Business Law Quarterly—Fourth Quarter 2010

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Editor's Column

This issue of BLQ is a bit late because we've had a transition in editors. We thank Stan Weinberger for his able efforts in getting BLQ going. Personally, as a contributor, I owe him a debt of gratitude for his help with my articles. I shall strive to meet the standard he set for this publication. I shall also strive to get future issues out in a more timely fashion.

The principal purpose of this publication is to inform our clients and any other readers. We know that our audience includes some lawyers, but most of our readers are not attorneys. Accordingly, we try to choose legal issues of interest to non-lawyers and to write about our topics in understandable language. Suggestions for topics are welcome. And if you have questions about something appearing herein, please contact the author of the article, who will be only too pleased to hear from and help you.

Dykema recently completed its sixth annual Mergers & Acquisitions Survey, which you can view on our website by clicking here. The survey showed increasing optimism about the M&A market, although somewhat more negativity about the outlook for the U.S. economy. Strategic buyers are still the main drivers of M&A activity, but private equity is beginning to show signs of activity, with M&A deals having more creativity in their structuring, using more earnouts, seller financing and subordinated debt. Financing contingencies and "MAC" (material adverse change) clauses are increasingly common as deal conditions. For details and more, please visit the website.

Fugitive Justice, a book by Northwestern Law Professor Steven Lubet about the Fugitive Slave Act and four significant cases under it, was just published. I found it interesting, well-written and informative. If you have a passion for U.S. history, you might, too.

***Andrew Connor**, Editor*

Illinois' New Angel Investor Tax Credit

The Illinois Innovation Development and Economy Act was enacted in July 2010. It amended the Illinois Income Tax Act to provide for an "Angel Investment Credit" against Illinois income tax. The credit will be equal to 25% of an investment in a "qualified new business venture" made in the period from the beginning of 2011 through the end of 2016, subject to certain per year and aggregate limitations. There is also a $40,000,000 annual limitation on the aggregate qualifying investments that may be claimed for investments made in a particular calendar year. In light of the annual limitation on aggregate tax credits that may be allocated to all qualifying businesses for a particular year, businesses hoping to use the credit to attract investments, and potential investors, should plan for Angel Investment Credits now and be prepared to act early in 2011, before any possible credit cut-off occurs for that year for otherwise qualifying investments.

Qualified New Business Venture

Under the Act, a "qualified new business venture" is limited to certain businesses that are registered and approved by the Illinois Department of Commerce and Economic Opportunity (DCEO). To qualify, a business must satisfy the following criteria for the year in which the qualifying investment is made:

- The business must be "headquartered" in Illinois and have been in operation in Illinois for not more than 10 consecutive years prior to the year of DCEO certification.

- The business must have fewer than 100 employees, and at least 51% of the employees must be residents of Illinois.
- The business must not have received more than $10,000,000 in aggregate private equity investments in cash or more than $4,000,000 in investments that qualified for the tax credit.
- The business must have the potential for increasing jobs in Illinois, increasing capital investment in Illinois, or both.
- The business must demonstrate that:

    1. it is engaged in innovative activities that apply proprietary technologies, or
    2. it is undertaking precommercialization activity related to proprietary technologies that include research, developing new products or business processes, or developing services that are principally reliant on the application of proprietary technologies.

The credit is not available to investors in businesses that are principally engaged in real estate development, insurance, banking, lending, professional services, wholesale or retail trades, transportation, construction (except construction of power plants using renewable energy resources), and certain other enumerated lines of business. It is hoped that DCEO will clarify the retail and wholesale trade exclusions, but for now we assume that they don't include manufacturers.

The credit is only available to direct investors in the qualifying business. However, a partner of a partnership, member of a limited liability company (LLC) taxed as a partnership, and a shareholder of an S corporation may also claim the credit for a qualified investment made directly by the partnership, LLC, or S corporation. But the credit may not be claimed by any person that directly, indirectly, beneficially, or constructively owns 51% or more of an interest in the qualifying business. Thus, owners of a business cannot get the credit for new capital contributions.

New Small Illinois Businesses

A new, "innovative" business that has a limited number of employees and all its operations in Illinois should be able to be certified as a qualified new business venture. Although the focus of the credit is on the development of new, innovative, Illinois businesses dependent on "proprietary technologies or services," there are some "old," "established," and out-of-state businesses that may also be able to structure their operations to attract investor funds eligible for this credit. A large or established Illinois or out-of-state business might be able to use the credit to attract "angel" investors if it establishes a new controlled entity that qualifies. The "angels" would invest in the new entity. Although the controlling member of such a new related business would be precluded from claiming a credit, the credit should be available to the "angel" investors.

Role of the DCEO

The DCEO will play a critical role in the administration of the credit program in two principal respects (even though the Illinois Income Tax Act is generally administered by the Illinois Department of Revenue).

First, the ability of a business to demonstrate that it has the potential for increasing jobs in Illinois, increasing capital investment in Illinois, or both, is a subjective factor.

Second, how will the DCEO address the limitation on the aggregate credit available to all claimants? Will allowable credits be allocated to qualifying businesses on a proportional basis if they exceed $40,000,000 in a year? Or will the DCEO award the credits on a first-come, first-served basis each year until $40,000,000 of credits for that year have been authorized? Until we know the answer, we think it would be a good idea to file as early as possible to be recognized as a qualified new business venture.

Credit Limitations and Recapture

The Angel Investment Credit is not a refundable credit and is allowed only against an actual Illinois tax liability. The maximum amount of a taxpayer's investment that may be used as the basis for a credit is $2,000,000 for each investment made directly in a qualified new business venture. Subject to that, the credit may not exceed the taxpayer's Illinois income tax liability for the year in which the credit is claimed, but any credit in excess of the taxpayer's Illinois liability may be carried forward for five taxable years. Credits are recaptured if a taxpayer does not retain its investment in the venture for three years, or if within that three-year period the business venture is moved from Illinois. It does not appear, at this point, that the

credit will be recaptured if the business simply ceases to be a qualified new business venture during the three-year period.

Steven Swibel, 312-627-5676

Exporters Large and Small Can Reduce Taxes by Forming a DISC

In 2004, to resolve a protracted trade suit against the United States by the European Union in the World Trade Organization, Congress eliminated most of the significant export subsidies in the tax code, but it left one in place. This last remaining subsidy, the Domestic International Sales Corporation (DISC), has somewhat complicated rules, but it can be advantageous for small and medium sized businesses that are closely held and which sell in foreign markets.DISC corporations are specialized entities that engage primarily in the business of selling the products of a related business entity in foreign markets.[1]

Unlimited Deferral and Ordinary Income Conversion

The attractive feature of the DISC law is that it allows the DISC corporation and its shareholders to indefinitely defer recognition of income, and thus the income tax, on up to $10 million of foreign sales per year.The only cost of this deferral is that the DISC's shareholders must pay a tax calculated as an interest charge, as though the federal government made a loan to the shareholders equal to the DISC's deferred tax at the one-year Treasury bill rate.The last rate published by the IRS of 0.63% highlights the advantages of DISC planning in the near future.[2] Lower Treasury rates result in a smaller DISC charge.

The interest charge on the deferred tax is calculated by determining the amount of tax each DISC shareholder would owe if the DISC distributed all of its earnings in the form of a dividend.This notional amount of tax is then subject to the applicable interest charge and the shareholder is required to pay a tax equal to the amount of the interest.Thus, the tax is based not on the income of the DISC, but on the interest on a loan of the amount of the tax that DISC shareholders would pay on the distribution of the income.

Shareholders are often individuals or pass-through entities owned by individuals, because the DISC rules favor this structure in a number of ways. Income attributable to foreign sales in excess of $10 million, and certain other disqualified income, is treated as a constructive dividend and taxed to the shareholders as such.Despite the fact that this portion of DISC income is taxed currently, the use of a DISC converts income that would otherwise be taxed at ordinary income rates to dividends, which are presently taxed at 15% for individuals but at 35% for corporations.This higher rate for corporations means that it is advantageous for DISC shareholders to be individuals. The extent of this benefit may be less if the individual tax rate on dividends is increased; but if the maximum individual tax rate is also increased, as anticipated, the rate differential could remain substantial.

There is a misconception that only small exporters can benefit from a DISC, but any corporation can defer tax on DISC income associated with its first $10 million of foreign sales.Because the one-year Treasury bill rate, generally is substantially less than a corporation's cost of capital, even larger companies can benefit from DISC deferral, despite the interest charge. In addition, DISCs owned by an individual (whether directly owned or indirectly owned through a pass-through entity) will benefit from lower tax rates on a portion of foreign sales income.For example, the DISC might be owned by a limited liability company that is itself owned by one or more corporate officers or owners of the selling corporation.

DISCs may have state income and franchise tax benefits as well if the DISC is formed in a state, such as Delaware, where DISC income is not subject to corporate tax.However, laws in other states vary on whether and to what extent DISC income is included in the taxable income of the exporter.In states in which the DISC income is not consolidated, the exporter may in some cases be able to avoid state tax on DISC income altogether.

Forming and Operating a DISC

A DISC can be a corporate subsidiary of the exporter,which can be another corporation or a pass-through entity, such as a partnership, LLC, or S Corporation, but it can also be owned by individuals.Often the individual owners are officers or owners of the exporter, but this is more of a practical choice.The tax law does not require it.The DISC does not need to have much operating infrastructure of its own.It can share officers and board members of its related exporter, and all its functions can be carried out by the exporter's employees.It can even make loans to its related exporter so that the deferred income

from foreign sales need not stay locked up in the DISC, although the rules governing such loans are complex.One definitive requirement not to be ignored is that the DISC must have its own taxpayer identification number, its own bank account, and a separate set of books and records.

The DISC's income and operations are governed, to a large degree, by statute.The DISC sells or leases goods and services produced by the exporter to buyers outside the United States and earns commissions and a markup on the sale.The amount of the commissions and intercompany prices that are the basis of the markup are set by one of three generous statutory formulae, and any amounts paid to the DISC, consistent with the formula, are deductible to the exporter. Commission income and receipts in excess of DISC costs attributable to the first $10 million of sales are not subject to federal tax, and all of the remaining income is deemed distributed to shareholders. For example, under the gross receipts formula, the DISC is entitled to earn 4% of the gross receipts from sales to foreign buyers plus 10% of its own export promotion expenses.These special pricing rules are the heart of the export subsidy provided by Congress, and they allow DISC owners to avoid any potential dispute with the IRS about accounting for sales between the exporter and the DISC.

Eligible Exports

The DISC benefits apply to foreign sales and leases of manufactured goods in cases in which 50% of the fair market value of the goods is generated in the U.S.Income from the sale of software also qualifies, as does income from architectural services and certain financing transactions.Even management service transactions can qualify in some circumstances.

Conclusion

Despite the clear advantages of using a DISC in a wide variety of industries, tax statistics suggest that many eligible companies are foregoing DISC benefits.In the last year in which data are available, the IRS counted a total of 727 DISCs. These DISCs reported just over $1.4 billion in gross income - about 0.1% of total United States exports for the year in question.Failing to take advantage of DISC export tax subsidies when they are available could unnecessarily increase an exporter's federal and state tax liability

Officers’ Privilege May Outweigh Contractual Rights

Protecting their shareholders’ interests has long been considered part and parcel of the duties conferred upon the officers and board members of a corporation. When a corporation’s contractual obligations clash with this duty, the interests of the shareholders may outweigh the interests of the contracting party. In a recent Fifth Circuit case applying Illinois law, the court reaffirmed the privilege that corporate officers and directors have to exercise their judgment to preserve the corporation’s and its shareholders’ interests.

The holding arose from an appeal of a tortious interference with contract case. Tortious interference (also known as intentional interference) with contract recognizes a contracting party’s right to see its contractual rights fulfilled. Such a claim arises when a third, unrelated, party allegedly causes one of the contracting parties to breach its contractual obligations. Despite what seems to be a straightforward rule on the requirements for such claims in Illinois, the application of the rule has caused confusion in Illinois courts for some time.

The Fifth Circuit, applying Illinois law, took a step to clarify the law on this issue in *Marathon Financial Insurance, Inc., RRG v. Ford Motor Co*., 591 F.3d 458 (Fifth Cir. 2009). Marathon Financial Insurance, Inc. (Marathon), is a Risk Retention Group (RRG) insurer that insures payment for repairs on extended service contracts. Marathon insured extended service contracts sold by Automotive Professionals, Inc. (API) at various Ford Motor Co. (Ford) dealerships. Ford also sold its own extended service contracts in competition with API.

National Warranty Insurance Company (NWIC), another RRG, filed for bankruptcy protection in 2003, and Ford found itself effectively assuming responsibility on numerous NWIC-backed contracts. In response to these events, Ford determined that starting in January 2005, it would no longer finance the purchase of extended service contracts unless the contracts were backed by an insurer with an A.M. Best rating of A- or better. Marathon did not have an A.M. Best rating and was unable to obtain such a rating. Despite API’s attempts to convince Ford to accept Marathon as API’s insurer, Ford refused to allow an exception for Marathon-backed contracts. In order to continue to work with Ford, API found an insurer rated A- or better by A.M. Best and ended its business relationship with Marathon. Marathon also lost other business due to its inability to insure API’s extended service contracts.

In 2005, Marathon filed suit against Ford claiming tortious interference with contract, among other things.In substance, Marathon claimed that Ford forced API toend its relationship with Marathon and thereby to breach its contract with Marathon. Ultimately, the district court granted summary judgment in favor of Ford on the issue of tortious interference with contract.

In order to prevail on an Illinois claim for tortious interference with contract, a plaintiff must show that (1)there was an enforceable contract, (2) the defendant was aware of that contract, (3) the defendant intentionally and unjustifiably induced a breach of the contract, (4) the breach resulted from the defendant's wrongful conduct, and (5) the plaintiff has been damaged. Smock v. Nolan, 361 F.3d 367, 372 (7th Cir. 2004) (citing HPI Health Care Servs., 137 Ill. Dec. 19, 545 N.E.2d at 676).

Marathon appealed the district court's decision, arguing that the court had misapplied Illinois law by placing the burden of proof on Marathon to show lack of justification for Ford's intentional interference with the API-Marathon contract. Marathon also argued that the district court had incorrectly concluded that Ford's conduct was justified as a matter of law.

In determining whether Ford had intentionally interfered with the contract between API and Marathon, the Fifth Circuit focused on the issue of which party bears the burden of proof. In *HPI Health Care Servs., Inc. v. Mt. Vernon Hosp., Inc*., the Illinois rule was stated: "Where the conduct of the defendant is privileged, it is plaintiff's burden to plead and prove that the defendant's conduct was unjustified or malicious." Under this rule, the threshold question is whether defendant Ford's conduct was privileged.

In Illinois, privilege exists in intentional interference with contract cases where the defendant was acting to protect an interest that the law deems to be of "equal or greater value than the plaintiff's contractual rights." This reasoning extends to corporate officers and directors for use of their business judgment, recognizing that their duties to their corporations' shareholders outweigh any duty they might owe to the corporations' contract creditors.

The Fifth Circuit weighed Ford's interest in changing its policy on reinsurers against Marathon's contractual interests and found that although Ford had intentionally interfered with the contract between API and Marathon, it had done so in an effort to protect its own interests and that under current Illinois law, Ford's actions were privileged. Therefore Marathon had the burden of proving that Ford's actions were not justified. Pointing out that this was not an instance of "outsiders intermeddling maliciously in the contracts or affairs of other parties," the district court's grant of summary judgment in favor of Ford was affirmed.

Ford's officers and directors made the decision regarding the rating change in accordance with their business judgment after analyzing the events resulting from NWIC's bankruptcy. By doing so, they had protected their shareholders' interests by shielding Ford from exposure to claims similar to those that arose after the NWIC bankruptcy. This benefit to the corporation was enough to deem Ford's actions privileged and justify the decision to no longer finance the purchase of extended service contracts backed by Marathon.

Although rights of contracting parties may be protected by the terms of their written agreement and general contract principles under the law, the interests of certain unrelated third parties may allow such third parties to interfere with the contracting parties' relationship. Contracting parties should be aware of this potential risk, and third parties should be aware of their right to protect their interests given the recent clarification of the law in Illinois.

Wisconsin Supreme Court Delivers Warning to Majority Shareholders of Closely-Held Business

A recent ruling by the Wisconsin Supreme Court reminds majority shareholders of the risks associated with using their control status as majority shareholders to benefit themselves at the expense of minority shareholders.

The case, *Notz v. Everett Smith Group*, 316 Wis.2d 640, 764 N.W.2d 904 (2010), involved a closely held company, Albert Trostel & Sons (ATS), which had 88.9% of its stock held by a single corporate shareholder, Everett Smith Group, Ltd. (Smith Group). At the time of the events giving rise to this dispute, the board of directors of ATS was composed entirely of members who were also officers and/or directors of Smith Group. In this case, ATS was considering the acquisition of the assets of Dickten & Masch, a competing plastics manufacturing business (D&M). ATS conducted due diligence, but ultimately the ATS board of directors decided to pass on acquiring D&M. Shortly thereafter, Smith Group acquired D&M. Within months, Smith Group's new D&M affiliate acquired, from ATS, the assets of ATS's plastics subsidiary, Trostel SEG.

After these events, Notz, one of the minority shareholders of ATS, commenced an action against Smith Group and four of its directors, alleging a breach of fiduciary duties by Smith Group and the individuals representing Smith Group on the board of directors of ATS. Ordinarily, a claim such as this must be brought by a minority shareholder either on behalf of the corporation or on a derivative basis.[3] The minority shareholder in this case, however, did not pursue a derivative claim; rather, the minority shareholder asserted that he was entitled to bring the claim on an individual basis.

Under well-established legal requirements (in Wisconsin, where this case arose, and in most other jurisdictions), in order to bring such a claim on a direct basis and not a derivative basis, a minority shareholder must show that the alleged wrongdoing harmed the minority shareholder differently than it did the other shareholders. But how can one do this in a case like this where the alleged wrong committed by Smith Group and its representatives on the ATS board of directors (the usurpation of a corporate opportunity for the benefit of Smith Group and to the detriment of ATS) would clearly affect all the shareholders?

The trial court dismissed the minority shareholder's claim that Smith Group had breached its fiduciary duties. Both an appeal to the Wisconsin appellate court and then an appeal to the Wisconsin Supreme Court followed. The Wisconsin Supreme Court decided to inform Smith Group and other majority shareholders in closely held businesses that when they act in their own interests and not in the interests of the company they control, they run the risk of being called on the carpet. The Wisconsin Supreme Court, apparently, did not like what it saw and did what a court sometimes does in such situations: it got creative.

The appellate court upheld the trial court's dismissal of the minority shareholder's claim that Smith Group had breached its fiduciary duties by orchestrating ATS's decision not to purchase D&M and to cause ATS to sell its plastics subsidiary to Smith Group. The court found that the minority shareholders had suffered no injury not shared by all ATS shareholders. What the appellate court did next, affirmed by the Wisconsin Supreme Court, was more surprising. Both appeals courts held that the expense incurred by ATS in conducting due diligence with respect to the potential acquisition of D&M did not benefit ATS; rather, it only benefited Smith Group. Both courts analogized this to a dividend received only by Smith Group and not by the minority shareholders. Thus, this claim could be brought on a direct basis by Notz and need not be pursued on a derivative basis.

The reasoning on this point seems questionable. One could certainly argue that the due diligence expenses did indeed benefit ATS and were a necessary cost to ATS's decision of whether or not to pursue D&M, and thus were also a benefit to the minority shareholders by leading the ATS board of directors to abandon the acquisition. Under the court's reasoning, any due diligence resulting in a decision not to consummate a potential acquisition could arguably be said to have not benefited the company. And, of course, that was not the case. Here, the court was obviously troubled by what it believed was self-dealing by Smith Group.

Although the court did not say this, the reader cannot help but think that the Wisconsin Supreme Court felt that Smith Group decided to reject the acquisition at the ATS level so that Smith Group could acquire D&M. As a result, the court decided that Smith Group should pay for that benefit.

This decision is noteworthy for a couple of reasons. Even though the case was framed as a technical ruling about whether a minority shareholder could bring a claim on a direct basis, what it really shows is that when a court believes that majority shareholders have acted in their own self-interest, a court may stretch a point to punish that conduct. The more troubling aspect of this case, from the standpoint of majority shareholders, is that it is difficult to guess to what extent a court will be troubled by a majority shareholder's receipt of a benefit that is not fully shared by the minority shareholders. For example, what if a company enters into an arm's-length agreement on commercially reasonable terms with a company owned and controlled by a majority shareholder? Are the majority shareholders receiving a benefit not shared by the minority shareholders and thus receiving a "dividend" not received by other shareholders? When the transaction is fair and on an arm's-length basis, one would think that would not be a likely consequence since the company would not get a better deal with a stranger. However, it is not out of the question that a court could find otherwise, given the court's reasoning in this case.

Only time will tell whether this was a case of bad facts making a bad precedent or whether the Wisconsin Supreme Court was adopting a new (and some would say groundbreaking) view of majority shareholder conduct.

Stephen Sayre, 312-627-2131

Acceptance, Rejection and Revocation of Acceptance

If you order goods, you are supposed to inspect them when they arrive or within a reasonable time thereafter. If they don't conform to what you ordered or if they otherwise appear to be defective, you can reject them under the Uniform Commercial Code (UCC). If you don't conduct an inspection, you are deemed to accept the goods and you lose your right to reject with respect to any defects you would have found via inspection. Acceptance triggers your duty to pay for the goods in accordance with the contract. But that's not the end of the subject, because the goods may be defective or not conform in a way that you cannot detect by inspection upon receipt and only learn about later. Thus, in some circumstances, you may accept (or be deemed to accept) the goods and still have a later right to revoke your acceptance if they are defective and if you could not reasonably be expected to discover the defects by inspection at the time of receipt.

Let's consider two recent cases. The first, *Wilderness Development, LLC v. Hash*, involved an effort to revoke acceptance of more than 400 pine trees that had been transplanted to the buyer's property. Wilderness Development was developing a golf course and residential community in Montana. It purchased approximately 665 ponderosa pines from Nancy and David Hash, who owned and ran a nursery in Idaho. Four hundred of the trees were transplanted in September and October 2006. By April 2007, many of them were turning brown and were infested with beetles. Wilderness contacted the Hashes and demanded compensation for the cost of the trees, to no avail. Subsequently, Wilderness sued.

The Hashes moved for summary judgment, arguing that Wilderness had accepted the trees and failed to timely reject them or give notice of any breach; therefore, the trees were not defective when delivered, and they pointed to UCC 2-607(3)(a), which provides that where a tender has been accepted, the buyer must notify the seller of any breach within a reasonable time after he discovers or should have discovered the breach. According to the Hashes, the buyer didn't give notice, because there was no breach.

Wilderness responded that this provision was not applicable and that UCC 2-608, relating to the revocation of acceptance, governed. Wilderness claimed that the trees were nonconforming when delivered, as they were unfit for the adverse environmental conditions at the site—a defect that was not detectable at the time of delivery by any means available to Wilderness. According to Wilderness, the beetle infestation occurred because the trees were unsuitable for the conditions. Therefore, they were nonconforming to the contract and Wilderness was entitled to revoke its acceptance once the defects became manifest.

The court noted that the parties acknowledged that there were no objectively noticeable or discoverable defects or nonconformities in the trees when they were delivered and planted. However, Wilderness introduced expert testimony that, because of the stress and shock the trees underwent due to transplanting, and because of the inadequate size of the root balls, they were not suitable for transplanting at the site. This raised a question of fact about whether the trees were defective. The court cited UCC 2-608(1)(b), which permits revocation when acceptance has been without discovery of the nonconformity if acceptance was reasonably induced by the difficulty of discovery before acceptance. The court also noted that although Wilderness had possession of the trees for several months before purporting to revoke acceptance, there was a real question as to whether possession by Wilderness was sufficient to have made it aware that the trees would be vulnerable to beetle infestation. Therefore, said the court, there were issues of fact as to whether the trees were nonconforming and whether Wilderness should have been able to discover that when they were delivered. So, summary judgment was denied. Wilderness was entitled to a trial on its claim.

In our second case, *Turner Envirologic, Inc. v. Griffin Industries, Inc*., the buyer discovered the nonconformity relatively quickly but continued to use the goods. Did the buyer thereby accept the goods with the defects, and through continued use lose the right to revoke acceptance later?

Griffin Industries ordered a large piece of air pollution control equipment from Turner Envirologic. Turner custom designed and manufactured the item (known as a regenerative thermal oxidizer, or RTO) for Griffin's plant in Centre, Alabama. Griffin's operations there dealt with recycling bakery waste goods into various kinds of animal feed. To produce the feed, Griffin dried the waste goods using a biomass burner that burned wood scraps sawdust and some of the bakery waste goods.

Griffin ordered the RTO in response to being told by the Alabama Department of Environmental Management that emissions controls must be installed. Griffin did some research, sought bids and awarded the job to Turner. But within a month after installation, the RTO began to have problems. Apparently, the type of RTO that Turner had provided was not appropriate for the materials being burned. Turner made some repairs, as required by its warranty, but problems persisted. Griffin then started trying to fix the problems itself. Eventually, Turner stopped making repairs and Griffin sent written notice revoking its acceptance of the RTO and seeking a refund. Then, about a year after the RTO was installed, Griffin filed suit. In the

meantime, Griffin had kept the RTO running via short-term fixes until it was able to have a replacement piece of equipment installed.

In court, Turner argued that Griffin could not revoke its acceptance because it had used the equipment for more than two years. Under UCC 2-608(2), revocation of acceptance must occur within a "reasonable time" after the buyer discovers the defect. Turner claimed that Griffin had not revoked within a reasonable time and instead continued to use the RTO.

The court did not agree, holding that what constitutes a reasonable time must be considered in light of the circumstances. Griffin could not operate the plant without the RTO, and therefore it was reasonable for Griffin to try to fix the problems after Turner stopped its repair efforts. A "reasonable time," therefore, would be long enough for Griffin to make its repair effort and decide whether the RTO could be fixed permanently.

UCC 2-608 also requires that revocation be before any substantial change in the condition of the goods that is not caused by their own defects. Turner also tried claiming that Griffin's modifications of the RTO changed its condition and therefore precluded Griffin from revoking. The court didn't buy this argument either. Griffin made modifications to keep the RTO operational so that the plant could stay open. In the court's view, that mitigated the damages caused by the faulty RTO and didn't result in a substantial change to the goods. Therefore, said the court, Griffin could still revoke its acceptance.

We think both these cases are somewhat unusual, particularly the second one, given that Griffin continued to use the RTO long after the defects were well established.But the cases illustrate that a buyer may still have recourse with respect to nonconforming goods after accepting them if there are defects that are later discovered.

Andrew Connor, 312-627-2264

Capital Raising—Changes to the Accredited Investor Definition

Under the U.S. securities laws, a security (e.g., stock, notes, limited partnership interests) must be registered or exempt from registration to be offered or sold. This rule applies to any security, whether issued by a large publicly held company or a newly formed private company raising capital. Registration under Federal law involves a lengthy and costly process, so most privately held companies look for an exemption. One of the most commonly used exemptions is the private offering exemption, a statutory exemption intended to be for wealthy and sophisticated investors who are capable of evaluating the merits and risks of investments without the protections of the Federal securities laws. In 1982, the Securities and Exchange Commission (SEC) adopted Regulation D to create an objective safe harbor to determine what is a private offering. Reg D is the exemption most privately held entities use to raise capital from investors.

Reg D introduced the concept of "accredited investor." One requirement of Reg D for offerings over $1 million is that there are no more than 35 investors in the offering who are not "accredited." This number limit makes it very important for an entity raising capital to clearly understand who is and who is not "accredited." Since its adoption, Reg D has provided that an individual investor was "accredited" if, among other things, the investor had a net worth of at least $1 million (including the investor's primary residence) or annual income in excess of $200,000 ($300,000 with spouse) in each of the last two years and expected for the current year.

Congress has recently passed, and the President signed, the "Dodd Frank Wall Street Reform and Consumer Protection Act." Although Dodd-Frank primarily deals with the issues which led to the recent financial crisis, it also contains provisions changing the accredited investor tests. As originally proposed, it would have increased the net worth test to at least $2,300,000, excluding the investor's primary residence, and increased the income standard from $200,000 to $450,000. It also would have made certain offerings subject to state review; and required 120-day SEC review of offerings that weren't subject to state review. (No reviews of Regulation D offerings were previously required by the SEC.) Various trade groups argued that these changes would be highly detrimental to capital formation by significantly reducing the accredited investor pool (by as much as 77%) and creating significant delays by the introduction of state and SEC review.

As a result of the efforts of these groups, major revisions were made. As adopted, Dodd-Frank keeps the $1 million net worth standard in effect for four years but now excludes the value of an investor's primary residence from net worth. Starting in four years, the SEC is required to increase the $1 million threshold. The SEC is also mandated to review the accredited investor standards as they apply to individuals and to adjust those standards as appropriate for protection of investors, and to repeat this process every four years. Lastly, Dodd-Frank disqualifies certain offerings from the protections of Reg D if such offerings are made by certain "bad actors" (persons who have been convicted of a felony or misdemeanor in

connection with the purchase or sale of any security or a false filing with the SEC or aren barred from association with regulated entities or from engaging in the business of securities, insurance, banking or in savings association or credit union activities for fraud, manipulation or deception).

Reg D requires that the issuer have a “reasonable belief” that an investor is “accredited.” Most issuers use a form of questionnaire to provide evidence of such belief. The most extensive of these questionnaires request detailed financial information, and include questions which require the investor to affirmatively state the reasons why the investor is accredited. As an alternative, the issuer may rely on letters from third persons, such as accountants, attorneys or bankers, who are knowledgeable about an investor’s financial position. Obviously, the better the evidence the more an issuer will be certain that its offering complies with Reg D.

The changes to the net worth test and the addition of the “bad actor” provisions should have very little present effect on the availability of Regulation D. In fact, Illinois’ state law accredited investor standard has always excluded one’s principal residence. However, this view may be altered in the future by the effect of the mandated SEC review and changes.

For more information about any of the material contained in the Business Law Quarterly, please contact the author or the editor or one of the Dykema attorneys with whom you work.

[1]The DISC rules are codified in Part IV of Subchapter N of the Internal Revenue Code, IRC Sections 991-997.
[2]Rev. Rul. 2009-36, 2009-47 IRB 650 (Nov. 11, 2009).
[3]A derivative action is a suit by a shareholder to enforce a corporate cause of action. The corporation is, thus, a necessary party to the action and any relief that is granted is a judgment in favor of the corporation.

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