to escape tax liability by sublicensing distribution rights, the court agreed with the Tax Tribunal that this was simply the nature of a value-added tax like the SBTA.

Single Business Tax—Undistributed Revenues from Foreign Subsidiaries Do Not Apply to Adjusted Tax Base

In *Ford Credit International, Inc v Department of Treasury,* 270 Mich App 530, ___ NW2d ___ (2006), plaintiff, an international financing company controlling financial corporations in other countries, reported for the tax years 1994 through 1996 $500 million in "deemed dividends," revenues earned by its foreign subsidiaries but not distributed to plaintiff. The Internal Revenue Code (IRC) requires such earnings to be reported as dividends, partly to reward domestic investment over foreign commerce. Defendant sued plaintiff so that it would include these "deemed dividends" in its adjusted tax base for 1994–96 for purposes of Michigan's Single Business Tax Act (SBTA). A provision of the SBTA, MCL 208.31(2), provides for a reduction of the adjusted tax base to 50% of a business's "gross receipts" if that 50% does not exceed the business's initial adjusted tax base. By not including its "deemed dividends" in its "gross receipts," plaintiff applied this discount to its adjusted tax base, since its in-state earnings and dividends would then be smaller than its initial adjusted tax base. Defendant notified plaintiff that it should have included these deemed dividends, and plaintiff paid additional tax and interest of $549,801.37 under protest. The trial court found that the SBTA is a value-added tax requiring inclusion of all business activity; thus, "gross receipts" in MCL 208.31

include deemed dividends. The court also found that this inclusion did not discriminate against foreign business activity, because all dividends were included without partiality.

The court of appeals reversed, noting that "gross receipts" was defined as "the sum of sales … and rental or lease receipts" MCL 208.7(3) (1982) (later amended by 2000 PA 477 to specify "the entire amount received … from any activity whether in intrastate, interstate, or foreign commerce"). The definition was expanded by *Genesee Merchants Bank & Trust Co v Department of Treasury*, MTT Docket Nos 35057, 35058 (1978), to include dividends received by financial organizations. The court found that "deemed" dividends not received should not be included in the adjusted tax base for reasons of statutory construction. First, the dictionary definition of "receipts" includes the notion that something is "received." Second, *Genesee Merchants* justified including dividends in gross receipts because the statute referred to "gross receipts" and "income," including "dividends" within "charges resulting from the use of money or credit." MCL 208.10(4). Finally, the SBTA relies on the IRC to define terms it does not itself define. MCL 208.2(2). IRC 316 defines dividends as "any distribution of property made by a corporation to its shareholders," but IRC 78 recognizes "deemed dividends" to be an accounting fiction. Since the foreign subsidiaries' revenues were not distributed, they are not dividends for the purposes for the SBTA.

Contracts—Statute of Limitations and Venue for Breach of Contract

In *Scherer v Hellstrom*, 270 Mich App 458, ___ NW2d ___ (2006), plaintiff had been divorced from defendant since 1981. In 1993, defendant and plaintiff had become residents of Florida and Georgia, respectively, and defendant asked plaintiff for a $25,000 loan to attend an out-of-state college. Defendant drafted, signed, and sent an agreement that plaintiff would loan her $25,000 interest free, payable with the first occurrence of one of the following: (1) the sale of defendant's Florida house; (2) the refinancing of that house; or (3) December 1, 1995. Plaintiff transferred the funds. Defendant later moved to Michigan, selling her Florida house on November 21, 1994. She did not pay off her loan or contact plaintiff; plaintiff contacted defendant in 1995, but did not receive the money. In 2000, plaintiff filed a breach of contract suit in Michigan district court. The court granted summary disposition to defendant under Michigan's borrowing statute, MCL 600.5861, which requires for a cause of action arising "without this state" the use of that state's statute of limitations, thus necessitating the application of Florida's five-year statute of limitations.

The circuit court reversed the grant of summary disposition, holding that Michigan's six-year statute of limitations applied; thereupon the lower court found for plaintiff, awarding $25,000 plus interest and costs. Defendant appealed again to the circuit court, which affirmed for different reasons, reapplying MCL 600.5861 and holding that even when using Florida's statute of limitations, the case was timely filed: the statute of limitations had tolled until December 1, 1995, since defendant had not informed plaintiff of the sale of her house.

On plaintiff's appeal, the court of appeals affirmed the decision of the circuit court, but its reasoning was closer to the circuit court's first opinion. First, the appeals court ruled that the statute of limitations begins to run at the time of the breach of contract, in this case when plaintiff sold her house in Florida in 1994. *Dewey v Tabor,* 226 Mich App 189, 193, 572 NW2d 715 (1997). Second, a cause of action does not accrue "until the condition is fulfilled, *and* the promise is not performed" (emphasis in original). Since defendant was living in Michigan when she failed to pay off her loan, not fulfilling her promise, plaintiff's cause of action accrued in Michigan. The borrowing statute did not apply, and therefore plaintiff's suit was timely filed, with Michigan's six-year statute of limitations applying to this breach of contract action. MCL 600.5807(8).

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SECTION CALENDAR

Council Meetings

DATE	TIME	LOCATION
September 26, 2006*	5:00 p.m.	Hotel Baronette, Novi
December 2, 2006	10:00 a.m.	Kerr, Russell and Weber, PLC, Troy

** Annual Meeting. Reception immediately following from 6:00 – 7:30 p.m.*

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DATE: October 9, 2006 **TIME:** 8:00 a.m. **LOCATION:** Sheraton Detroit, Novi