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UNPAID INTERNSHIPS: LEGAL OR NOT?

By Rachel Brochert Roe, Attorney

It's summertime... the time that many employers eagerly anticipate using summer interns, a/k/a free labor! If the use of summer interns is part of your business plan, beware: the Department of Labor announced this spring that it will step up enforcement efforts against employers who offer unpaid internships. In past years, the rule as to whether interns were actually employees, and therefore entitled to benefits such as minimum wage and overtime, was blurry. For instance, in 2002, the Department of Labor indicated in an opinion letter that whether an intern must be paid depends on whether "productive work performed by the [intern] would be offset by the burden to the employers from training and supervision provided."

In fact, you will not find the word "intern" anywhere in the Fair Labor Standards Act (FLSA), which is the law governing the payment of wages to employees. Rather, the FLSA only specifies between "employees" and "trainees." Employers must pay those classified as "employees" minimum wage, as well as overtime compensation for all hours worked over 40 in a work week. A very narrow exemption exists for "trainees." For an intern to be legally classified as a "trainee," and therefore work without compensation, they must meet the following six factor test:

1. The training received by the intern is similar to what might be offered in an academic institution or vocational school;

2. The training is for the benefit of the trainees;

3. The trainees do not displace regular employees, but work under their close supervision;

4. The employer derives no immediate benefit from the training, and occasionally the employer's operations may be impeded by the training;

5. Trainees are not entitled to a job at the end of the training period; and

6. The employer and trainees understand that the trainees are not entitled to wages for time spent in training.

If all of the factors listed above are met, then the worker is a trainee, and an employment relationship does not exist. This means that the FLSA's minimum wage and overtime provisions do not apply to the worker.

However, it is important to note that the definition of employee under the FLSA is broad, and the trainee exception is a very narrow one. Most employers have a rather relaxed and unstructured summer internship program. The Department of Labor is emphasizing that without the structure of a formal training program, very few internship programs with for-profit employers will be exempt under this rule. The best bet if you are uncertain as to whether your internship meets the test above is to pay interns at least minimum wage and require them to keep track of all hours worked for you. Prior to concluding that your internship program does satisfy the six criteria above, consultation with an attorney specializing in labor and employment law is a must. Remember: just because you call it an unpaid internship does not mean that the Department of Labor will agree with you.

Rachel Brochert Roe is a business counselor and employment lawyer who advises many types of businesses – from small start-ups to those with hundreds of employees – in industries such as health care, manufacturing, government, and education. She can be reached directly at 231.486.4503 or rroe@shrr.com.

PROTECTING MANUFACTURERS FROM BANKRUPTCY PREFERENCE CLAIMS

By Daniel M. Morley and Kristen A. Campbell, Attorneys

Michigan's manufacturing industry is being particularly hard hit in the current economy. It is common for manufacturers that have already suffered a loss as a result of a customer's bankruptcy to later receive a letter from the customer's bankruptcy trustee demanding that the manufacturer pay back monies it received from the bankrupt customer within the 90 day period prior to the bankruptcy filing. This 90 day period is known as the "preference period." The United States Bankruptcy Code presumes that debtors are insolvent during this 90 period. Although it may not seem fair, the basis for the disgorgement and return of preference payments under the Code is based on the concept of ensuring the fair and equal treatment of all unsecured creditors. Reclaiming payments made during the preference period is intended to redistribute the bankruptcy estate's assets equitably among all of the bankrupt's unsecured creditors.

Manufacturers can defend a preference claim but it can be very costly. It may be possible to alter a manufacturer's status from an unsecured creditor to a perfected secured creditor, and by doing so the manufacturer may be able to effectively avoid a preference claim. A payment made to a fully secured creditor during the 90 day preference period is not considered preferential because in return for the payment, the debtor receives a release of its equity in the collateral. Technically, there is no depletion of the debtor's estate and the creditor does not receive more than it would in a Chapter 7 bankruptcy proceeding.

Purchase Money Security Interests

In a typical setting, a manufacturer delivers goods to its customers on credit terms that may vary from "Net 30", to "Net 60", to "Net 90", or even longer. And all too frequently, payments from the customer tend to be delinquent a month or more past what the contract terms permit. Effectively, and involuntarily, the manufacturer is providing its customers with short-term financing for the produced goods.

One way to alter a manufacturer's position from a "general unsecured creditor" to that of a "secured creditor" is by the manufacturer obtaining and perfecting a "purchase money security interest" in the goods supplied to the customer on credit. A purchase money security interest (PMSI) is described as a security interest held by a creditor that has financed the purchase of collateral to secure repayment of all or part of the purchase price. A common example of a PMSI occurs when a bank provides financing to a party in order for the party to purchase a new piece of equipment. In return for providing the financing, the bank takes a security interest in the equipment. In the event the borrower defaults on the loan, the bank then repossesses the equipment to satisfy all or a part of the indebtedness.

A manufacturer must follow the same requirements that any other creditor must follow to obtain a security interest in the equipment. First, there must be a debt. If the manufacturer is supplying the goods on open account, this requirement is satisfied. Second, there must be an agreement between the borrower/customer and the manufacturer that grants a security interest in the goods to the manufacturer. In many cases the security agreement terms can simply be included in the formal contract between the parties. However, many manufacturers contract through various proposals, purchase orders and invoices as opposed to a single controlling contract. In this case the contract terms can be included in the boiler-plate provisions of the manufacturer's forms. Care should be taken in inserting security interest terms into the form documents to adequately establish a security agreement. Whenever possible, a formal security agreement signed by the customer is preferable to boiler-plate security interest terms that are inserted into form purchase order documents.

Finally, the manufacturer is also required to record a financing statement in the appropriate office in the state in which the customer is located. In Michigan the proper location to file the financing statement is the Michigan Secretary of State, UCC Unit.

Taking a PMSI in goods that become inventory of the manufacturer's customer is slightly more complicated. The manufacturer will need to obtain a UCC search to determine if any other creditors of the customer claim a security interest in the customer's inventory. If so, the manufacturer needs to send a notice to the other creditors advising them that the manufacturer intends to take a security interest in the customer's inventory. The manufacturer must again ensure that it files a financing statement within 20 days after the debtor/customer takes possession of the goods.

A manufacturer with a PMSI in a "floating mass," such as a fluctuating pool of inventory, may still be subject to a preference claim to the extent the manufacturer improves its position during the 90-day preference period. If a manufacturer with a perfected security interest in the customer's inventory is better off on the date of the petition than it was 90 days before the petition there is a preference. However, the amount of the preference claim will likely be less than if the manufacturer held no security interest in the customer's inventory.

Obtaining a Special Tools Lien.

Manufacturers of equipment may also find it possible to avoid a preference claim if they follow the procedures to perfect a lien in the equipment under the Michigan Special Tools Lien Act. The Michigan Special Tools Lien Act was enacted in 2002 to provide protection to manufacturers by allowing liens to be imposed upon specially designed and created products used in manufacturing in order to collect amounts owed for the creation of the special tools. The Act provides a very broad definition of "special tool" including any tools, dies, jigs, gauges, gauging, fixtures, special machinery, cutting tools or metal castings manufactured by a special tool builder.

The lien arises out of the law. No agreement with the customer is necessary to obtain the lien. Similar to the PMSI process, there is a time sensitive and detailed process that the manufacturer must follow in order to perfect its lien rights in the "special tool." First, the manufacturer must permanently record its name, street address, city and state on every special tool that it fabricates, repairs or modifies. Additionally, the Act also requires that the manufacturer files a financing statement in the same manner it would to perfect a security interest under Michigan's Uniform Commercial Code. The manufacturer should record its financing statement as soon as it is able to identify the equipment, even before delivery of the equipment to the customer. The manufacturer needs to perfect its lien interest by filing the financing statement within 20 days after the customer takes delivery of the equipment.

Under the Act the special tool builder holds a lien in the equipment for the amount that the customer owes for the fabrication, repair and/or modification of the special tool.

Tips and Considerations Regarding PMSIs and Special Tools Liens

Obtaining a PMSI and relying on a Special Tools Lien have advantages and disadvantages. Whenever possible, the manufacturer should attempt to obtain and perfect both a PMSI and a Special Tools Lien. Customers may object to the inclusion of language in contract documents that grants the manufacturer a PMSI in the equipment or inventory. Since a Special Tools Lien is created by law, there is no reason to include provisions for the lien in the contract.

When equipment is delivered out of Michigan, unless the laws of the destination state provide a similar lien, a manufacturer may be unable to claim a Special Tools Lien. The manufacturer may be able to avoid this problem by inserting language in the contract documents specifying that Michigan law governs the contract, even though the equipment is located in another state. The manufacturer should also have its legal counsel review the laws of the state of the equipment's destination to determine whether that state provides a lien similar to the Special Tools Lien.

Revised Article 9 of the Uniform Commercial Code has been adopted in all fifty states. Thus a manufacturer should be able to create a PMSI in any U.S. destination, although attention should be given in reviewing the applicable provisions of the state where the UCC-1 financing statement will be filed to ensure the perfection of the PMSI.

Conclusion

Having to disgorge a preference payment can have a devastating effect on a manufacturer. By utilizing a purchase money security interests or, where applicable, a special tools lien, a manufacturer may be able to avoid a preference claim altogether. Manufacturers are urged to have their contract documents reviewed by legal counsel to provide as much protection as possible to avoid these potentially fatal claims.

This article is based on an article by the authors, "Minimizing a Manufacturer's Exposure to Bankruptcy Preference Claims by Asserting Purchase Money Security Interests and Special Tools Liens," that appeared in the Michigan Business Law Journal, Spring 2010.

Dan has 20 years of experience as a commercial and business law attorney representing financial institutions, real estate developers, construction companies, utilities, manufacturers, and other businesses throughout Michigan. He can be reached directly at 231.486.4538 or dmorley@shrr.com.

Kristen practices in the areas of business law, property and real estate law, and elder law. She can be reached directly at 231.486.4542 or kcampbell@shrr.com.

SMITH HAUGHEY RICE & ROEGGE
BUSINESS LAW ATTORNEYS

George F. Bearup
231.486.4510
gbearup@shrr.com

Joseph E. Belsito
616.458.2490
jbelsito@shrr.com

James G. Black
616.458.4253
jblack@shrr.com

Kristen A. Campbell
231.486.4542
kcampbell@shrr.com

Scott D. Harvey
231.486.4545
sharvey@shrr.com

Gregory R. Kish
231.486.4557
gkish@shrr.com

Adam M. Lett
231.486.4507
alett@shrr.com

Jeffrey J. McManus
231.486.4554
jmcmanus@shrr.com

Kirk W. Morgan
616.458.3319
kmorgan@shrr.com

Daniel M. Morley
231.486.4538
dmorley@shrr.com

Rachel Brochert Roe
231.486.4503
rroe@shrr.com

Jonathan J. Siebers
616.458.5298
jsiebers@shrr.com

Robert C. Stone
616.458.3622
rstone@shrr.com

Jeffrey R. Wonacott
231.486.4509
jwonacott@shrr.com

Stephen C. Chambers
Of Counsel
231.486.4546
schambers@shrr.com

Ellen A. Fred
Of Counsel
231.486.4558
efred@shrr.com

Patrick J. Wilson
Of Counsel
231.486.4541
pwilson@shrr.com