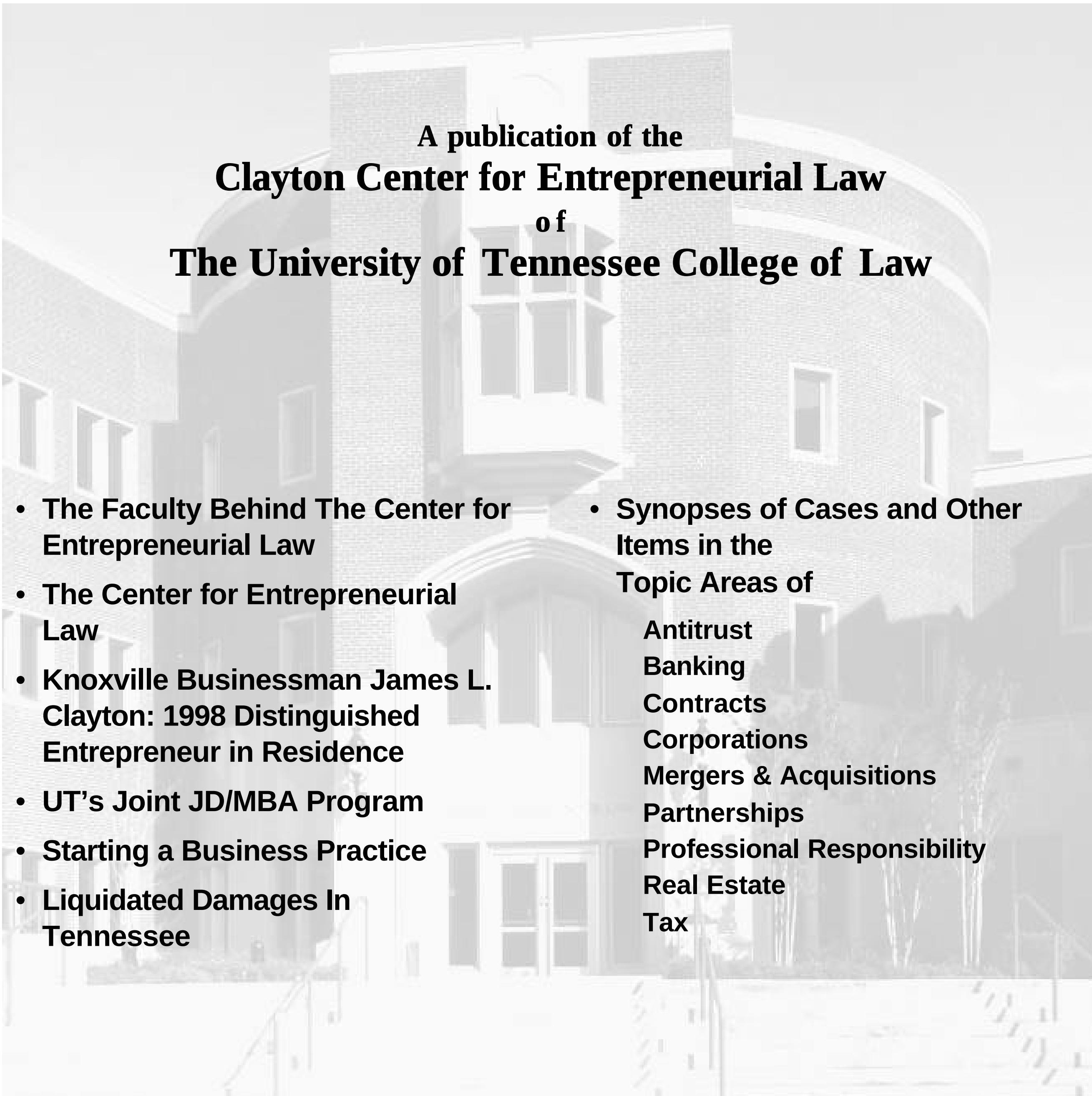
# TransactionS

Tennessee Journal of Business Law



A publication of the
## Clayton Center for Entrepreneurial Law
of
## The University of Tennessee College of Law

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# Transactions: Tennessee Journal of Business Law

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## Notes from the Editor in Chief

As Editor in Chief, I would like to thank all the students, faculty, and lawyers who have invested in the idea of the College of Law's Business and Tax Law Association that the College of Law, its students, and the practicing bar would be well served by the publication of a journal focusing on transactional practice. Without their efforts, the publication of this inaugural issue of *Transactions* would not have been possible.

This journal serves several purposes. First, it provides students with an opportunity to learn about business and transactional law topics by researching and writing essays or synopses to be published in the journal. The journal also serves the legal profession by alerting transactional practitioners to legal developments affecting their practices. Finally, *Transactions* is intended as a showcase for The University of Tennessee College of Law, its Center for Entrepreneurial Law, and the talents of its students.

The journal is divided into three main sections. The first contains general information about the Center for Entrepreneurial Law and other business law activities at the College of Law. It will highlight recent and upcoming Center activities and the students, faculty, and practitioners who support these activities. The second section includes synopses of recent cases and statutory or regulatory action of particular interest to business and transactional law practitioners in Tennessee and the Southeastern region. The third section includes short articles on various topics of interest to business lawyers. We anticipate offering a mix of articles written by students, practicing attorneys, and academic writers, aiming to provide attorneys with practical information on current issues.

I hope you enjoy this complimentary copy of *Transactions* and find it useful. I know I enjoyed working on it for you.

*Thomas A. Kulaga*

## Your Complimentary Copy

Complimentary copies of *Transactions* are being distributed to introduce this new journal to the legal community and in particular, to regional business practitioners.

*Transactions* will be published twice annually by the Center for Entrepreneurial Law at The University of Tennessee College of Law. *Transactions* is available as a printed hardcopy delivered by mail or an electronic version delivered by e-mail.

Please show your support by reading and passing on this complimentary copy.

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# Professors Robert Lloyd and Carl Pierce
# The Faculty Behind the Center for Entrepreneurial Law

Seated left to right are Professors Robert Lloyd and Carl Pierce.

The College of Law owes a debt of gratitude to Professor Robert M. Lloyd for his contributions as the first director of the College's new Center for Entrepreneurial Law. During his tenure, Professor Lloyd helped develop the curriculum for the business transactions concentration. More generally, his efforts laid the foundation from which the Center's future programming will arise.

Professor Lloyd came to The University of Tennessee College of Law from Los Angeles, California where he practiced commercial law with a large law firm. Through this experience, he came to realize the need for better law school training of new lawyers interested in a transactional practice.

The changing market for legal services was one of the key motivating factors for the creation of the business transactions program. The College of Law had a wonderful program for students interested in advocacy but did not have a comparable program for those with business interests. Lloyd realized that a high-quality transactional curriculum would help those students secure high-quality employment upon graduation and more rapidly adjust to the demands of a fast-moving transactional practice. What emerged was a vision of a Center for Entrepreneurial Law for the College of Law, the centerpiece of which would be a curricular concentration in business transactions.

Then-Dean Richard Wirtz, the faculty, and supportive alumni quickly realized the wisdom of Lloyd's vision and began to support his efforts to convert his vision into reality. The result was the birth of the College of Law's Center for Entrepreneurial Law, the development of the business transactions concentration, and the eventual graduation in 1996 of the first group of students to successfully complete the concentration.

From the beginning, Lloyd has unselfishly contributed to the improvement of the Center and its programs. He soon discovered that serving as Director of the Center was demanding time that he would rather spend teaching and writing about commercial law—the activities that had attracted him to the College of Law in the first place. Confident that the curricular concentration afforded the Center a solid footing for further growth, Professor Lloyd decided it was time to pass the baton to someone else.

Professor Carl Pierce has now assumed the reins as director of the Center for Entrepreneurial Law. Although his primary academic interest is Professional Responsibility, he also teaches Contracts, Corporate Finance, Business Associations, Agency & Partnership, and Securities Regulation. Pierce's separate interests in Business Associations and Professional Responsibility have, in recent years, led him to pay special attention to the professional responsibilities of corporate counsel and transactional lawyers. He frequently speaks on these matters at Continuing Legal Education seminars throughout the state. In addition to his responsibilities as Director of the Center, Pierce is currently serving as the Reporter for the Tennessee Bar Association Committee for the Study of Standards of Professional Conduct. Also, he is one of the two Reporters for the American Bar Association Commission on Evaluation of Rules of Professional Conduct.

Although Pierce has many responsibilities in other areas, he is devoted to the development of the Center for Entrepreneurial Law. Always on the lookout for ways to further strengthen the transactions curriculum, Pierce is particularly interested in having the Center sponsor a broader range of programs. He wants the Center not only to provide an educational opportunity to the students, but also to provide useful services to the bench, bar, and public. These services will also provide meaningful co-curricular and extracurricular activities for students who have a special interest in transactional practice and will lead to closer ties between the business bar and the College of Law. Some of these activities include a monthly speaker's series, a student pamphlet series, a practitioner pamphlet series, a series of legal bibliographic pamphlets focusing on various aspects of transactional practice, the sponsorship of Continuing Legal Education programs, and the publication of *Transactions.*

Eventually, Professor Pierce would like to oversee the creation of a course that focuses exclusively on the provision of legal services to corporate clients. This course could be required for students in the joint J.D./ M.B.A. program but would also be available as an elective to other students. In the class, students would learn about how corporations procure and lawyers deliver efficient, high-quality legal services that are responsive to the needs of an ever-more demanding and dynamic corporate clientele.

All of this activity is consistent with the College of Law's commitment to prepare its graduates for success in the job market and in their legal careers. Through the energy and talents of faculty members like Professors Lloyd and Pierce, the Center for Entrepreneurial Law has become a distinctive program in which the College of Law's students and alumni can take pride.

*Donrua Hulsey*

## The Center for Entrepreneurial Law at The University of Tennessee College of Law

*Carl A. Pierce, Director*

Conceived five years ago as part of a plan to provide a more coherent academic program for those students who aspire to represent clients in business transactions rather than lawsuits, the Center for Entrepreneurial Law now serves as the focal point for the College of Law's ongoing effort to be a regional and national leader in teaching, scholarship, and public service relating to transactional practice. Through the efforts of our promoters and investors—faculty, students, the University administration, and many loyal alumni—the Center is now turning an educational profit. Of particular importance to the Center's success has been the leadership of Professor Bob Lloyd, my predecessor as Director of the Center, and major financial commitments by Woolf, McClane, Bright, Allen & Carpenter, PLLC; Richard and Donna Plumley; and a donor who wishes to remain anonymous.

With respect to our primary mission—the preparation of our students for the transactional practice of law—the profit has already been substantial and the prospects for future profits look good. At the heart of the Center is our curricular concentration in business transactions in which students take 19 hours of prescribed coursework (Business Associations, Commercial law, Land Finance, Fundamentals of Income Taxation, Taxation of Business Organization, and Contract Drafting) as the prerequisite for a capstone course. Representing Enterprises is that capstone course and it requires each student to plan and draft documents for a variety of simulated transactions. The success of this curricular innovation is due in large part to the efforts of practicing transactional attorneys who have shared their knowledge and experience with our students in Contract Drafting and Representing Enterprises. Another curricular option within the Center is our J.D.-M.B.A. program in which our students can earn both a J.D. and an M.B.A. degree in four years. One can, of course, envision a future in which the Center will house new, different, and even better curricular options for our students who aspire to be business lawyers.

With respect to our mission to promote scholarship and provide public service, we have also turned a respectable profit. The Center has brought distinguished lawyers to the College of Law, including Daniel Mahoney, a nationally known expert on partnering between corporate legal departments and law firms. Wyatt, Tarrant & Combs, through the good offices of Thomas R. Dyer, '66, sponsored his visit. Jim Clayton, '64, CEO of Clayton Homes, Inc., joined us for four days as our first Distinguished Entrepreneur in Residence. The details of that visit are detailed in the next article. The Center has sponsored or co-sponsored a variety of Continuing Legal Education programs (including the annual program the Center co-sponsors with the Tennessee Chapter of the American Corporate Counsel Association).

As a public service, the Center has published and distributed a student-authored pamphlet alerting prospective small business entrepreneurs to some of the legal issues associated with starting a new business. Currently

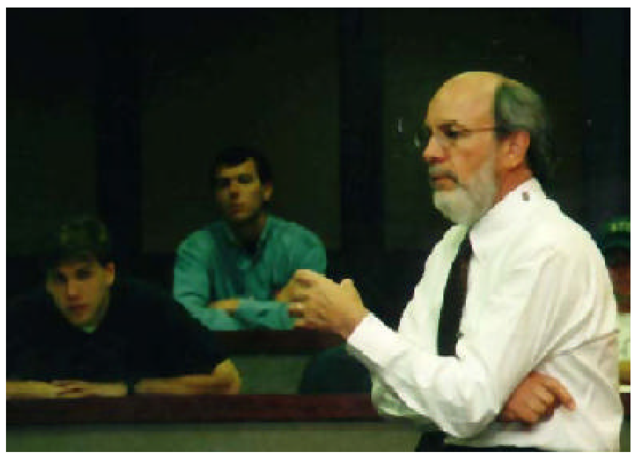
in the works is a similar student-authored pamphlet addressed to aspiring franchisees and a practitioner-authored pamphlet on Real Estate Investment Trusts. You are reading the first volume of *Transactions*, an electronic and hard copy publication intended to inform transactional lawyers about the Center and its activities, to note recent developments in and new literature about transactional practice, and to serve as a vehicle for the publication of short essays by students, faculty, and practitioners about topics of interest to transactional practitioners.

The future is bright. We will be hiring a new faculty member who will teach in the corporate and securities area and who we will expect to make significant contributions to the Center. The University has funded a new position that we will use to hire a new Director for the Center, a step that will enable the current Director to direct his attention to curricular and outreach initiatives focused on the professional responsibilities of transactional lawyers. Our new Dean—Tom Galligan—has just announced an extraordinarily generous gift of Jim and Kay Clayton. It is surely fitting that our Center will bear their names. I am also very encouraged by my conversations about the Center with numerous alumni and transactional practitioners who have applauded our concept, made suggestions for improvement and new directions, and volunteered to help. My vision of the Center for Entrepreneurial Law, then, is that of a young but ambitious enterprise that is well-positioned to take-off as a major player in the preparation of law students for careers in transactional practice and in the ongoing efforts of transactional lawyers to improve the quality of the service they render to their clients.

## Knoxville Businessman James L. Clayton
## 1998 Distinguished Entrepreneur in Residence at UT College of Law

In April 1998, the faculty and students of the College of Law welcomed James L. Clayton as the Center for Entrepreneurial Law's first Distinguished Entrepreneur in Residence. Mr. Clayton is a 1964 graduate of the College of Law and the founder and current CEO and Chairman of the Board of Directors of Clayton Homes, Inc. In his capacity as Distinguished Entrepreneur in Residence and drawing on his long experience as an entrepreneurial client, Jim Clayton made presentations and provided materials for discussion in four law classes plus a faculty forum. He returned to the College of Law to be the featured speaker at a well-attended public Continuing Legal Education forum focusing on "Entrepreneurial Perspectives on Law and Lawyers." Joining Clayton at the CLE forum were Patrick W. Semegen, the then General Counsel at Clayton Homes, Inc.; Tamara E. Boyer, the General Counsel at Vanderbilt Mortgage and Finance Inc. (Clayton Homes' wholly-owned finance subsidiary); and Thomas N. McAdams, a partner in Bernstein, Stair and McAdams, the law firm that has for many years served as the primary outside counsel for Clayton Homes, Inc., and its affiliated companies.

Clayton's visit is the first of what the Center hopes will be a regular program of extended visits to the College of Law by distinguished business lawyers and business clients. The Center's goal is to increase contacts between the College of Law and the world of transactional practice. With this goal, the Center hopes to enrich the educational experience of our students, promote careful thought about transactional practice, and provide useful programming that meets the needs of transactional lawyers who are looking for relevant continuing legal education programs. In particular, the Distinguished Entrepreneur in Residence program recognizes the importance of including clients and lawyer-client "teams" in an ongoing dialogue about how lawyers can better serve business clients in a changing legal and business environment.



The Center is extremely grateful that Clayton was willing to be our inaugural Distinguished Entrepreneur in Residence. His career has taken him from being the founder of a fledgling and struggling small business to serving as the CEO and Chairman of the Board of an extremely successful public company, the shares of which are actively traded on the New York Stock Exchange. He has also served on the board of directors of several other public companies. Acting individually and on behalf of his companies, he has purchased businesses and engaged in a wide variety of financing. He has hired, worked with, and fired lawyers.

Clayton is a strong supporter of the University, as well as other charitable and civic activities. He especially enjoys helping students. Jim Clayton was just the right person to inaugurate our effort to bring business clients and business lawyers into the law school for the purpose of enhancing the learning experience of our students.

Clayton started his visit with a presentation to the 100 students enrolled in the Professional Responsibility course. He spoke about "A Client's-Eye View of Business Lawyers and their Responsibilities." He then met with the faculty for a forum discussion about "Preparing Law Students to Represent Entrepreneurs and Their Companies." The next day, he lectured in several classes. He spoke with the Corporate Finance class about "Legal and Business Consideration in Buying Banks." In the Business Associations class, he spoke about "Corporate Governance." Finally, in the Representing Enterprises class, he spoke about "Asset Purchases and Securitization." In addition to five-and-one-half hours of teaching, he hosted a lunch for student leaders from our Business and Tax Law Association and this Journal. During his lectures, Clayton provided samples of lawyer work product such as corporate charters and bylaws, merger agreements, asset purchase agreements, regulatory filings, and a due diligence checklist for buying a bank. These materials, plus Clayton's experience as a client, his willingness to speak openly and candidly, and his sincere interest in our students made his visit a great success.

For the CLE program, Clayton (as the business client), was joined by his primary lawyers-Patrick Semegen, Tamara Boyer and Thomas McAdams. The Center was pleased to welcome all to the College of Law, but it was especially honored to be able to introduce and welcome Pat Semegen to Knoxville and the Knoxville bar. He had recently joined Clayton Homes, Inc., as its General Counsel. Semegen comes to Knoxville after a long and successful stint as General Counsel at Western Auto, Inc.

The thrust of the CLE program was a discussion of how clients and lawyers work together as a team to further the accomplishment of the business objectives of the client when, to borrow a phrase from Jim Clayton, there are "legals" involved. The three hour program was well-received by the fifty lawyers in attendance.

Without a doubt, Jim Clayton's visit as the first Distinguished Entrepreneur in Residence was a wonderful way to inaugurate this prong of the Center's efforts to connect the College of Law with the world of transactional practice. We extend a sincere thank you to Jim Clayton, our distinguished entrepreneur, and to his distinguished lawyers. They made an important contribution to the College of Law by sharing their limited time and substantial talents and experience with our students and with those lawyers who came "back to school" for our CLE forum.

*Carl A. Pierce, Director,*
*Center for Entrepreneurial Law*

## An Extraordinary Opportunity: The Joint J.D./M.B.A. Program

The University of Tennessee's joint J.D./M.B.A. program offers students the unique opportunity to earn two graduate degrees simultaneously. In four years, a participant is able to earn a Doctorate of Jurisprudence and a Masters in Business Administration. If pursued separately, the two degrees take a total of five years to complete. To qualify for the program, joint degree students must be admitted individually into both colleges. Students may begin their studies in either college but they must enroll solely in law or business school courses for the first year of each program.

After the first year in each college, students may earn the remaining credit hours in any combination of their choice, provided that they meet all requirements of both programs. To satisfy the curriculum requirements of both colleges in four years, each college accepts nine credit hours from the other college. The Graduate Business School requires that the nine hours transferred be business related law courses. The College of Law accepts any graduate-level business credits, other than first-year core course work, on the assumption that all business courses are law related. While enrolled in the joint J.D./M.B.A. program, students may concentrate their studies in a certain field within each school, such as advocacy or business transactions in the law school, or marketing or finance in the business school.

The University founded the joint degree program to promote several fundamental goals. First, the program is based on the premise that a highly integrated program in both law and business so fundamentally enriches a student's learning that any reduction in total credit hours is greatly outweighed by such an experience. The two programs emphasize radically different learning structures and allow students to develop distinct skills.

The M.B.A. program focuses on learning through the integration of business disciplines, such as marketing and finance, in a first-year core curriculum based upon the initial start-up of a business. In the context of building this enterprise, each student works in a team throughout the first year and much of the second year of the program. M.B.A. students learn to work with associates in addition to gaining valuable communication skills and substantive business knowledge.

The J.D. program emphasizes legal reasoning and analytical skills, as well as the development of strong writing skills. The first year curriculum, generally prescribed for every student, includes fundamental legal courses such as civil procedure, contracts, torts, and legal writing. Thereafter, law students may choose from a number of elective courses. In addition, the College of Law offers concentrations in both trial advocacy and business transactions. The J.D. and M.B.A. programs offer distinct skills valuable in the practice of both law and business. Their integration within the joint degree program provides students with a rich and varied learning experience.

As a second goal, the joint degree program strives to provide students with many potential career paths after graduation. Students are well equipped to enter either the world of management or the practice of law. The double-degree gives students strong legal reasoning and problem solving skills as well as a comprehensive understanding of their clients' unique needs and viewpoints. A graduate may experience a short-term advantage in finding employment. However, the primary benefit of a joint degree is that a student acquires both an understanding of the dynamic interdependent relationship between law and business, and the framework in which to solve the problems posed by this complex interrelationship.

Third, the joint degree program is designed to prepare students for an increasingly complex and interrelated legal and business world. The student who prefers to practice law has been exposed to the problem-solving approach of business executives and can, therefore, structure legal advice to be most beneficial to either a business or a corporate client. In addition, an attorney with an M.B.A. degree is better prepared to undertake management decisions in a law firm as it increases in both size and complexity. Alternatively, the student who prefers to enter the business field as an executive can more effectively anticipate and solve the many legal problems that are inevitably intertwined with many business decisions.

Intense and challenging, the J.D./M.B.A. program provides many rewards to those who will commit themselves to four years blending the best of legal and business education. The joint degree program provides the prospective attorney or business executive with the broad and flexible problem-solving skills so vital to the complex legal and business world of the twenty-first century.

*Gregory E. Glass, J.D./M.B.A*

## SYNOPSES

### ANTITRUST

***State Oil Co. v. Khan*, 118 S. Ct. 275 (1997)**

For the last thirty years, lawyers for manufacturers who wanted to control the retail price charged by resellers have had to advise their clients that vertical maximum price fixing was a per se violation of the Sherman Act, 15 U.S.C. § 1 (1994). In support, lawyers would cite the United States Supreme Court's decision in *Albrecht v. Herald Co.*, 88 S. Ct. 869 (1968). In *State Oil*, however, the United States Supreme Court overruled *Albrecht* and held that vertical maximum price fixing is not a per se violation of the Sherman Act.

Khan entered into an agreement with State Oil Co. (State Oil) whereby Khan leased and operated a service station owned by State Oil. Under the agreement, Khan procured his supply of gasoline from State Oil at a price equal to the suggested retail price set by State Oil, less a fixed margin that represented Khan's profit. Khan was free to sell the gasoline at a price lower than State Oil's suggested retail price, but the loss in per-gallon revenue reduced Khan's fixed margin. If Khan sold the gasoline at a price higher than the suggested retail price, State Oil received a rebate of the excess marginal price. After Khan became delinquent on his lease payments, State Oil moved to terminate the lease agreement. Khan filed suit in the United States District Court alleging that the lease agreement effectively prevented him from raising or lowering retail gas prices, and therefore, State Oil was in violation of the Sherman Act's prohibition against price fixing.

Typically, courts consider Sherman Act violations under a "rule of reason" test whereby an agreement must be an unreasonable restraint on trade to violate the Act. However, where a particular activity has a "predictable and pernicious anticompetitive effect," the Supreme Court labels the activity as a per se violation of the Act. To recover in such a case, a plaintiff must simply prove that the activity occurred. In *Albrecht v. Herald Co.*, the Supreme Court held that vertical maximum price fixing was a per se violation of the Sherman Act. Commentators and courts alike have sharply criticized the Court's decision in *Albrecht*. The Court has since limited the scope of per se violations of the Sherman Act.

In *State Oil*, the Supreme Court noted that fixed low prices generally facilitate competition, provided that they do not reach the level of predatory prices. Further, since many retailers operate in restricted districts granted by their wholesalers, vertical maximum price fixing may actually protect the consumer by preventing exploitation of local monopolies. The Court concluded that, while vertical maximum price fixing may in some instances result in a "restraint on trade" under the Sherman Act, the effects are not so consistently anticompetitive as to warrant a per se violation of the Act.

This decision significantly alters the legal environment in which lawyers will be advising their clients about the antitrust implications of vertical maximum price fixing agreements. Vertical maximum price fixing schemes are no longer per se illegal. The question lawyers will now have to answer is whether their clients' fixing of a maximum resale price for their products will unreasonably restrain competition. To do this, they will have to take into account the factors usually considered in rule of reason cases, such as the nature of their client's business, its condition before and after the maximum pricing scheme was instituted, and the precise nature and effect of the pricing scheme in use.

*Christopher Schwab*

### BANKING

***First American Nat'l Bank v. National Project Servs., Inc.*, No. 01-A-01-9702-CH-0005, 1997 WL 576341 (Tenn. Ct. App. Sept. 17, 1997), *reh'g denied* (Oct. 17, 1997)**

Wholesalers and retailers use various financing techniques for their inventories to smooth cash flows for their operations. Some examples of such financing techniques include floor-planning, lines of credit, and financing specific purchase orders. While lenders memorialize their respective duties through written agreements, a good faith obligation is implied in every con-

tract. In *First American*, the Tennessee Court of Appeals considered whether a bank had an implied duty to give reasonable notice of its intent to stop extending credit to a business.

National Project Services, Inc. (NPS) was in the business of reselling industrial supplies. To fund its inventory purchases, NPS borrowed from First American to cover specific purchase orders. In 1990, First American established a line of credit to finance NPS's operations. First American increased this line of credit to $180,000 in 1991, and NPS subsequently drew the whole line. In 1992, First American ceased making individual loans to finance NPS's purchase orders, assuring NPS that loans would be resumed when a transfer of NPS's account to the bank's central office was completed. NPS did not look for any other source of financing and continued to solicit orders at the same level. In 1993, First American finally notified NPS that it would not extend any more credit to NPS to finance individual purchase orders. By this time, NPS had exhausted its working capital, and it ceased operations.

An implied duty to give reasonable notice of termination of credit exists if one has a reasonable expectation of continued credit. Where a bank customer has an existing written line of credit and the requested draw is within the available line, the bank has a good faith obligation to provide notice to a customer to allow a reasonable opportunity to find other financing sources. *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 759 (6th Cir. 1985).

In the present case, NPS had fully drawn its available line of credit. The oral promises by First American were not in any specific amount or for any specific period of time. Because First American was not obligated to fund any purchase orders, the bank did not have any duty to notify NPS of its intention to stop extending credit. NPS had no reasonable expectation of continued credit to fund purchase orders. The court of appeals affirmed the trial court's decision that First American had no implied duty of notification.

Attorneys for lenders should advise their clients that they have a good faith obligation to advance funds that are within a customer's granted line of credit. Generally, a bank customer has a reasonable expectation of continued credit when the bank has obligated itself to provide such credit. This obligation may impose a duty on the bank to give notice to its customer when the bank refuses to advance funds within the line of credit. Attorneys for bank customers should advise their clients that assurances of credit extensions not specific as to amount and duration fail to create a reasonable expectation of continued credit.

*Tommy G. Meredith*

## CONTRACTS

### ***Majors Jewelers v. A.B.X., Inc.*, 117 F.3d 922 (5th Cir. 1997)**

As more business is conducted on a national and international basis, more goods will be shipped by air. There is always a risk that shipped goods will be lost or destroyed. In *Majors Jewelers*, the Fifth Circuit considered whether, after a jeweler's shipments were lost, an air carrier had effectively limited its liability by providing in its airbills and service guide that it would neither accept nor be liable for shipments of jewelry. The court also considered whether the federal court had jurisdiction over the case as one involving federal common law, and whether the plaintiff's state law claims had been preempted by the Airline Deregulation Act of 1978 (ADA).

Majors Jewelers (Majors) contracted with A.B.X. d/b/a Airborne Express (Airborne), an air carrier, to transport three shipments marked as "merchandise" from Texas to New York. Each of these shipments contained jewelry. The back of the airbills, completed by the jeweler, listed items for which Airborne would not be liable in the invent of a loss. This standard airbill made reference to the carrier's service guide (which was readily available). The service guide specifically mentioned jewelry as an item that could not be shipped. The three shipments never arrived in New York, and the jeweler brought suit.

After an extensive discussion of the history of federal regulation of air transport, the Court of Appeals held that federal common law governs the liability of air carriers for lost or damaged cargo. The court noted that the federal common law predated statutory regulation and the regulatory acts contained saving provisions preserving this cause of action.

Applying federal common law, the court held that the airbill serves as a contract for carriage in

transactions with air carriers. Carrier liability may be contractually limited if the limiting provision is sufficiently plain and conspicuous, as shown by a two-part test. First, examination of the physical characteristics of the airbill must indicate evidence of reasonable notice. Additionally, the conditions under which the carriage was made must indicate that the customer was not misled. The shipper's familiarity with the shipping process typically satisfies the second condition.

The airbill that Majors signed was Airborne's standard airbill. Although the only specific reference to Airborne's disclaimer of liability for shipment of jewelry was contained in a service guide that Airborne made available to customers only upon request, the court found that Airborne had given plain and conspicuous notice because there was a conspicuous notice on the front of the bill directing the customer to the terms and conditions on the back side of the airbill, which in turn directed the customer to the service guide that was available upon request. With respect to the second prong of the test, the court emphasized that Majors was an experienced shipper, having shipped on an almost daily basis for several years, and had ample opportunity and incentive to examine the airbill with care and to obtain and similarly examine the service guide. Under these circumstances, the court held that Airborne's disclaimer of liability for lost jewelry was binding on Majors.

Majors also asserted a claim alleging violations of the Texas Deceptive Fair Practice-Consumer Protection Act. The court held that the ADA preempted claims based on state statutory regulation of air transport. Allowing the state law claims would permit Texas to impose its own standards on air carrier service and that would be inconsistent with the ADA.

After *Majors Jewelers*, lawyers for clients who regularly ship valuable goods by air would be well-advised to brush up on the federal common law governing common carriers. Lawyers should also fully read their clients' airbills or counsel their clients to read their airbills and question what they do not understand. To be fully informed about the terms and conditions governing a proposed shipment, the lawyer needs to heed the references and cross-references on the airbill to other terms and conditions printed on the the airbill or contained in other documents, such as service guides. Air transport companies, on the other hand, might be well advised to place all disclaimers of liability in the airbill, even if a second page is needed to do so, rather than leaving them in a service guide. These companies would be well advised to take the initiative and provide all regular customers with a copy of the current version of any service guide referenced in the airbill.

*Matthew Bashore*

## ***Big Yank Corp. v. Liberty Mut. Fire Ins. Co.*, 125 F.3d 308 (6th Cir. 1997)**

Procuring reasonably priced workers compensation insurance is important to many businesses. Premiums will depend on how a company's claims experience relates to the industry average. In *Big Yank*, the Sixth Circuit Court of Appeals applied Kentucky law to resolve a controversy between Liberty Mutual and Big Yank. The controversy arose over increased premiums that Big Yank had to pay because of Liberty Mutual's alleged "bad faith" handling of an influx of claims filed by Big Yank's employees shortly after Big Yank announced that it was closing the plant where they worked.

Plaintiff Big Yank Corporation, a clothing manufacturer, entered into a contract with Liberty Mutual pursuant to which Liberty Mutual would provide Big Yank's employee's with workers compensation insurance. According to express terms of the policy, Liberty Mutual agreed to "defend Big Yank against any workers compensation claims ... but had the sole right to investigate and settle [any] claims, proceedings or suits."

In 1991, Big Yank announced the closing of one of its facilities. Within the next few weeks, 429 workers compensation claims were filed by 108 employees, which was considerably more than in prior comparable time periods. Liberty Mutual opened a file for each of the 429 claims, established a reserve for what was expected to be paid on each claim, and reported the claims to the National Council on Compensation Insurance (NCCI), the organization that establishes the ratings that are used for determining the premiums to be charged for workers compensation insurance. Liberty Mutual submitted the claims to Big Yank for verification of the validity of

claims and received no indication that Big Yank thought the claims were bogus. Subsequently, Liberty Mutual , with the approval of Big Yank's comptroller, settled the claims for $4,800,000. Because of these claims, NCCI increased Big Yank's experience rating from 1.73 to 5.07. Big Yank claimed the increase would result in payment increases of $6,000,000 for each subsequent year of coverage.

Big Yank filed suit, alleging that Liberty Mutual acted in bad faith by mishandling the claims and improperly reporting the claims' nature to NCCI. Big Yank then filed for bankruptcy, citing its financial strain caused by the increase in insurance premiums for its remaining facilities.

Applying Kentucky law, the Sixth Circuit held that an insurer can only be held liable for acting in bad faith if it can be shown that the insurer intentionally engaged in some wrongful conduct. The court noted that more than mere negligence is required. The conduct must have some degree of conscious wrongdoing, recklessness or be an unjustified gamble that puts the insured at risk. Noting that Liberty Mutual had acted according to the terms of the policy, had sought to verify the validity of the claims, and had settled the claims with the approval of Big Yank's comptroller, the court held there was no evidence of bad faith or even negligence. The court also generally asserted that "a party's acting according to the express terms of a contract cannot be considered a breach of the duties of good faith and faith dealing."

Although *Big Yank* suggests that courts are unlikely to find bad faith when an insurer processes and settles workman's compensation claims in accordance with the terms of the policy in question, insurers can further minimize the likelihood of such a finding by documenting that the insured was afforded the opportunity to question the validity of claims and to approve any settlements that could have a substantial effect on the insured's experience rating. To protect against unexpected increases in the cost of worker's compensation insurance, on the other hand, the insured companies should monitor the processing and disposition of claims that are likely to have a substantial effect on the company's experience rating.

*Ursula Bailey*

## Corporations

### Tennessee Code Annotated § Section 48-17-203(b) Corporate Proxies

During the 1998 legislative session, the Tennessee General Assembly amended the corporate proxy laws to keep abreast of business trends in proxy solicitations. The revised statute allows for the availability of new communications technology. The amendment to Tenn. Code Ann. § 48-17-203(b) more clearly defines the methods by which a corporate shareholder may authorize the appointment of a proxy to vote or otherwise act on the shareholder's behalf.

Prior to the 1998 amendment, the statute provided that shareholders appoint a proxy by executing a writing. This execution could be done by "any reasonable means, including facsimile transmission."

As amended, Tenn. Code Ann. § 48-17-203(b) provides that transmission of proxy authorization may now be accomplished by "telegram, cablegram, facsimile or other means of electronic transmission." However, the means used must contain sufficient information to show that the shareholder authorized the proxy. The statute still provides that proxies may be executed by a writing.

Larger corporations commonly use proxy solicitation firms or proxy support organizations. The amended statute specifically identifies the recipients of transmitted proxies. The recipients may be proxy solicitation firms, proxy support organizations, the holder of the proxy, or other authorized agents. The clear designation of the groups that may hold the electronically transmitted proxy puts Tennessee in line with current business trends.

With pressure by corporations to minimize expenses, corporations will use the cheapest means of sending and receiving proxy materials. Corporations are experimenting with soliciting proxies through the Internet. The amended statute allows "other means of electronic transmission" for proxy materials. However, the statute requires that there be a method of determining that the shareholder authorized the proxy. Lawyers representing corporations need to ensure that their clients handle their proxy materials prop-

erly, specifically, solicitation by electronic transmission. Lawyers may have to examine the use of technology to ensure that their clients meet the statutory requirements.

*Jay L. Johnson*

### *McAlister v. Peregrine Enters., Inc.*, No. 02A01-9610-CH-00262, 1997 WL 746373 (Tenn. Ct. App. Dec. 4, 1997)

Most shareholder agreements contain redemption rights for the shareholder. These redemption rights, however, may be subject to state statutes concerning corporate distributions. In *McAlister*, the Tennessee Court of Appeals considered whether a preferred shareholder could force the corporation to redeem his shares pursuant to his right of redemption when doing so would render the corporation unable to pay its debts as they come due.

Peregrine Enterprises sought to raise additional capital by authorizing the designation of two series of preferred stock and through the private placement of 520,000 shares of common stock. McAlister owned preferred stock which included the right of redemption. McAlister requested the redemption of his preferred stock, but Peregrine refused to redeem McAlister's preferred shares, citing two grounds. First, the right of redemption was conditioned on the successful offering of the common stock. Second, the redemption would render the corporation unable to pay its debts in the ordinary course of business.

A redemption of shares by a corporation is a distribution to a shareholder. Tenn. Code Ann. § 48-11-201(8) (1995). Distributions to Tennessee corporation shareholders are governed by T.C.A. § 48-16-401 (1995). A corporation's indebtedness to a shareholder incurred by reason of a distribution is at parity with the corporation's unsecured creditors except to the extent subordinated by agreement. Tenn. Code Ann. § 48-16-401(f). However, no distribution to a shareholder may be made if doing so would render the corporation unable to pay its debts as they become due in the usual course of business. Tenn. Code Ann. § 48-16-401(c)(1).

After reviewing the "entire contract" according to its plain terms, the court found no merit to Peregrine's claim that any redemption was conditioned on the successful common stock offering. As for the second claim, because the trial court granted McAlister's motion for summary judgment, the appellate court assumed that Peregrine's redemption of McAlister's preferred stock would render Peregrine unable to pay its ordinary debts to creditors. The court then found that § 48-16-401(c)(1) does not distinguish between a voluntary distribution and distributions mandated by contract (which McAlister argued were not governed by that section). Therefore, the court found that § 48-16-401(c)(1) prohibited the redemption of McAlister's stock if doing so would render Peregrine unable to pay its debts as they become due in the usual course of business. The court reversed the trial court's granting of summary judgment in favor of McAlister.

Practitioners need to be aware of Tennessee law concerning distributions to shareholders under § 48-16-401. These statutes are designed to protect creditors' interests. As the court found in other states, a preferred shareholder may not force a redemption if it would render the corporation insolvent.

*David C. Simcox*

### *Barger v. McCoy Hillard & Parks*, 488 S.E.2d 215 (N.C. 1997)

Shareholders of a close corporation can play several roles in the business. In addition to their role as shareholders, they often serve as directors, employees, and even as individuals with contractual relations with the business. In *Barger*, the North Carolina Supreme Court considered whether shareholders of a corporation, who had personally guaranteed the corporation's debts, could individually pursue actions against the corporation's accounting firm to recover damages for injuries to the corporation resulting from inaccurate financial statements.

Plaintiffs, as the sole shareholders and directors of The Furniture House, Inc., and acting on its behalf, employed the Defendant accounting firm to provide accounting services and financial advice. Based on the accountant's advice that the corporation was financially able to expand, Plaintiffs expanded their operations. The expansion required personal guarantees of several loans. After experiencing cash flow shortages, Plaintiffs personally guaranteed additional

loans because of assurances provided by Defendant that the shortages were temporary. At this point, a prospective purchaser of the corporation approached Plaintiffs. Defendant valued the corporation at $800,000. However, the buyer obtained an independent audit which revealed accounting errors in the compiled financial statements produced by the Defendant that had concealed the fact that the corporation and Plaintiffs' shares were worthless. When the corporation became insolvent, Plaintiffs were required to pay its debts pursuant to their personal guarantees.

The general rule that a shareholder cannot pursue individual causes of action against third parties for injuries to the corporation has two overlapping exceptions. The general rule will not apply if there is a special duty owed to the shareholder by the wrongdoer or if the shareholder suffered a separate or personal injury not suffered by other shareholders of the corporation. The court held that the general rule, with the exceptions, applies equally to both shareholders and personal guarantors of corporate debts. However, the rule and exceptions must be applied to each role separately.

Plaintiffs, as shareholders, had no claim because they did not satisfy either exception of the general rule. Plaintiffs, as guarantors, did not suffer an injury "separate and distinct" from that of the corporation. However, Plaintiffs relied upon the accuracy of the Defendant's financial statements when they personally guaranteed the debts. This act created a genuine issue of material fact as to whether the Defendant owed the Plaintiffs a special duty as guarantors, separate from the duty Defendant owed to the corporation itself. The court held that Plaintiffs, as guarantors of the corporation's debt, may pursue individual actions against the defendant under the special duty exception to the general rule.

This North Carolina decision recognizes that members of corporations often wear "different hats." More importantly, the decision recognizes that wearing these different hats can give rise to different rights. Thus, attorneys rendering advice to members of corporations must make certain to whom they are rendering advice (for example, the corporation or the individual). Though this can often be a difficult task, it is necessary in order to determine to whom one will be liable. Conversely, attorneys determining possible causes of action should always examine possible roles in which the corporation's members could have received and/or relied upon advice from a third party.

*Brian Blind*

### *Nelson v. Martin*, 958 S.W.2d 643 (Tenn. 1997)

Close corporations are a fairly common structure in the corporate landscape. The close corporation is characterized by a small number of shareholders who generally also serve as the corporation's directors, officers, and employees. A breakdown in shareholder relationships in a close corporation can jeopardize the operations of the entire organization. In *Nelson*, two of the three shareholder-employees in a closely held corporation discharged the third shareholder-employee. The Tennessee Supreme Court considered two issues of primary importance: (1) whether the discharged shareholder-employee had a cause against the other two for wrongful interference with a prospective economic advantage, and (2) whether the two shareholder-employees violated a fiduciary duty owed to the remaining shareholder-employee when they discharged him.

Nelson was one of three equal shareholders of a corporation. All three shareholders served as employees and directors and officers of the corporation. After a dispute between Martin and Nelson, Martin, acting as president of the corporation, discharged Nelson. At a board of directors meeting, the discharge was ratified by two of the three shareholder-directors. Additionally, the two shareholder-directors voted and removed Nelson as an officer and director of the corporation. Shortly after Nelson's discharge, all three shareholders sold their stock.

Tennessee has not previously recognized a cause of action for wrongful interference with a prospective economic advantage, either statutorily or at common law. Nonetheless, the court heard the issue and considered whether it should be a cause of action. With little discussion, however, the court concluded that there was no cause of action in Tennessee for wrongful interference with prospective economic advantage.

In Tennessee, majority shareholders owe a fiduciary duty to minority shareholders. In *Nelson*,

the court concluded that shareholders of a close corporation also owe a fiduciary duty to each other to deal fairly and honestly with each other and not to act out of avarice, malice, or self-interest. These shareholders also owe a fiduciary duty to the corporation to act in the corporation's best interest. Though at times the two duties may seem conflicting, as long as the shareholders are protecting the interests of the corporation, the mere presence of ill-will will not render them or the corporation liable for their actions as a breach of a fiduciary duty. Because the evidence on the record did not present a disputed issue of material fact with regard to this issue, the court remanded for further proceedings.

The court failed to address whether Nelson's discharge and removal from the board was engineered to make the sale easier, and it also failed to discuss in adequate detail the reasonable expectation a shareholder-employee would have of being fired only for cause. Because the court failed to recognize that a shareholder-employee would reasonably have such an expectation, attorneys should advise shareholder-employees in Tennessee to negotiate and set forth that expectation clearly in a written employment agreement.

*Shannon D. Coleman*

### *Man O' War Restaurants, Inc. v. Martin*, 932 S.W.2d 366 (Ky. 1997)

Management compensation and incentives often include stock ownership in the business. In fact, the stock ownership can become an integral part of the employment contract itself. In *Martin*, the Kentucky Supreme Court considered the enforceability of an employment contract provision which compelled a corporate shareholder to transfer stock upon termination of his employment without regard to the stock value and without resort to a formula for equitable compensation.

Martin was hired as a manager of a Sizzler Restaurant owned by Man O' War Restaurants, Inc. Martin's employment contract allowed him to purchase 25% of the stock in the corporation for $1,000. The terms of the contract included a five-year employment agreement and a provision for Martin to return the stock for the exact amount he paid if his employment was terminated during those five years. After the five years, Martin's ownership rights were unrestricted. During his employment, Martin could receive stock dividends and was free to sell his stock at market price. Less than three years into the contract, the corporation terminated Martin's employment and demanded the return of his stock for $1,000. The termination was deemed for good cause and not for an improper purpose.

A corporation and its shareholders are allowed to contract for a re-purchase or "buy-back" right, but this right requires that some valuation method be used in determining the stock price. Acceptable valuation methods include consideration of the corporation's fiscal performance and current financial condition. Also, liquidated damages for breach of contract are permissible in agreements, but when damages are fixed and grossly disproportionate, they are nothing more than a penalty or forfeiture which are unenforceable.

The contract provision failed to recognize Martin as the owner of the stock independent of his employment. As stock owner, Martin had property rights in the stock. Also, the re-purchase provision made no reference to any concept of present value but relied on the stock's original purchase price. The court ruled that one who is compelled to transfer stock for an amount which bears no relationship to the value of the stock can hardly be called the owner. Such a transfer was a form of excessive liquidated damages and thus a forfeiture of property rights, which is against public policy. The court held the re-purchase provision unenforceable.

A lawyer structuring an employment contract with a corporate stock repurchase provision must have some method of valuation for the stock. Without some valuation method, the provision runs the risk of being unenforceable unless the stock is purchased for book value or fair market value. Alternatives to repurchase provisions in employment contracts include stock options that would be exercisable upon the occurrence of definite events, such as after a fixed period of time.

*Jon M. Cope*

## Mergers & Acquisitions

### *Newman v. Warren*, 684 A.2d 1239 (Del. 1996)

Proxy statements are widely used to increase voting efficiency in matters concerning shareholders. Proxies contain recommendations from the board of directors as to how they would like shareholders to cast their votes. In *Newman*, a Delaware Chancery Court considered whether, under the fiduciary duty of candor, it was necessary for a proxy statement to contain a board member's reason for not endorsing a transaction that the majority of the board of directors recommended.

Professional Sports Care Management, Inc. (PSCM), a provider of outpatient physical therapy and rehabilitation services, was considering a merger with HealthSouth, Corp., also a provider of outpatient surgery and rehabilitative services. During a PSCM board meeting, members discussed the status of negotiations with HealthSouth. At the meeting, two members voiced concerns over the merger's possible effect on an upstart subsidiary of PSCM. At a subsequent meeting, which the two concerned members did not attend, the board of directors unanimously recommended the merger.

A PSCM shareholder filed suit claiming that the board of directors had failed to disclose facts material to a shareholder decision to approve or reject a proposed merger agreement. Specifically, the shareholder claimed that the proxy statement should have contained the grounds for the judgment of two directors who did not vote in favor of the merger.

The law of fiduciary disclosure requires the disclosure of material facts but not the grounds for a particular decision. Generally, institutional rules require only that a certain percentage of board members agree on a specific outcome. This is true whether the institution is a legislature, appellate court, or a corporate board. The *Newman* court found that the grounds for the judgment of two directors was not a material fact for which disclosure was required.

Under *Newman*, a company's proxy statement does not have to include a board member's reason for dissension where the majority of the board has recommended the transaction to the shareholders. Requiring companies to disclose the reasons for a particular decision causes practical and logical problems since board members may agree on a specific outcome but for different reasons. Requiring board members to agree on the reasons for an outcome, as well as the outcome, could make the agreement process lengthy, complicated and expensive.

In addition to its primary holding, the court also held that, under the facts of this case, it was not necessary for the proxy statement to disclose familial relationships among directors or to disclose consulting contracts that the directors may enter into following approval of the merger. Only material facts relating to the company and the transaction are required to be disclosed.

Attorneys representing board members and corporations must consider the related fiduciary duties of these parties. *Newman* demonstrates that the fiduciary duties of a corporation to its shareholders require the disclosure in proxy statements of only information material to the company or a particular transaction. Also, a fiduciary duty does not extend to directors to include reasoning for a dissenting vote in a proxy statement where a majority of the board of directors has approved the recommended transaction.

*Nancy Wood*

## Partnership

### *Riggan v. Askew*, No. 02A01-9511-CH-00246, 1997 WL 675462 (Tenn. Ct. App. Oct. 29, 1997)

When a partnership suffers losses, the sharing of those losses among the partners can become a bone of contention. This is particularly true when some partners have lost more money than others because they had provided more of the capital that was lost in the conduct of the partnership business. *In Riggan*, the Tennessee Court of Appeals reviewed a judgment of the Chancery Court resolving a dispute between two partners over whether one partner, who had advanced most of the money needed for the business, could force the other partner, who contributed much less money but assumed almost exclusive responsibility for running the business, to share in his losses.

In 1974, the plaintiff, Riggan, offered the defendant, Askew, an opportunity to enter into an industrial development scheme that involved the purchase of 200 acres of resale property in Mississippi. The two men formed a partnership but did not reduce their agreement to writing. Both men understood that Riggan would be the primary financial contributor and that Askew would use his expertise and real estate contacts to market the property to potential buyers. By 1989, when the partnership was dissolved as a result of Riggan's personal bankruptcy, Riggan had invested $638,000 in the venture, compared to $72,000 invested by Askew. After the sale of the partnership's property and the distribution of the proceeds to satisfy claims against the partnership, Riggan had lost $150,000 more than Askew. Tax returns filed by the partnership following dissolution also confirmed that Riggan lost $150,000 more than Askew.

Riggan thought Askew ought to share the loss. Askew disagreed. In 1992, after the breakdown of their efforts to resolve their differences, Riggan filed for an accounting in Chancery Court, alleging that he had loaned the partnership the $638,000 and was entitled to be repaid the principal with interest. He then claimed that Askew, as a co-equal partner, was legally obligated to bear 50% of Riggan's additional losses, $75,000 as lost principal and $274,380 as unpaid interest.

In the absence of an agreement to the contrary, the Tennessee Uniform Partnership Act provides that partners must share losses, capital or otherwise, in proportion to the partners' share of the profits. It also provides that a partner who makes a capital contribution is not entitled to interest on the amount contributed until such time as the partner is entitled to return of the capital investment. On the other hand, a partner who advances funds to the partnership in excess of capital is entitled to be paid interest on the amounts advanced. At trial, Riggan testified that he and Askew had agreed that the $638,000 he advanced to the partnership was a loan for which Askew would be liable. Askew in turn contended that he and Riggan had agreed that Riggan would bear all risk that his investment might be lost. As support for this contention, Askew introduced evidence of his agreement to allow Riggan to use the partnership property as security for personal loans to Riggan, an action he said evidenced his belief that Riggan was to bear all the financial risk associated with the partnership. The chancellor ruled that Askew had failed to prove an agreement with Riggan whereby Askew would not be required to share in the losses suffered by Riggan. The chancellor also ruled that Riggan's advances to the partnership should be treated as loans on which interest was payable rather than as capital contributions.

The Tennessee Court of Appeals affirmed the judgment. In so doing, the court held that Riggan was not judicially estopped from asserting his claim by failure to list the claim against Askew in his bankruptcy petition. The court also rejected Askew's claim that the filing of a partnership tax return upon its dissolution operates as a final settlement of its accounts. Then the court rejected Askew's claim that Riggan's action was barred by the six year statute of limitations applicable to contract claims. The court held that a partner may only seek reimbursement for advances to the partnership in an action for an accounting, and such a claim could not have accrued until the dissolution of the partnership in 1989. With respect to the merits of the claim, the court found no error in the chancellor's holding that Askew had not proven an agreement with Riggan that would exempt Askew from a partner's statutory responsibility to share all losses in proportion to his or her share of the profits. Finally, the court refused to consider Askew's challenge to the chancellor's characterization of Riggan's advances as a loan because Askew's brief did not point to any part of the trial record in which objection was made to the award of interest on Riggan's contribution to the partnership.

*Riggan* serves as yet one more reminder that prospective partners need to be advised that Tennessee's partnership law provides for sharing among partners of all losses, capital or other, in proportion to their respective share of the profits, but permits partners to agree to allocate such losses differently. As evidenced by this case, however, such agreements should be in writing. This case also serves as a reminder of the distinction drawn in the Tennessee Partnership Act between a partner's capital contributions, which do not accrue interest during the life of the en-

terprise, and "payments or advances beyond the amount of capital [the partner] agreed to contribute, which shall be paid interest from the date of the advance." Again, the Partnership Act permits partners to characterize a partner's contribution as either a capital contribution or as a loan. Because of the importance of this characterization, it should also be memorialized in a writing. Such written agreements about the financing of the partnership and how losses will be shared may not prevent business failures, but they should prevent the additional losses that all partners are likely to suffer if they must resort to litigation to resolve who among the partners ought to bear the partnership's losses.

*Emily B. Holloway*

### *Meyers v. Cole,* No. 01A01-9710-CH-00543, 1998 WL 485667 (Tenn. Ct. App. Aug. 19, 1998)

Where no written partnership agreement controls, dissolution of a partnership can give rise to numerous complications. Although the Uniform Partnership Act ("UPA") sets forth the rights and responsibilities of partners in connection with dissolution, winding up, and termination, determining the respective rights of the partners can be difficult. This is especially true where there has been a falling out among partners, one or more of whom continue separately to conduct business as they had done prior to dissolution, and in which they make use of copyrighted materials authored by another partner in the course of the partnership's business. Such was the situation presented to the Tennessee Court of Appeals in *Meyers v. Cole*.

In *Meyers*, the two partners formed an oral partnership to produce and sell advertisement jingles. Meyers was responsible for the creation of the jingles while Cole handled sales. During the course of the partnership, Cole proposed that the partnership expand the business to include video footage with the jingles. This decision led to a rift between the partners that culminated with Meyers' decision to make a "clean break" from Cole. Subsequently, Meyers and Cole divided the partnership business equipment between themselves, but made no disposition of the partnership name, customer list, or audio/video tapes containing edited music and commercials.

Meyers filed suit seeking a declaratory judgment as to the respective rights of the parties, and Cole cross-claimed seeking a complete accounting. While the suit was pending and eight months after Meyers' split from Cole, Cole developed advertising using works created by Meyers during the partnership. Despite Meyers' protests, the trial court did not require Cole to account for the income from these projects. Instead, the trial court found that Meyers breached his fiduciary duty to the partnership by not sharing profits from jobs begun before dissolution but completed afterward. Further, the court ordered that the audio/video tapes containing edited music and commercials be sold. The court ordered that the proceeds be partitioned equally between Meyers and Cole.

On appeal, Meyers raised two issues. The first was whether the trial court erred in ruling that Cole did not have to account for transactions that occurred after dissolution but prior to termination involving commercial property developed during the partnership. Under the UPA, a partnership of indefinite term may be dissolved by the express will of a partner. However, dissolution does not terminate the partnership. The partnership continues until winding-up is completed, which includes an accounting and distribution of the partnership assets. Until termina-

tion, the interests of the partnership assets, profits, liabilities, and losses do not change whether they exist at or occur after dissolution. Thus, partnership transactions undertaken after dissolution but prior to termination must be included in the partnership accounting.

Also, Meyers disagreed with the trial court's order to sell the tapes without first determining who owned the copyrights to the jingles on the tape. The trial court's order implied that the copyrights to the jingles were partnership property, which § 8 of the UPA defines as "[a]ll property originally brought into the partnership stock or subsequently acquired by purchase or otherwise, on account of the partnership . . .." Consequently, if the tapes were partnership property, the UPA required that they be sold and the proceeds distributed to the partners in accordance with their interest in the partnership. Challenging the trial court's order, Meyers argued that he, as the author of the jingles, was the owner under federal copyright law.

Copyrights are governed by the Copyright Act of 1976 (beginning at 17 U.S.C. § 101), which preempts state law. Under the Copyright Act, two situations exist whereby the holder of a copyright is someone other than the creator of the work. The first of these arises under the work made for hire doctrine. This doctrine provides that in the absence of a written agreement to the contrary, an employer owns the copyright to a work created by an employee in the course of his employment. However, there is no indication that Congress intended to include partners within the definition of employees. Thus, the appellate court held that the work made for hire doctrine does not apply to partners.

Where the work made for hire doctrine does not apply, the copyright to a work rests in the creator. The creator may transfer the copyright by agreement. Such agreement is valid only if in writing and signed by the owner. Therefore, an oral agreement is insufficient to transfer ownership. Consequently, the appellate court held that, in the absence of a contrary written agreement, the copyright to a created work developed as part of the partnership business rests in the creator, not the partnership. However, where multiple partners contribute to the development of the copyrighted property, they may be considered joint owners.

As *Meyers* illustrates, legal planning for a partnership with intellectual property requires consideration of issues not present in other partnerships. Chief among these issues is who owns the copyright to the original material. *Meyers* resolved the copyright ownership issue to the extent that it found that copyrights vest in the author, not the partnership, in the absence of a written agreement to the contrary. However, it is likely that multiple partners will contribute to the creative process. In that situation, *Meyers* does nothing to settle copyright disputes among the individual partners. Where copyrightable works are developed in the course of a partnership's business, a transactional lawyer should advise his clients to avoid an oral partnership agreement and define the rights of each partner in a written partnership agreement.

*Joel Roettger*

## PROFESSIONAL RESPONSIBILITY

### Proposed Rule 1.13, Organizational Clients

Lawyers frequently represent corporations, associations, partnerships, and other business organizations. In connection with its proposed revision of Tennessee's Code of Professional Responsibility, the Tennessee Bar Association Committee for the Study of Standards of Professional Conduct has recommended the adoption of a Rule 1.13 that will govern the lawyer's relationship with organizational clients. It is intended to address issues not currently addressed by way of disciplinary rule in Tennessee's Code of Professional Responsibility and to provide more guidance to lawyers than currently provided by Ethical Consideration 5-18. Addressing the Tennessee lawyer's current obligations for representing organizations, EC 5-18 states that

> [a] lawyer employed or retained by a corporation or similar entity owes allegiance to the entity and not to a stockholder, director, officer, employee, representative, or other person connected with the entity. In advising the entity, a lawyer should keep paramount its interests and the lawyer's professional judgment should not be influenced by the personal desires of

> any person or organization. Occasionally a lawyer for an entity is requested by a stockholder, director, officer, employee, representative, or other person connected with the entity to represent that person in an individual capacity; in such case the lawyer may serve the individual only if the lawyer is convinced that differing interests are not present.

Paragraph (A) of Proposed Rule 1.13 provides that the lawyer for an organization "represents the organization acting through its duly authorized constituents." Organizational constituents include officers, directors, employees, shareholders, and partners, among others. Commentary makes clear that a lawyer retained to represent an organization does not, absent a separate agreement with the constituent, create an attorney-client relationship between the lawyer and the constituent. The lawyer needs to explain to the constituent that the lawyer represents the organization, not the constituent, if it becomes apparent that the constituent's interests are adverse to the organization's.

A lawyer has a duty to protect the organizational client from constituent misconduct. Constituent misconduct consists of past, present, or future conduct that violates a legal obligation to the organization or violates a law in which the conduct could be reasonably imputed to the organization. If the conduct is likely to result in substantial injury to the client, the lawyer is required, upon knowledge of the misconduct, to proceed as is reasonably necessary in the best interest of the client.

Paragraph (B) does not mandate any specific remedial measures that must be taken. Rather, it suggests a variety of factors and measures the lawyer should consider in deciding which remedial measures are appropriate. The factors include the seriousness of the misconduct and the scope and nature of the attorney's representation. Examples of measures the lawyer may take include asking the client or constituent to reconsider their conduct, advising the client to obtain a separate legal opinion, and ultimately, referring the matter to the highest authority in the client organization. Ordinarily, the board of directors, or in some cases, independent directors, constitute the corporation's highest authority. The proposed rule requires the attorney to minimize the disruption of the client and any risk of breaching confidentiality.

If the highest authority in the client organization insists on conduct which is a clear violation of law and which is likely to result in substantial injury to the client, the proposed rule allows the lawyer to resign. However, the lawyer must still maintain any client confidences after resigning.

Paragraph (E) provides that lawyers may represent both the organizational client and any of the constituents. Lawyers must remember, of course, that the conflict of interest rules still apply.

The comments indicate that there may be some situations in which a lawyer may jointly represent a corporation and its directors in defense of a derivative action. However, when the claim involves serious charges of wrongdoing by the board or the organization's highest authority, the conflict of interest rules may require the organization to use independent counsel in the derivative action.

Currently, Ethical Consideration 5-18 permits a lawyer to represent a constituent "only if the lawyer is convinced that differing interests are not present." The proposed rule is consistent with the discussion of joint representation of organizations and their constituents contained in *Lazy Seven Coal Sales, Inc. v. Stone & Hinds, P.C.*, 813 S.W.2d 400 (Tenn. 1991).

The proposed rule will serve to eliminate ambiguity in the existing ethical standards because it details constituent misconduct and provides guidelines for dealing with the misconduct, allowing resignation or withdrawal in extreme cases. Clarity in the ethical standards will be enhanced because the proposed rule identifies requirements for dealing with and representing constituents. The TBA's Committee for the Study of Standards of Professional Conduct is currently reviewing comments and preparing a final version of the proposed rules. The full preliminary draft is available on the TBA's Internet web site at http://www.tba.org/Committees/Conduct. Comments may still be made at the web site.

*Thomas A. Kulaga*

**ABA Formal Opinion 98-410, Lawyer Serving as Director of Client Corporation**

The Model Rules of Professional Conduct do not prohibit a lawyer from serving as a director of a client corporation. However, while serving clients in a dual capacity, a lawyer should address numerous ethical considerations. Formal Opinion 98-410 provides general guidelines for lawyers serving as directors on their client's board that will help minimize the risk of ethical violations.

The Committee divided the issues that arise into three sections: (1) advising corporate management and the board when the lawyer acts in a dual capacity, (2) protecting confidential information and privileges, and (3) confronting and resolving issues that arise during the dual relationship. The Committee recognized that lawyers face different issues depending on the nature of the legal services provided, the nature of the client's business, and the nature of the lawyer's representation. The Committee meant for the Formal Opinion to address general issues and not the facts of every possible dual-relationship scenario.

Ideally, the lawyer should communicate the potential ethical and practical pitfalls of the dual relationship with the corporation's executives and other board members before becoming a board member. The lawyer should communicate conflict of interest concerns, the potential for confusion to ensue over what constitutes legal advice or business advice, and the potential for a loss of confidentiality or attorney-client privilege protection to these parties. The lawyer-director should revisit this subject throughout the relationship if situations of potential conflict arise. A written memorandum can clarify the lawyer-director's dual roles and the differences between serving as a director and serving as counsel.

The scope of the attorney-client privilege in the corporate setting is often construed to be very limited. Some jurisdictions distinguish between purely legal advice and unprotected business advice. Because the lawyer is acting as a director, communications between the lawyer-director and other board members or corporate executives may lose their protection. When management or the board consults the lawyer-director for legal advice, the lawyer-director should make clear that the advice is purely legal. If possible, another lawyer from the lawyer-director's firm should be present at a meeting to provide legal advice. Following these procedures will provide the best support for privilege protection and will alert those present to the confidential nature of the communications. The attorney-client privilege may be waived if the lawyer-director is perceived as acting as a director rather than as counsel. The lawyer-director should also be aware that the lawyer-director's actions could be imputed to the corporation if she is acting as a director and that the lawyer-director has the same fiduciary obligations to third parties as other directors.

The Committee addressed four potential ethical issues that may arise during the course of the dual relationship and what actions the lawyer may take to avoid these violations. The issues addressed were (1) serving as counsel in a matter that the lawyer-director opposed as director, (2) opining on past board actions in which the lawyer-director participated, (3) acting as a director in corporate actions affecting the lawyer-director as a lawyer, and (4) representing the corporation in certain types of litigation.

When a corporation decides to pursue an objective that the lawyer-director opposed as a director, the lawyer-director must determine whether her representation would be materially limited by her opposing view. If the lawyer-director determines that representation will not be adversely affected and the client consents to the lawyer-director's continued representation, the lawyer-director's representation may continue. However, the lawyer-director may be well advised to suggest that a lawyer from a different firm should represent the corporation in the matter. There is a risk that, if the lawyer-director must withdraw as the lawyer, the lawyer-director's firm may also be required to withdraw. In this situation, the lawyer may need to resign from the board. The lawyer-director needs to be aware that a non-consentable conflict of interest may arise.

Certain situations may arise when the board asks a lawyer-director to provide advice concerning prior decisions of the board in which the lawyer-director participated as a director. Seek-

ing a waiver of conflict would be problematic because the lawyer-director was directly concerned with the question raised. The lawyer-director may be unable to provide independent judgment in some cases. This problem could possibly be mitigated by the participation of other counsel.

A conflict issue may also arise when the board considers actions which will affect the lawyer-director's firm. The lawyer-director's independent judgment as a director then comes into question. The lawyer-director should consider recusing from any decisions involving the pecuniary interests of the firm. A prudent lawyer-director should, at a minimum, abstain from voting as a director on issues that will directly involve the corporation's relationship with the lawyer-director's law firm. A lawyer-director would not violate any Model Rules for participating in corporate action that resulted in the corporation employing the lawyer-director's law firm.

If the corporation, its directors, and its officers become defendants in litigation, ethical issues arise when one of the board members is a lawyer in the representing law firm. If there are potential conflicts between the corporation and its directors, cross-claims are filed, or a controversy arises between the corporation and its lawyers, indirectly conflicting interests may require independent representation. Finally, prior representation of the corporation may prevent the firm from representing its own member under Model Rules 1.9(a) and 1.1(a).

The Committee suggested that the lawyer-director should:

· Ensure that management and the board of directors understand the differences between the lawyer-director's role as a director and as a lawyer, that the lawyer-director represents only the corporate entity, and that conflicts of interest may force the lawyer-director to recuse as director or require independent counsel or co-counsel to represent the corporation in some matters.

· Ensure that the management and the board of directors understand the potential limits of the attorney-client privilege when the lawyer acts as both lawyer and director.

· Recuse herself as director when the relationship of the lawyer-director's firm and the corporation is under consideration.

· Consistently maintain a lawyer's independent professional judgment, recommending against unethical or illegal courses of action.

· Represent the client corporation zealously, even when the lawyer-director disagrees with the course of action, unless that course involves fraudulent or criminal conduct, self-dealing, or would otherwise violate the Model Rules.

· Decline any representation as counsel when the lawyer-director's interests conflict with the lawyer-director's ability to represent the corporation competently and diligently.

*Emily B. Holloway*

## REAL ESTATE

### ***Keith Hardware, Inc. v. White,*** **956 S.W.2d 500 (Tenn. Ct. App. 1997),** ***cert. denied*****, (Dec. 1, 1997)**

As the retail landscape shifts to a "one-stop" shopping strategy, restrictive covenants in shopping center leases will continue to be important to landlords, tenants, and shoppers. First, for landlords, these restrictive covenants work to entice potential tenants to sign leases but may preclude these landlords from accepting future tenants that sell similar merchandise. Second, for tenants, restrictive covenants give a certain amount of security because tenants know that they will not have large-scale, direct competition in the immediate vicinity. Finally, for shoppers, restrictive covenants provide less of an opportunity to comparison-shop in the immediate vicinity and may require multiple stops to obtain the best price and selection on the desired merchandise.

In *Keith Hardware*, the Tennessee Court of Appeals for the Eastern Section considered whether a restrictive covenant in a shopping center lease was too broad to be enforceable. The plaintiff operated a retail hardware store as a tenant in the defendants' shopping center. A lease agreement clause provided that the plaintiff would have the "exclusive and sole right" to operate a store, the principal business of which was the sale of an enumerated list of items. The

clause provided that no other retail tenant in the center could have the sale of any enumerated item as its principal business, and it limited sales of the enumerated items by each retail tenant to a maximum of 25% of its total sales. The defendants subsequently rented space to two retailers who may have violated this provision and the plaintiff sued for injunctive relief. The court of appeals reversed the trial court's denial of the injunction and remanded.

Since no prior Tennessee decisions addressed the issue, the court of appeals looked to the law of other jurisdictions. Other states have found restrictive covenants enforceable only if they are reasonable in effect and scope.

First, the court found that the clause was reasonable in *effect* because it affected only one shopping center, and the plaintiff was reasonable in wanting to avoid competition within the center. The court reasoned that the clause would not adversely affect the public interest where there are several available shopping centers in a community. Second, the court found that the clause was reasonable in *scope* even though the clause contained a rather lengthy list of items that other stores were restricted from carrying in significant amounts. While the list of goods was long, it clarified ambiguities that courts might otherwise find difficult to interpret. Because the list was limited to items that provided significant portions of the plaintiff's sales, the clause was not overly broad in scope and was enforceable.

This case upholds the validity of covenants in commercial leases that reasonably restrict competition. The decision is likely to result in a proliferation of the "exclusive list" type of restrictive covenant in commercial leases. Drafters should list the *specific* items affected by this type of covenant because courts may be less willing to give broad meanings to vague terms, and drafters should also restrict covenants to a narrow geographical area.

*Michael S. McKinney*

## SECURITIES

### *Rubin v. Schottenstein*, 143 F.3d 263 (6th Cir. 1998)

In *Rubin v. Schottenstein*, the 6th Circuit, in an en banc decision, addressed legal issues of considerable importance to lawyers who represent buyers or sellers in connection with the sale of securities. The court addressed the extent of the personal liability of a seller's attorney for violation of Rule 10b-5 of the 1934 Securities Exchange Act. The court also considered the extent to which a buyer's cause of action may be defeated because the buyer's lawyer relied upon the statements made by the seller's lawyer.

Medical Designs, Inc. (MDI), a financially troubled corporation, was in default on its principal source of financing, a line of credit with Star Bank. Under their credit agreement, any further investment in the company would cause a material breach and would constitute an event of default with the bank. Yet, MDI sought to raise additional capital by issuing notes and shares to two investors, Robert Rubin and James Cohen. MDI retained Attorney Richard Barnhart, a partner with Schottenstein, Zox & Dunn, to render a legal opinion in connection with their transaction that would be limited to questions as to whether MDI possessed the power to seek further investment. MDI also asked that the letter address whether the investors' note was authorized, executed, and delivered by MDI and whether it was enforceable against MDI. Rubin and Cohen were represented in the transaction by their lawyer, Stephen Weiss.

In response to inquiries by the investors and their attorney about MDI's financial condition and its relationship to Star Bank, MDI referred the investors to Barnhart. In conversations with Rubin and Cohen and again with Weiss, Barnhart incorrectly told the investors that there was no problem with the company's relationship with the bank. Further, Barnhart responded that in his opinion the relationship with the bank was fine and that Star Bank would *increase* its funding to MDI after Rubin's investment. For purposes of its decision, the court assumed that at no time did Barnhart reveal what he knew about the company's actual relationship with the bank, such as the fact that MDI was already in default or that the granting of a security interest would also constitute an event of default. Lastly, Barnhart stressed to Rubin, Cohen, and Weiss that there was no need to contact the Bank as part of the investor's due diligence.

Following these conversations, neither the investors nor their attorney contacted Star Bank to confirm the accuracy of Barnhart's statements; rather, they proceeded to purchase the notes and shares. Shortly thereafter, Star Bank froze MDI's account and declared the line of credit in default. MDI declared bankruptcy, resulting in Rubin and Cohen losing their entire investment. They filed suit against Schottenstein, Zox & Dunn and Barnhart, alleging that Barnhart violated § 10(b) of the Securities Exchange Act of 1934.

The District Court for the Southern District of Ohio granted summary judgment for the attorney, Barnhart. On appeal, a divided panel affirmed the summary judgment, holding that Barnhart had no affirmative duty to disclose information, and to the extent that Barnhart misrepresented the circumstances, Rubin and Cohen had not reasonably relied on Barnhart's representations.

Upon a rehearing en banc, the Sixth Circuit vacated the previous decision and held that liability under Rule 10b-5 arises when an attorney is a "primary participant." The court identified two possible avenues for attorney liability as a primary participant under Rule 10b-5. An attorney participating in a securities transaction owes no duty under Rule 10b-5 to the opposing party unless the attorney (1) assumes the affirmative duty to provide information or (2) undertakes to provide information with respect to the transaction. In this case, Barnhart had assumed no duty to provide information to Rubin and Cohen beyond what he agreed to provide in the legal opinion. Such information did not relate to the relationship between MDI and Star Bank; therefore, there was no omission in the opinion.

However, when an attorney undertakes to speak on matters outside the scope of the legal opinions the attorney agreed to provide, the law imposes a duty to speak truthfully and to provide all the information necessary to prevent the statements made from being misleading. Barnhart assumed such a duty when he chose to speak with the investors about MDI's financial relations with Star Bank. Though outside the scope of his legal duty to speak, Barnhart's failure to disclose MDI's default created a misleading picture of the relationship between MDI and the bank, and thus created liability.

Although the court acknowledged that there could be circumstances in which an attorney could be held liable for remaining silent in a securities transaction, the court emphasized that Barnhart's liability was premised on the fact that he undertook to make representations about the financial relationship and failed to provide the information necessary to prevent the statement from being misleading.

The court then proceeded to reject Barnhart's argument that the plaintiff could not recover because the plaintiff did not act reasonably due to their attorney's failure to investigate. With respect to Barnhart's omissions, the court held, consistent with prevailing authority, that there is a presumption of reliance. All that the plaintiff must establish is that (1) facts were withheld, and that (2) those facts would be considered material to a reasonable investor. For purposes of the motion for summary judgment, the court re-

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jected Barnhart's attempt to rebut the presumption by claiming that the investors or their counsel could have sought confirmation from the bank.

With respect to Barnhart's misrepresentations, the court held that the investors were not reckless in relying on the representation made by the seller's counsel. In a misrepresentation scenario, the test is whether there is absence of recklessness. If there is no special knowledge of the facts misrepresented, no actual access to information that would reveal fraud, and no personal knowledge of the seller, then neither the investor nor the investor's attorney are deemed reckless in relying upon the seller's attorney's statements. In the present case, the court held that the investors held no special knowledge, and indeed asked for further information through probing questions. However, the court did note that perhaps in transactions that involve larger sums of money, such as millions of dollars, the due diligence of the investors might be under closer scrutiny.

Finally, in response to claims by Barnhart, the court refused to exempt lawyers from the duties imposed by Rule 10b-5 on all participants in securities transactions. The court noted that if misrepresentation by a participating attorney is related to law, it may be unreasonable for the buyer's lawyer to rely on the representations of the seller. However, the court determined that the investors were not unreasonable for relying on representations of fact. The court rejected the holding of the panel opinion, which suggested that the representation of investors by a lawyer affects the extent to which the investors are able to rely on the statements made by the sellers or their counsel. Again, the en banc court did not include any special treatment for attorneys.

*Rubin* is important because it is one of the first cases to address lawyer liability for Rule 10b-5 violations since the Supreme Court held that attorneys are not liable for aiding or abetting in securities transactions. *Central Bank v. First Interstate Bank*, 511 U.S. 164 (1994). The essential point in *Rubin* is that a court will only deem a seller's lawyer a "primary participant" if the lawyer assumed a duty to speak, or elected to speak to participants in the transaction.

In light of *Rubin*, attorneys for sellers should be aware of the need to be forthcoming with information when they assume a duty to speak, as for example, they do whey they agree to render a third party legal opinion related to the transaction. This duty, however, only applies to subjects about which the attorney has agreed to render an opinion. Although an attorney may decide that it is unwise to speak on behalf of a client on matters beyond the scope of the representation, attorneys who choose to speak are on notice that they must be accurate and must provide information necessary to prevent the statement from being misleading.

*Rubin* also serves to alert lawyers who are representing purchasers of securities to reflect on the extent to which they may rely on representations made to them by sellers. The court suggested that it may be inappropriate to rely on seller's counsel about matters of law, but seems to suggest that, otherwise, lawyers are as free as any participant to rely on representations made by sellers' counsel. Under *Rubin*, the law will not impose a different standard for lawyers regarding lawyers' reliance on information of fact.

*James C. Cotey*

## TAX

### *Hutton v. Johnson*, 956 S.W.2d 484 (Tenn. 1997)

Frequently, taxpayers will trade or exchange their old property when purchasing new or replacement property for their businesses. Section 1031 of the Internal Revenue Code allows deferral of any gain on the disposal of the traded property for certain qualifying exchanges. Also, Tennessee will allow a reduction in the use tax base for the value of any property traded for the newly purchased property. In *Hutton*, the Tennessee Supreme Court considered whether a Tennessee resident was required to pay use tax on the full value of an aircraft he purchased or if he could reduce the tax to reflect the value of an aircraft he sold to fund the purchase. The sale and purchase were part of a purported "deferred § 1031" exchange. *See* I.R.C. § 1031(a)(3) (1997).

Hutton, the taxpayer, sold an aircraft to Bell Aircraft, Inc., under an agreement in which the buyer agreed to purchase and transfer to Hutton

a replacement aircraft to be identified by Hutton. Pending the identification, Bell Aircraft placed the net purchase price in an escrow account. If Hutton failed to identify an aircraft within a stated time, he was absolutely entitled to the escrowed funds. Within the appropriate time, Hutton identified the replacement aircraft, but Hutton, rather than Bell Aircraft, executed the agreement to purchase the aircraft from an out-of-state seller. Bell Aircraft released the escrowed funds, which were used to satisfy a portion of the purchase obligation under the agreement.

Tennessee law governed the transaction between Hutton and Bell Aircraft. A Tennessee resident must pay a 6-percent use tax on the personal property he or she purchases in another state but uses in Tennessee. Tenn. Code Ann. § 67-6-203(a) (1996). Although the tax is generally based on the value of the purchased property, that base is reduced by (or credited with) the value of any property traded for the purchased property. *Id.* § 67-6-510(a).

Because Hutton purchased the new aircraft outside Tennessee but used the aircraft in Tennessee, he was obligated to pay use tax on that purchase. Further, Hutton had to pay the tax on the full value of the new aircraft because, the court concluded, Hutton did not trade his old aircraft for the new aircraft. The court reached that conclusion because (1) neither transaction was dependent on the completion of the other and (2) the seller of the new aircraft received the full purchase price in cash.

At trial, Hutton produced some documents that purported to assign his interest in the purchase agreement to Bell Aircraft. The seller, however, limited assignments under the agreement, and the court apparently gave the assignment no legal effect. Additionally, because Hutton used the funds to satisfy a portion of his purchase obligation for the new aircraft, he should be treated as if he received those funds and I.R.C. § 1031(a)(3) should not apply to the sale and exchange. *See* Treas. Reg. § 1.1031(k)-1(f) (1991).

*Hutton* offers insight for the transactional attorney in structuring such an exchange to achieve the client's desired tax results. Although not altogether clear from the opinion, it appears that the court would find that the typical deferred I.R.C. § 1031 exchange cannot involve a trade because the seller in the deferred purchase typically receives only cash and the deferred purchase is not contingent on the earlier sale. In contrast, a properly-structured, simultaneous three-party § 1031 exchange should involve a trade because the seller's transfer will be contingent on his or her receipt of the like-kind property.

*Jason E. Havens*

# Starting a Business Practice

*Bradley H. Hodge**

## INTRODUCTION

"Are you crazy? Do you really want to start your own firm? You should go back to the established law firm – where you belong," exclaimed one of my good friends. "Don't you know that you have a wife and family to feed?" remarked one of the partners at an established law firm. Another friend and colleague stated, "Well, if you don't have enough food, come over and we'll feed you."

When I made the decision to begin a small general business practice, I felt as if I were standing at the precipice with everyone anticipating that I would fall to my professional death. Although I felt like the first person to face this experience, the majority of attorneys in the United States work as solo practitioners or in small firms such as the one that my partner and I started.[1]

Lawyers who do not practice solo or in small firms often find themselves considering the option. In addition to those with a budding entrepreneurial spirit, many lawyers are forced to do so by employment conditions of the times. Downsizing by large firms, government, and corporations, as well as competition among the great numbers of new law school graduates, continually act to push more lawyers into opening their own firms or working for small practices.[2] There are approximately 900,000 lawyers in the United States, with law schools producing over 35,000 new lawyers each year.[3] The Bureau of Labor Statistics recently predicted that there will be 28 percent more lawyers by the year 2005.[4] Thus, while healthy competition can be expected today, it can only become more fierce in the future.

Before I started my firm in July 1997, I spent five-and-one-half years working as a law clerk in the United States District Court for the Eastern District of Tennessee. I had practiced business law with a large firm before joining the Court;

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The author would like to thank Jason E. Havens, a student at The University of Tennessee College of Law, for his help in researching many of the sections in this article and providing helpful suggestions on style and content.

[1] Theodore M. Becker, *The Small Law Firm Revolution: The World Is Getting Smaller, So Should Law Firms*, Merrill's Ill. Legal Times, Aug. 1996, at 8, *available in* WL ALLNEWSPLUS database.

[2] Cara Jepsen, *Small Law Firms Rule: More Legal Eagles Flying Solo*, Crain's Small Bus.-Chi., Nov. 1, 1996, at 28, *available in* WL ALLNEWSPLUS database.

[3] Ward Bower, *Keys to Success, and Things that the Small Firm Can Do to Survive and Thrive*, Or. St. Bar Bull., May 1997, at 33, *available in* WL JLR database.

however, a long time had passed between my experience with the large firm and my new practice. I had not been exposed to extensive client contact during the interim. The information in this article is based on the information which I voraciously began to study only a few months before I left my job with the Court. The tips are very practical, focusing on the various aspects of planning and the early operation of a business practice.

For most lawyers, starting a law firm can be difficult and risky. This reality offered a challenge for me as well, but my firm succeeded as a venture and provided valuable clients who are still an important part of my practice. I welcome the opportunity to share my experiences with other small firm lawyers and solo practitioners, including those who may be contemplating a small business law practice.

**TOWARD QUALITY**

Finding clients and generating business–rainmaking–are crucial. Rainmaking should emphasize both quality and performance of the firm. These attributes, if perceived by clients and other lawyers, will inevitably lead to a successful practice.

In any area of practice, especially a business practice, the client will ultimately judge the lawyer by what is accomplished, not by what is promised.[5] Consequently, if you keep the client's welfare and not just your own at heart, your practice will necessarily become more productive and, hence, more profitable. Stated another way, if, as a small business lawyer, you constantly assess how you can add value to your clients' businesses, then their increased ability to compete and their productivity will ultimately translate into more profit for you. The best way to implement this strategy is to view yourself as a partner with your business clients. Thus, as the clients' businesses grow, so will the clients' need for legal services. The goal is to make yourself more valuable to your clients than any other attorney can be.

According to a national survey of why clients leave,

- 1% die,
- 3% move,
- 5% dislike the lawyer's work product,
- 24% have some dispute which is not resolved, and
- 67% leave because they feel they were treated discourteously, indifferently, or simply were not given good service.[6]

With the increase in competition among lawyers generally, business lawyers must continue to learn exactly what the client wants. The most often cited reasons for client satisfaction include, in order of importance, "lawyer accessibility, accurate cost estimates, good value, clear pricing policies, and timeliness."[7]

The business lawyer just starting a practice should not have much trouble providing lawyer accessibility. If a lawyer treats clients as individuals and cultivates personal relationships, the clients will perceive and appreciate the fact that the lawyer will be there to help.

The importance of cost estimates cannot be overstated, especially for a small business practitioner. Small firms can provide a cost advantage to clients, while demonstrating the ability to provide the same level of service and expertise as a larger firm. The key for a small firm is to concentrate on the particular needs of the prospective client and show the ability to serve those needs. The "hands on" approach of small firm lawyers and their responsiveness to client needs translate into greater efficiencies in representation and overall value.

A simple way to emphasize the cost advantage of a small firm or solo business practitioner

[4] Francis H. Musselman, *Developing a Client-Oriented Law Practice*, N.Y. ST. BAR J., May/June 1997, at 20.

[5] DANIEL B. KENNEDY, LAW FIRM MARKETING: SUCCESSFULLY PROMOTING AND BUILDING YOUR SMALL FIRM OR SOLO PRACTICE 34 (1994).

[6] JAY FOONBERG, HOW TO START & BUILD A SUCCESSFUL LAW PRACTICE 134 (3d ed. 1991).

[7] Barbara Hagenbaugh, *What Clients Want*, BUS.

is to make a habit of providing a cost estimate every time the client brings business. A cost estimate shifts the focus from billing to rendering service to the client.[8]

Another indicator of client satisfaction is the number of referrals received. As with any service provider, the biggest single source of business should be referrals from acquaintances and other professionals. Of course, to receive referrals from other attorneys, you must cultivate a good reputation and acquire technical skill and knowledge in your chosen areas of concentration. Credibility is your stock in trade. If you conduct yourself in the highest traditions of the bar at all times; practice in an honest, ethical, professional, and technically-proficient way; and show that you care about your clients, then you will earn the respect of your professional colleagues. With respect will come referrals.[9]

Other lawyers will recognize whether you maintain these high standards and whether you offer quality work in a timely manner. When I look for an attorney to refer a case, I consider only those whom I would trust to handle the case if I were the client.

As a check, all lawyers, especially business lawyers, should always assess whether the client had a positive experience dealing with the firm. One way to assess performance in this category is through the use of client and performance evaluations. Although it may be difficult to subject yourself to criticism in this way, it is probably the most effective way to gear your practice toward the needs and expectations of business clients.

There are no shortcuts to obtaining the necessary skills to practice in any area of the law, including business law practice. You should be willing to work hard to learn more about the field than others who practice in the same area. One approach is to spend at least one hour a day acquiring expertise in your chosen field. I know of one local lawyer with a negligence defense practice who begins each morning with a review of all reported appellate court opinions. He accesses these opinions through the TBA Link Internet homepage, an on-line service of the Tennessee Bar Association.[10] Numerous web sources provide business information.[11] Two free e-mail services are Law Journal Express Corporate Express and Tennessee Opinions from TBALink Opinion Flash.[12] These services send periodic e-mail messages, free of charge, with information on current news and cases.

In any area of practice, a lawyer should never stop searching for knowledge, never discount any source as a possible source of information, and always look for ways in which knowledge can be tested by interaction with other lawyers.

Another "skill" a business lawyer should have is a general understanding of business. All too often, clients encounter business lawyers who, surprisingly, lack an understanding of business. This shortcoming is sometimes reflected by lawyers who are too cautious, advising their clients to operate only by the letter of the law, without allowing their clients to take financial risks, which are vital to the business world. Although lawyers from all backgrounds may be competent, those with a history of non-law related business experience seem to understand the particular needs of the client in a business law practice. For example, my father and grandfather owned and operated grocery stores. They allowed me to work in those businesses from a very young age, and I saw first-hand the unique needs of the entrepreneur. Because I intended to pursue a legal career and I believed that a better understanding of business would assist me in my practice, I obtained a minor in business administration as an undergraduate student.

L. TODAY, Jan./Feb. 1996, at 23, 24.

[8] *See* Brett C. Don, *Implementing Task-Based Billing: A Law Firm Perspective*, TENN. BAR J., July/Aug. 1997, at 25.

[9] Sheldon J. Stark, *Responsible Rainmaking: How to Build Your Practice*, TRIAL, Jan. 1996, at 57, 58.

[10] *Tenn. Bar Assoc. TBALink*, <http://www.tba.org/>.

[11] An excellent starting point for gaining exposure to nearly any area of law is FindLaw's web site at <http://www.findlaw.com/>. Because the site is organized by topic, legal research is simplified.

[12] *Law Journal Express Corporate Express* <http://www.ljx.com/corpcounselor/express/>; *Tennessee Opinions from TBALink Opinion Flash* <http://www.tba.org/>.

Finally, perhaps the best way to show a business client that you understand business needs and care about the client's business is to learn that client's business. Make a habit of visiting the client regularly, tour the plant, and get to know the managers and employees. This experience will provide a better understanding of the business for purposes of delivering legal services.[13]

## COUNTING THE COST

Once you have made the commitment to quality and performance, you need to count the costs of starting and operating the law practice. These costs have escalated dramatically in recent years.[14] The demands of creating a new law firm will tax your entrepreneurial skills, business acumen, and personal relationships. A small law firm is like a marriage: its success depends on the members' willingness to work together, make decisions, and compromise when necessary.[15]

When I ventured out, I had to weigh what I wanted from my practice against the capital resources needed and the dramatically increased risk in starting a firm. I had to assess sources of available cash, the cost of office property, and even the depth of my skills and the ability to acquire those skills.

For those intending to concentrate on business practice, it is very helpful to talk to business executives, other lawyers and judges, accountants, and, for lack of a better descriptive term, the community "movers" and "shakers." Of course, you must always keep your ultimate goals for starting a practice at the fore. Otherwise, you run the risk of becoming confused or too fearful to make the move.

My partner and I decided that we should commit to the areas of practice which we enjoyed and really wanted to pursue. I realized early on that I did not want to practice "door law," taking virtually anything that walked through the door. I wanted to focus my practice on business-related matters, including business planning, transactional law, employment law, and general business litigation. For example, while practicing in our firm, I created corporations for small businesses and counseled clients on their choice of business entity. During the first month of our practice, I represented the buyer in a stock-purchase acquisition of a business established in 1923. During that same month, I drafted employment agreements for sales representatives and other key employees, including covenants not-to-compete and "golden parachute" agreements.

I cannot emphasize enough the need to reject the temptation to take cases in the hopes of squeezing out a fee simply because you perceive you must have something to do. Learn to say "no." As a small business lawyer, I "specialize" by exclusion. That is, I limit my practice by identifying the types of matters or clients that I will not accept.

Similarly, solo practitioners and small firms must also learn to say "no" to clients who are either unwilling or unable to pay a fee. Early qualification of clients should occur by fee counseling, engagement letters, and fee memos, all of which should clearly spell out the client's obligations. There is little, if any, risk in doing this. The client who goes elsewhere is the one who would be unlikely to pay the bill in the first place. Instead of wasting resources serving the non-paying client, you can better spend your time developing clients who are willing and able to pay.

## FLYING UNDER THE MARKETING RADAR[16]

To date (and probably for the foreseeable future), business lawyers have resisted "hawking" their services on television or even in yellow page ads. As any veteran practitioner knows, however, marketing is a substantial key to success for small law firms.

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[13] Bower, *supra* note 3, at 35.

[14] Getting Started: Basics for a Successful Law Firm, (Arthur G. Greene ed. 1996).

When we began planning our practice in Farragut, Tennessee, my partner and I developed a simple marketing strategy, amounting to no more than a few tasteful ways to make our names and firm known in the Knoxville community. We decided to make announcement cards an integral part of our marketing plan. Having worked in the Federal District Court, I developed relationships with numerous lawyers who had no interest in transactional or general business law. These lawyers responded to our announcements by referring a steady source of business to our firm. Although my partner was the full-time litigator, I was retained as East Tennessee counsel for a large multi-national company, representing it in commercial and products liability litigation, all as a result of a referral from another firm. I was also retained by a referred bank client, which has resulted in several commercial financing projects.

The changing nature of the practice of law, which in no small way has been driven by changes in technology, demands that small law firms respond. Because clients want to know that firms are on the technological cutting edge, investment in technology is a competitive requirement in today's marketplace. Developing an Internet web site addresses this reality. Our web site proved to be a crucial component of our practice and our marketing.

Given the exploding Internet climate, we determined that our web site should be detailed and interactive, offering numerous links to legal resources for both the lawyer and the non-lawyer. The address for the site was listed on our business cards, our letterhead, and even our announcement cards. We averaged around 1,500 visitors per month and received numerous inquiries and several clients from the web pages. Other lawyers seemed to be the most frequent visitors, possibly because of the exhaustive links to resources we included on the site. Having lawyers visit our web pages was simply another way to keep our firm in the minds of other lawyers for potential referrals.

Lawyers often boast of their institutional business clients, implying that they provide services only to the biggest and best; however, statistics belie the boast. "[A]pproximately 97 percent or more of all businesses qualify as 'small businesses.'"[17] Naturally, a portion of our web site discussed small and family business issues.

The use of electronic mail also showed that our firm was responsive to technological advances. This proved to be a useful tool for sending drafts of contracts to my clients for review, as well as for other tasks. I began the process of establishing strategic on-line alliances with other practitioners in order to better serve clients. The level of computerization for the new business practice is a very important part of the practical, philosophical, and of course, financial requirements of the practice. Fortunately, my partner and I shared values on this issue and used technology in our marketing efforts.

Lastly, our firm intended to develop an office brochure, which, in many respects, already existed on-line. The office brochure should be consistent with the firm's vision and the image that it wants to promote. For the business lawyer, the brochure should highlight the practice areas which will service or appeal to small businesses.

Our total marketing plan included passive advertising, in the form of brochures, pamphlets, and the web site; community and public relations efforts ranging from actively participating in chambers of commerce to sponsoring youth baseball teams; and client relations improvements. A major focus was on improving the quality of services delivered to clients and the cost-effectiveness of those services.

## CONCLUSION

Many aspects of the practice of law have changed significantly in the past decade, especially lawyers' increased reliance on automation. However, the requirement for success has not changed: it is still hard work. Law is not an easy business, particularly for lawyers in small firms. However, a willingness to work hard and work smart will inevitably result in a successful business law practice, and contrary to the pessimistic popular belief, there will always be food to eat.

[15] *Id*.

# Liquidated Damage Clauses

*Cheryl A. Davis*

Parties to a contract have the option to include in their agreement a provision that specifies an amount payable for loss they expect may be suffered by one of the parties due to breach. The agreement may also state that, in the event of default, one party will forfeit specified rights to which they would otherwise be entitled, such as rights under a promissory note associated with the transaction or a right to restitution of sums previously advanced in connection with the transaction.[1] Such provisions are commonly called liquidated damage clauses.

Liquidated damage clauses serve a useful purpose in business transactions. They provide certainty where damages are uncertain and not easily proven. This certainty affords protection to both parties to a contract—protection to the promisee from damages caused by unsatisfactory performance, and assurance to the promisor that his liability is defined and limited in the event that he does not meet his contractual obligations. Moreover, adjusting for damages in advance, at a time when parties are amicable and relatively reasonable, promotes equitable dealing and prompt resolution of disputes. This is generally preferable to judicial resolution of the dispute at a time when the relationship between the parties is strained and they have assumed an adversarial posture.

Liquidated damage clauses must be carefully drafted. Both parties, of course, must be able to understand their obligations in the event of breach. Moreover, liquidated damage clauses must represent a good faith effort to estimate the actual harm caused by default. Courts will not enforce damages clauses where the parties' intent is to penalize the breacher. Lawyers drafting liquidated damage clauses, then, must be familiar with the general legal principles that courts in their jurisdiction use when they determine whether or not to enforce a liquidated damage provision. The lawyer should understand what factual circumstances have prompted courts to invalidate such clauses in the past. It is the purpose of this essay to alert Tennessee lawyers to case law of which they should be aware prior to drafting contracts and advising clients regarding liquidated damage clauses.

## I. GENERAL PRINCIPLES

When faced with a challenge to a liquidated damage clause, Tennessee courts, like courts in most jurisdictions, focus on reasonableness; they examine whether the stipulated amount was the result of an honest effort by the parties to reasonably anticipate the actual harm caused by default. "If the [contract damage] provision is a reasonable estimate of the damages that would

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[1] In general, a forfeiture is a "divestiture of specific property without compensation; it imposes a loss on a party by the taking away of some preexisting valid right without compensation." Directed toward contract law, a forfeiture is "the deprivation or destruction of a right in consequence of the nonperformance of some obligation or condition." BLACK'S LAW DICTIONARY 449 (6th ed. 1990).

occur from a breach, then the provision is normally construed as an enforceable stipulation for liquidated damages."[2] On the other hand, if the clause is designed as a penalty, to effectively coerce performance by punishing a breach, courts will invalidate the clause as a matter of public policy.

There is a split of authority as to whether the courts should use a prospective method or retrospective method, or both, to evaluate reasonableness for determining whether a liquidated damages provision constitutes a penalty. Under the prospective approach, a court will consider "whether the liquidated sum was a reasonable estimate of potential damages and whether actual damages were indeterminable or difficult to measure at the time the parties entered into the contract."[3] Damages that are predictable at the time the parties are formulating their agreement, or those which the parties are certain would be easily calculable at the time of breach, are not subject to liquidation in a contract. When the liquidated damages provision satisfies those two factors and reflects the parties' intentions to compensate the injured party, then ordinarily the provision will be upheld as a reasonable agreement for liquidated damages.[4] In a prospective analysis, the amount of actual damages suffered by the nonbreaching party is immaterial to granting recovery. Using a retrospective approach, however, a court may refuse to enforce a liquidated damage clause if the contractually specified damages would be "grossly disproportionate" to the actual damages suffered as a result of the breach.[5] The major difference between the retrospective and prospective approaches is timing: whether the court evaluates the reasonableness of the stipulated damage amount from the view of the parties at the time of contract signing or after the breach occurred.

This question remained unsettled in Tennessee until June 1999, when the Tennessee Supreme Court decided in *Guiliano v. Cleo, Inc.* that Tennessee courts "must focus on the intentions of the parties based upon the language in the contract and the circumstances that existed *at the time of contract formation*."[6] The prospective approach is now the proper method for determining whether a liquidated damages provision is a penalty in Tennessee. Prior to *Guiliano*, several Courts of Appeals had refused to enforce liquidated damage clauses that called for damages which were grossly disproportionate to the actual damages sustained.[7] The Supreme Court, however, concluded that there were "inherent problems with retrospective analysis" and expressly rejected this method. The court reasoned that a prospective approach was "the better rule" based upon two important interests which surfaced in the *Guiliano* case: (1) the freedom of parties to bargain for and agree to mutually acceptable terms (such as liquidated damages) without interference from outside observers; and (2) the limitations set by public policy.[8] Respecting freedom to contract, the court concluded that a retrospective approach undermined important benefits of contract negotiations, including certainty and risk allocation, thereby defeating the purpose of agreeing to damages in advance.[9] Moreover, efficient dispute resolution is not promoted when supposedly resolved matters can be dredged up via litigation. At the same time,

[2]V.L. Nicholson Co. v. Transcon Investment and Financial Ltd., Inc., 595 S.W.2d 474, 484 (Tenn. 1980).

[3]*Guiliano v. Cleo, Inc.*, 995 S.W.2d 88, 100-01 (Tenn. 1999).

[4]*Id.* at 100.

[5]*See e.g.*, Beasley v. Horrell, 864 S.W. 2d 45, 48 (Tenn. Ct. App. 1993)

[6]*Guiliano*, 995 S.W.2d at 100 (emphasis added). This approach "incorporates the cardinal rule of contract interpretation, requiring courts to ascertain the intentions of the parties based upon the language in the contract." *Id.* at 100 n.12.

[7]*See* Harmon v. Eggers, 699 S.W.2d 159, 163 (Tenn. Ct. App. 1985), *overruled by* Guiliano v. Cleo, Inc., 995 S.W.2d 88 (Tenn. 1999); Eller Bros., Inc., v. Home Fed. Sav. & Loan Assoc., 623 S.W.2d 624, 628 (Tenn. Ct. App. 1981), *overruled by* Guiliano v. Cleo, Inc., 995 S.W.2d 88 (Tenn. 1999); *see also* Southpace Properties, Inc. v. Acquisition Group, 5 F.3d 500, 505 (11th Cir. 1993) (applying Alabama law); Browning Ferris Indus. of Nebraska, Inc. v. Eating Establishment 90th & Fort, Inc., 575 N.W.2d 885, 888-89 (Neb. Ct. App. 1998); Highgate Assoc., LTD. v. Merryfield, 597 A2d 1280, 1282 (Vt. 1991) (reviewing the totality of the circumstances).

[8]*Guiliano*, 995 S.W.2d at 100.

[9]*See id.*

however, the court believed that it should not interfere with an individual's business affairs, but instead should carry out the intentions of the party unless, of course, the terms of the agreement violated the second important interest, limitations set by public policy.[10]

Tennessee courts further determine the validity of liquidated damages clauses by focusing on the substance of the transaction rather than the descriptive terms or the particular language used in the agreement. In other words, the parties' subjective characterization of the liquidated damages clause as an "estimate" of damages (or as a "forfeiture") does not influence the court's decision or preclude it from finding that the clause is in fact a penalty.[11] Conversely, a contractual provision need not explicitly include the term "liquidated damages" to constitute a liquidated damages provision.[12] In short, language is not dispositive. If the parties agreed in the contract on the amount of damages to be recovered for compensation upon the occurrence of a particular defaulting event, then damages are liquidated unless the contract states otherwise. Tennessee lawyers also should remember that the courts will not enforce a liquidated damages clause if the party seeking damages was responsible for or significantly contributed to the breach.

Finally a lawyer must be aware that there still remains some variability in the law relating to the validity of liquidated damage clauses. *Guiliano*, of course, now stands as the definitive statement of the common law rule to be applied to determine the validity of a liquidated damage clause that specifies a sum of money to be paid upon breach. If the contract is for the sale of goods, however, the validity of such a liquidated damages clause will not be determined by reference to the common law, but rather by Tenn. Code Ann. § 47-2-718.[13] Also, in cases in which the liquidated damages have been cast in the form of the forfeiture of an existing right, courts may supplement or replace the traditional liquidated damages analysis with a more general discussion of principles of equity and the law's abhorrence of forfeitures. In the end, however, it

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[10]*Id.* Where the court briefly discussed violations of public policy with respect to contract terms, it did not elaborate on its meaning of "public policy," but referred to the case *McKay v. Louisville & N.R. Co.*, 182 S.W. 874 (Tenn. 1916). In *McKay*, the Tennessee Supreme Court stated that "the right of private contract was no small part of the liberty of the citizen, and that the usual and most important function of courts of justice was rather to maintain and enforce contracts than to enable parties thereto to escape from their obligation on the pretext of public policy, unless it clearly appeared that such contracts contravened public right or public welfare." *McKay*, 182 S.W. at 876. Further citing *Baltimore & Ohio S.W. Ry. Co. v. Voight*, 176 U.S. 498, 505 (1900), the *McKay* opinion continued:

"It must not be forgotten that you are not to extend arbitrarily those rules which say that a given contract is void as being against public policy, because, if there is one thing which more than another public policy requires, it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts, when entered into freely and voluntarily, shall be held sacred, and shall be enforced by courts of justice. Therefore you have this paramount public policy to consider; that you are not lightly to interfere with this freedom of contract." *Id.*

[11]*See* Testerman v. Home Beneficial Life Ins. Co., 524 S.W.2d 664, 669 (Tenn. Ct. App. 1974).

[12]*Guiliano*, 995 S.W.2d at 97.

[13]Tenn. Code Ann. §§ 47-2-718 (1) and (2) state:

(1) Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.

(2) Where the seller justifiably withholds delivery of goods because of the buyer's breach, the buyer is entitled to restitution of any amount by which the sum of his payments exceeds:

(a) the amount to which the seller is entitled by virtue of terms liquidating the seller's damages in accordance with subsection (1), or

(b) in the absence of such terms, twenty percent (20%) of the value of the total performance for which the buyer is obligated under the contract or five hundred dollars ($500), whichever is smaller.

TENN. CODE ANN. § 47-2-718 (1996).

is likely that liquidated damages clauses which pass muster under *Guiliano* will also pass muster under Tenn. Code Ann. § 47-2-718 and the more general equitable principles that have been articulated in cases where the contract calls for a breaching party to lose rights to which they would otherwise be entitled.

Using these basic principles, Tennessee courts will determine the validity of liquidated damages clauses on a case-by-case basis. Thus, it is important that lawyers not only understand the general principles of law, but also the various circumstances in which courts have both invalidated and enforced such clauses. What follows, then, is a sampler of some of the relevant Tennessee case law pertaining to the validity of liquidated damages clauses.

## II. ENFORCEABLE LIQUIDATED DAMAGE PROVISIONS

Lawyers may look to several Tennessee cases for examples of liquidated damage clauses that have been enforced in spite of a claim by the party in breach that the clause should be invalidated as a penalty. Three involve traditional liquidated damage clauses. Two involve provisions calling for the party in breach to lose a right to which they otherwise would have been entitled.

***Guiliano v. Cleo, Inc.:*** [14] As noted above, the Tennessee Supreme Court recently rejected the reasoning of those cases in which the Tennessee Court of Appeals had adopted a retrospective approach to invalidate a liquidated damages clause. Guiliano was an employee who had been constructively terminated from his job at Cleo, Inc.[15] The trial court granted summary judgment, awarding Guiliano the remainder of his salary, $90,125, as liquidated damages according to the terms of his contract. Upon review, the Court of Appeals agreed that Guiliano had been constructively terminated, but held that the liquidated damages provision imposed an unenforceable penalty upon the employer. Afterward, the Tennessee Supreme Court reversed the Court of Appeals, upholding the validity of the liquidated damages agreement.

Guiliano was employed by Cleo, Inc., under a three-year contract for an annual salary of $103,000. The contract, in pertinent part, stated that "[i]n the event the Company terminated this Agreement and your employment without cause, you shall continue to be paid your then current salary from the date of termination through October 31, 1995."[16] After Guiliano was asked to leave, the company agreed to honor the employment agreement so long as he did not accept other employment prior to October 31, 1995. With approximately eleven months remaining on his contract with Cleo, Inc., Guiliano accepted new employment at a higher salary. Cleo, Inc. dropped Guiliano from its payroll when he began his new job, and Guiliano filed suit.

The Tennessee Supreme Court affirmed the Court of Appeals on the issues of uncertainty and reasonableness of damages amount. Both courts felt that damages were indeterminable at the time the parties entered into the contract and viewed the provision's estimate of potential liquidated damages as fairly within the contemplation of the parties.[17] Clearly, neither Guiliano nor Cleo, Inc. had certain knowledge whether Guiliano would be able to secure other employment in the event he was terminated without cause. Also uncertain was whether Guiliano would

[14] 995 S.W.2d 88 (Tenn. 1999).

[15] *See id.* at 91-92. After several upper management changes in 1994, Cleo, Inc. relieved Guiliano of all management duties. The company's new president stated in his deposition that, based upon his observations of Guiliano's work performance, Guiliano had a poor relationship with his peers and subordinates and that he was not leading his department in a direction that best suited the company. *Id.* at 93. He replaced Guiliano with someone who had more "industry experience and a successful track record." *Id.* The new company president asked Guiliano to return the company credit cards in his possession and informed him that all future assignments, if any, were to be performed from his home. *Id.*

[16] *Id.* at 92 (paragraph 7 of employment contract).

[17] *See id.* at 101.

be able to find a position at the same salary, and whether he might suffer other damages difficult to prove such as loss of professional status, prestige, and advancement opportunities.[18] Then, rather than evaluate reasonableness of the stipulated damages in light of what damages were actually suffered by Guiliano, the Tennessee Supreme Court changed the rule and held that "[t]he liquidated sum is recoverable based upon [the] conclusion that it was reasonable at the time the parties entered into the contract and that it reflects the parties' original intentions to compensate for a termination of employment."[19] Under the new rule, plaintiff's inability to prove actual damages was irrelevant; the extent of actual damages no longer has any bearing on the recovery of liquidated damages. Having held Guiliano's lack of proof of actual damages was irrelevant, the court concluded that he was entitled to recover the full amount stipulated in the contract provision.

In its conclusion, the court reaffirmed the importance of the parties' intent when examining a contract. Given that the parties were in the best position to know what considerations influenced their bargaining at the time they entered into the contract, and even though "the bargain may be an unfortunate one for the delinquent party, . . . it is not the duty of courts of common law to relieve parties from the consequences of their own improvidence."[20]

***Vanderbilt Univ. v. DiNardo:***[21] Consistent with *Guiliano*, the Sixth Circuit Court of Appeals upheld the validity of a liquidated damage clause in an employment contract designed to protect the employer from breach in *Vanderbilt Univ. v. DiNardo*. Again, the decisive issues were whether damages were reasonable and uncertain at the time the contract was signed. DiNardo, the head football coach for Vanderbilt University, terminated his agreement to accept a position as head coach with another University. As a result, Vanderbilt brought action against DiNardo for breach of contract. The district court's decision, upheld on appeal, was that the liquidated damages clause was reasonable and enforceable.[22]

DiNardo's employment agreement required him to pay an amount equal to his base salary, multiplied by the number of years remaining on the contract, in the event of breach.[23] Both the trial court and the court of appeals found that the sum was "reasonable" when compared to the actual damages likely to be suffered by Vanderbilt University due to DiNardo's breach; potentially substantial damages which included recruiting a new head coach and staff, loss of stability in the athletic program, damage to reputation and public relations, lost profits from reduced football ticket sales, lost alumni support, and sundry other harms.[24] The appellate court concluded that "the stipulated damage amount [was] reasonable in relation to the amount of damages that *could be expected* to result from the breach."[25] Moreover, the agreement was reasonable because the contract did not state a lump sum for damages, but contained a *sliding* damages scale based upon the length of the contract term remaining after the breach.[26]

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[18]*Id.*

[19]*Id.*

[20]*Id.*

[21]174 F.3d 751 (6th Cir. 1999).

[22]Vanderbilt University v. DiNardo, 974 F.Supp. 638, 638 (M.D. Tenn. 1997). The Sixth Circuit Court affirmed the district court's judgment that the contract contained an enforceable liquidated damages provision and affirmed the portion of the judgment reflecting damages calculated under the original contract, but reversed and remanded the district court's judgment concerning enforceability of an addendum to the contract. This matter was not relevant to the discussion of liquidated damages, but concerned issues regarding enforceability of a condition precedent and acceptance. *See DiNardo*, 174 F.3d at 759.

[23]*DiNardo*, 974 F.Supp. at 640.

[24]*Id.* at 642.

[25]*DiNardo*, 174 F.3d at 755 (emphasis added).

[26]*DiNardo*, 974 F.Supp. at 642-43.

In addition to considering the damage amount reasonable, the court concluded that the circumstances in *DiNardo* satisfied another significant element necessary for a valid liquidated damages clause—damages were properly uncertain at the time the contract was drafted. Although DiNardo's salary was not directly attributable to specific anticipated damages, salary amount was reasonable to use for the damages calculation given the unquantifiable nature of damages in this case. The court noted that "[t]he potential damage to Plaintiff [Vanderbilt] extends far beyond the cost of merely hiring a new head football coach. It is this uncertain potentiality that the parties sought to address by providing for a sum certain to apply toward anticipated expenses and losses."[27] Defining this "uncertain potentiality" is an important goal of liquidated damages clauses in general.

The court noted that DiNardo had the benefit of counsel when drafting his agreement, pointing out that the damages provision had already been renegotiated and reduced once from the original amount (gross to net salary).[28] In fact, the contract contained another liquidated damages provision, very similar to the clause that DiNardo argued was unreasonable, that protected DiNardo in the event that the roles were reversed and Vanderbilt breached the contract.

***City of Memphis v. Ford Motor Co.***[29] Ford Motor Co. sought to recover $252,576.78 in liquidated damages paid after breaching a contract for utility services. The damages amount was for unsupplied electricity during the time remaining on the contract between the City of Memphis and Ford Motor Co. after Ford discontinued its business operations there. The services paid for as stipulated damages were neither rendered nor received. The district court decided that the City's charges for unused electricity were valid as liquidated damages because (1) damages were uncertain at the time of contract, (2) Ford's responsibility for these costs was the express intent of the parties, and (3) the City incurred large expenditures to supply the contractual requirements of Ford.[30] Judgment for the City was affirmed on appeal to the Sixth Circuit.[31]

Ford had contracted to purchase its electricity from the City and agreed to a minimum monthly payment for a period of five years. Nevertheless, with 34 ½ months remaining on its contract, Ford sold its plant, paid those bills which were due at the time of sale and left town. Ford contended that it no longer needed electricity at a location not in use and argued that any interpretation of a damages clause which would oblige Ford to continue paying for electricity "that the City did not generate and that Ford would not and could not use was unusual and oppressive in its results."[32]

The court disagreed with Ford. First, it found that the parties intended the minimum payments for electric service to continue regardless of Ford's requirements.[33] "When an agreement is fairly and understandingly entered into with a view to just compensation for the anticipated loss, there is no sound reason why it should not be enforced."[34] Secondly, the court observed that the damages were properly uncertain at the time the contract was signed. Upon breach of such a contract, the stated intention to pay stipulated sums is given effect because actual damages were uncertain in nature and amount.[35] No one could possibly know how much electricity would actually be used. Third, upholding the validity of the damages provision was equitable when the expenses incurred by the City were taken into account. It was apparent from the record that large expenditures, aggregating more than $163,000,000, were paid by the City to meet its contractual requirements.[36] Ford was "not being

[27]*Id.* at 642.

[28]*Id.* at 643.

[29]304 F.2d 845 (Sixth Cir. 1962).

[30]*Id.* at 853.

[31]*Id.* at 845.

[32]*Id.*

[33]*Id.* at 848. The contract stated in pertinent part, "nothing contained in this paragraph shall relieve customer from any minimum bill requirements." Id.

[34]*Id.* at 852.

[35]*Id.*

[36]*Id.* at 853.

penalized by being held liable for the payments it agreed to make, even though it does not take the electricity, which it agreed to purchase."[37] Accordingly, the court concluded that the sum of over $250,000, though large, was reasonable when all of the facts were considered.[38]

***Testerman v. Home Beneficial Life Ins. Co.:***[39] Even in the days when Tennessee courts were allowed to use a retrospective comparison of damages, liquidated damages clauses requiring payments greatly in excess of actual harm to the nonbreaching party could be upheld. In *Testerman,* for example, the court found that liquidated damage amounts well in excess of the actual damages suffered were both reasonable and enforceable.

Testerman, a real estate developer, contracted with a lender to borrow $1.5 million and then sued for a refund of the $30,000 standby deposit fee when the loan was not consummated.[40] Testerman argued that, because interest rates had increased, the lender actually suffered no damage but instead *benefitted* from the breach because he could now lend the money at a higher rate.[41] Testerman further asserted that since the lender suffered no financial damages, the standby fee constituted an uncollectible and unenforceable penalty. On the other hand, the lender claimed that, although out-of-pocket costs to the lender were only $3877.35, due to the loss of participation in rents the total loss to the loan company would amount to $97,000.[42] The loan company was unable, however, to point to any particular loan they failed to make because of their commitment to Testerman.[43]

The court found that the standby fee was reasonable based upon the circumstances "as viewed from the vantage point of the parties on the date of execution of their agreement, not on the basis of what did happen, but rather on what could or might have happened."[44] The court also based its determination on principles of equity and fair dealing. Specifically, the lender was required by the terms of the contract to keep $1,500,000 million dollars available to Testerman for a period of twenty months, and it did so in good faith.[45] By contrast, Testerman's conduct embodied a considerable lack of good faith which clearly displeased the court. After the contract was signed, Testerman had found a different lender with whom he could deal more advantageously and then sought to capitalize on the fact that the lender was able to recoup its losses. Based upon the circumstances, the court found the liquidated damages clause reasonable and announced that "a court of equity [sh]ould be the last place [for Testerman] to seek relief."[46]

Moreover, the court determined that standby fees similar to the one in Testerman's agreement are standard and used by most loan companies.[47] The fee was acceptable as partial consideration for Testerman's loan commitment and, in the absence of oppression and overreaching, was likewise enforceable.[48] Although the court did not discuss the uncertainty of damages in this type of transaction, lost opportunity to loan the money elsewhere is clearly a legitimate

[37] *Id.* The court further stated that "where a party bound by an executory contract repudiates his obligations or disables himself from performing them before the time for performance, the promisee has the option to treat the contract as ended, so far as further performance is concerned, and maintain an action at once for the damages occasioned by such anticipatory breach." *Id.* at 852.

[38] *Id.* at 853.

[39] 524 S.W.2d 664 (Tenn. Ct. App. 1974).

[40] *See id.* at 666. Amid other objections, Testerman argued that the loan commitment letter was ambiguous because it provided for a fee if the loan was closed, but said nothing regarding disposition of the fee in the event the transaction was not consummated. The court believed that disposition of the fee was implicit in the agreement, but did not refer to what specific language led them to this conclusion. *Id.* at 669-70.

[41] *Id.* at 670 (emphasis added).

[42] *Id.* at 668.

[43] *Id.*

[44] *Id.* at 670. Note the court's use of a prospective analysis.

[45] *Id.*

[46] *Id.*

[47] *Id.* at 668.

[48] *Id.* at 669.

albeit unpredictable concern and could have provided a basis for validating the liquidated damages provision.

Lastly, the *Testerman* court reaffirmed that the words used by parties in contracts are not conclusive proof as to the intent of the parties respecting their agreement or the court's evaluation of the stipulated damages sum. For purposes of determining whether the amount specified in a contract is a penalty or liquidated damages, contract drafters must bear in mind that the particular words used in the writing are not determinative because it is the substance of the transaction, and not the words, that govern. In this case, the court pointed specifically to the word "forfeited," used by the loan company in a letter to Testerman, and said that use of the word did not change the substance of the transaction.[49] Nonetheless, lawyers drafting liquidated damages clauses should be careful to avoid words such as "forfeit," or "penalty," which imply that the provision is other than a proper clause. It does not hurt to include language such as, "in the event that . . ., *X* shall pay to *Y* the sum of . . . as liquidated damages and not as a penalty." While such language is hardly dispositive, it places one more obstacle in the way of a breaching party seeking to set aside the provision as a penalty.

***Kendrick v. Alexander:***[50] Kendrick, a prospective purchaser of real property priced at $500,000, filed action against the seller, Alexander, to recover amounts forfeited when the contract failed to close. There were two sums in issue: (1) an initial down payment of $10,000, which would be credited toward the purchase price, but would be forfeited if Kendrick failed to complete the purchase and (2) in connection with two separate extensions of the closing date, an additional $50,000 earnest money, which would also be credited toward the purchase price, but would likewise be forfeited if the purchase failed. Finally, as consideration for yet one more extension of the closing deadline, Kendrick agreed to pay Alexander $50,000 that would not be credited toward the $500,000 purchase price but would be retained by Alexander whether or not the purchase was completed. Ultimately, Kendrick was unable to secure the purchase funds, Alexander sold the property to someone else for $550,000, and Kendrick filed suit to recover the sums paid as earnest money, alleging that the forfeiture provisions in the contract were invalid as a penalty.

Treating the contract as one that called for a forfeiture of $110,000 as stipulated damages for the buyer's breach, the trial court held that the forfeiture was a penalty rather than a reasonable effort to estimate damages that would be difficult to prove.[51] The Tennessee Court of Appeals reversed, holding that the final payment of $50,000 should not have been treated as liquidated damages, but rather as separate consideration for the final extension of the deadline for closing. Viewing the remaining $60,000 as monies withheld as stipulated damages, the court then concluded that this sum, representing 12% of the total purchase price of $500,000, was not an unreasonable amount—particularly when some portion of the increase in liquidated damages might be viewed as consideration for the first two extensions of the closing deadline.[52] The court also emphasized that these terms were bargained for by the parties and that there was no evidence of oppression or overreaching in the transaction.[52]

## III. UNENFORCEABLE PROVISIONS

It is also important that lawyers who are drafting liquidated damages clauses be aware of the various circumstances in which Tennessee courts have refused to enforce stipulated damages provisions and why. Courts do not enforce damage provisions which are unreasonable when compared to the damages that one would expect to be suffered upon breach, and they do not accept stipulated damage amounts where damages would be certain or easy to calculate. Likewise, fixed damages which are not adjustable for the severity of the breach but which take the

[49] *Id.*

[50] 844 S.W.2d 187 (Tenn. Ct. App. 1992).

[51] *Id.* at 189.

[52] *Id.* at 190-91.

[53] *Id.* at 191.

form of a lump sum no matter what the offending action may be are generally disfavored. The following cases highlight those conditions and circumstances that have led courts to rule that a liquidated damages clause was unenforceable as a matter of law.

***Beasley v. Horrell:*** [54] As part of a sale and leaseback agreement on two buildings owned by the Beasleys, Horrell executed a nonnegotiable promissory note in the amount of $100,000 payable to the Beasleys. The leases required the Beasleys to make a variety of payments including rent, all taxes and assessments, premiums for property damage and liability insurance, all utility bills, and certain types of repairs. In addition, Horrell's promissory note contained a cancellation provision which stated that, in the event of default in the payment of any rent or any other payments due under the leases, the indebtedness represented by the note "shall be automatically revoked and the note shall ipso facto be null and void."[55]

Eleven months later, the Beasleys were no longer able to make all of the payments required under one of their leases, so they entered an agreement with Horrell to effectively terminate that lease and to facilitate the sale of the building. At the time of the sale, the Beasleys owed a total of only $5810.70 in unpaid rent, taxes, and insurance. As a result of this deficiency, however, Horrell voided the note and the Beasleys brought suit.

The Court of Appeals held that the cancellation provision was unenforceable, in part, because the damages were ascertained, not by reasonable calculation of any kind, but solely by an arbitrary lump sum set out in the agreement.[56] The *Beasley* court did not like the fact that, under the express terms of the note, the plaintiffs would "forfeit" the entire principal amount of $100,000, plus up to $40,000 in interest, if they were late in making even one of the many payments due under the agreement.[57] The court calculated that the foreseeable damages to the lender were equal to *only* the amount of the missed payments, and that this amount could not fall anywhere near $100,000.[58] A single lump sum, the court concluded, cannot be construed as a reasonable approximation of compensation for breach of each individual covenant listed in the contract.[59]

Secondly, the damage clause would not be given effect because damages (i.e., unpaid rent, taxes due, insurance) were easily ascertainable at the time of contract. When it is apparent that it will be easy to determine at the time of breach the amount of damage caused by the breach, it is unnecessary and inappropriate to have a liquidated damages clause.[60] Liquidated damage clauses are intended only to be suitable when damages are uncertain, not when they can be precisely ascertained as was possible in this case.

***Kimbrough & Co. v. Schmitt:*** [61] In *Kimbrough*, the court found a provision unenforceable as a penalty for reasons similar to those discussed in the *Beasley* decision: the stipulated damages were not a reasonable forecast of the damages likely to occur in the event of default, and it would not have been difficult for Kimbrough to ascertain or prove damages at the time of breach.

The buyer, Schmitt, contracted to buy residential property from Kimbrough and agreed to a financing period of three years. The provision governing the seller's damages in the event of buyer default said that if the buyer defaulted in

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[54] 864 S.W.2d 45 (Tenn. Ct. App. 1993).

[55] *Id.*

[56] *See id.* at 49.

[57] *See id.* The record does not reflect whether the word "forfeit" was used descriptively by the court in reference to the effect of the agreement or whether it was included in the language of the contract.

[58] *Id.* at 51.

[59] *Id.* at 49.

[60] *Id.*

[61] 939 S.W.2d 105 (Tenn. Ct. App. 1996).

buyer default said that if the buyer defaulted in any payment required by the contract or the promissory note, the buyer agreed to pay to the seller as liquidated damages an amount equal to 15% of the original contract price ($71,658.57).[62] The liquidated damages amount was to be reduced by 1% for each year that the buyer made all payments as required by the contract.

Schmitt made payments satisfactorily throughout the five-year period of the contract, at the end of which Kimbrough accelerated the note causing the entire debt to be due.[63] Schmitt did not have the money to pay off the note at that time, and his attempts to sell the property were also unsuccessful. So, Kimbrough retook possession of the property and demanded liquidated damages in the amount of 13% of the original purchase price, as well as interest at a rate of ten percent.[64]

Similarly to the unenforceable contract terms in *Beasley*, the liquidated damages provision in Kimbrough's contract provided for a very large damage amount in the event the defendant defaulted on any one of his payments.[65] But even though the provision in *Kimbrough* reduced damages for each year that payments were satisfactorily made (unlike the disfavored *Beasley* provision which did not contain a sliding scale nor adjust the damages according to when the breach occurred), this did little to bring the liquidated damages amount within reason.[66] In its discussion, the court described the results of this provision as having "unconscionable consequences."[67 • 6]

Finally, as in *Beasley*, the court also based its decision on the fact that damages were *not* uncertain and that they would be *easy* to calculate in case of breach.[68] Both criteria, damage certainty and ease of calculation, are factors the resence of which makes stipulated damage amounts inappropriate in business contracts. For these reasons, the trial court held the damage clause invalid and unenforceable as a penalty

***Harmon v. Eggers:*** [69] It is well-settled in Tennessee law that forfeitures and penalties are not favored by the courts, and "where there is a doubt whether a sum is in fact a penalty or liquidated damages, courts are inclined to hold the former."[70] Unlike the enforceable forfeitures in *Testerman* and *Kendrick*, the Tennessee Court of Appeals concluded in *Harmon* that a forfeiture was "contrary to the interests of justice."[71]

The Harmons dispute concerned a real estate sale contract for the purchase of a house and lot. The contract provided that failure of the Harmons to make any monthly installment when due would be a breach of the contract for which the sellers could retake possession without notice. At default, according to their agreement, all monies previously paid by the Harmons would be retained by the sellers as liquidated damages for the breach. The Harmons paid a total of $32,000 toward the purchase price of $63,000 before they stopped, allegedly due to a dispute over a drain field. Upon eviction, they brought suit to recover the sums they had paid.

The court of appeals relied upon the Tennessee Supreme Court's decision in *Beaden v. Bransford Realty Co.*[72] when they determined whether this type of provision provides for liquidated damages or, in fact, assesses a penalty. The plaintiff in *Beaden* entered into an agreement with a realty company to purchase real property. (The option contract contained a liquidated damages provision quite similar to the one in the *Harmon* case.) When the plaintiff allowed the repossession to occur, his payments totaled 53% of the purchase price. The facts made it "perfectly clear" to the *Beaden* court that

[62] *Id.* at 107.

[63] *Id.*

[64] *Id.*

[65] *Id.*

[66] *See id.* at 109.

[67] *Id.*

[68] *Id.*

[68] 699 S.W.2d 159 (Tenn. Ct. App. 1985).

[70] V.L. Nicholson Co. v. Transcon Investment and Financial Ltd., 595 S.W.2d 474, 484 (Tenn. 1980).

[71] *Harmon*, 699 S.W. at 164.

[72] 232 S.W. 958 (Tenn. 1921).

the provision was a mere penalty and putting the plaintiff out of possession was tantamount to declaring a forfeiture.[73] The court commented that, "[u]nder such circumstances, on declaration of the forfeiture, the rights of the parties should be settled upon the basis of permitting . . . a recovery of all purchase money paid, as well as the amounts paid for taxes and insurance, subject to a credit for reasonable rent."[74]

Similarly, the *Harmon* court concluded that the liquidated damages clause, being nothing more than a penalty, was unenforceable.[75] The court announced that "to give effect to the 'liquidated damages' provision . . . under these facts would be equivalent to our sanctioning a forfeiture/penalty, contrary to the interests of justice. This we cannot do."[76]

***Schimpf v. Tennessee Mfg. Co.:*** [77] A minor employee was required by contract to automatically forfeit all wages due him if he quit without giving two weeks notice. The court found this type of damages clause to be "an unreasonable and oppressive forfeiture," and that "no such forfeiture could be enforced against wages which an employer was to have paid his employee before he committed a breach of duty."[78] In addition, the court expressed its disfavor regarding contract clauses which do not require that the damage awards vary with the seriousness of the breach.[79] So, abhorrence of a forfeiture and a liking for adjustable damages, according to breaches of various sort, appear to be long-standing principles. As the Court stated: "[n]o system of laws would command our respect, or secure willing obedience, which did not, to some extent, provide against the mischief resulting from improvidence, carelessness, inexperience and under expectations on one side, and skill, avarice, and a gross violation of the principles of honesty on the other."[80]

## IV. CONCLUSION

Liquidated damage clauses are an excellent device to help prevent and settle disputes and also to provide for fair compensation to the nonbreaching party in the event of a breach where damages would be indeterminable or difficult to prove. The contract drafter who successfully crafts a valid liquidated damages clause acceptable to both parties will save the parties both time and expense in the event the contract is breached. The overarching concern of the courts when deciding liquidated damages cases is the reasonableness of the provision. To satisfy this standard, a valid damages provision must reflect that the parties contemplated in advance what damage amounts would reasonably flow from a failure to perform as promised.

It bears reemphasis that courts in Tennessee will now be using a prospective approach to determine the validity of stipulated damages.[81] If agreed to, a clause providing for damages greatly in excess of actual losses is enforceable. Finally, courts look to the language used by the parties in the contract. Be wary. Although contractual terms are not determinative *per se*, care must be exercised in their selection because a court may attribute their plain meaning to them. A contract drafter should remember the default rule: that courts will resolve any doubts whether a provision serves as a penalty or as reasonable compensation for a breach in favor of finding a penalty in most cases.

The reasonableness of contractually specified damages will be determined on a case-by-case basis, as illustrated by comparing the results in *Kendrick*[82] and *Kimbrough*.[83] The "reasonable" damage clause in *Kendrick* called for damages calculated at 12% of the transaction amount, but the court in *Kimbrough* labeled damages val-

[73] *Harmon*, 699 S.W.2d at 163.

[74] *Id.* at 163-64.

[75] *Id.* at 164.

[76] *Id.*

[77] 6 S.W. 131 (Tenn. 1887).

[78] *Id.*

[79] *Id.*

[80] *Id.* at 132.

[81] *See supra* notes 6-10, 14-19 and accompanying text.

[82] *See supra* notes 50-53 and accompanying text.

[83] *See supra* notes 61-68 and accompanying text.

ued at 15% of the transaction "totally unreasonable." These results are partially reconciled by examining the circumstances presented to the court as it searched for justice between all the parties. In *Kendrick*, the case involved sophisticated parties, experienced in the area of real estate, doing business with the benefit of counsel. And, the 12% stipulated damage amount in *Kendrick* included consideration for additional terms. The parties knew, or should have known, what they were doing. The court specifically observed that there was no evidence of fraud or overreaching in the case. On the other hand, the contract in *Kimbrough* was called "unconscionable." This case concerned the purchase of a home by an ordinary homeowner who had been faithfully making payments to his lender for five years. If the damages provision was strictly upheld, the borrower stood to lose everything he had paid *plus* liquidated damages when Kimbrough accelerated the note. This the Court thought was "unconscionable" rather than "reasonable." Drafters of liquidated damage clauses will be well-served to keep in mind the idea that if something smells bad, a court will find a way to conclude that it is rotten.

In Tennessee, liquidated damage clauses are more likely to be enforced if they call for payment of sums that vary depending on the nature and timing of the breach rather than for the payment of a lump sum for any breach. Case law also counsels that liquidated damages should be specified only when damages will be difficult to ascertain or are uncertain at the time of contract. Damages are readily determinable in financial matters such as loan agreements and real estate contracts. Where the contract concerns land, often the remedy for breach by the seller is specific performance which does not involve money damages. If monetary damages are called for, the proper amount could probably be ascertained as a function of the market value of the property, contrary to a sum stipulated in advance. On the other hand, agreements concerning employment and service contracts involve circumstances quite dissimilar to those found in money exchanges and land deals. For instance, the situations in *Guiliano*,[84] *DiNardo*,[85] and *City of Memphis*,[86] offer examples of situations in which the damages actually suffered would be difficult, if not impossible, to prove with reasonable certainty. In these and similar cases, liquidated damages clauses are not merely proper, but also a valuable tool to be used by businesspeople, with the assistance of knowledgeable legal counsel, to reduce the likelihood of litigation in the event that one of the parties cannot perform as promised.

[84] *See supra* notes 14-20 and accompanying text.

[85] *See supra* notes 21-28 and accompanying text.

[86] *See supra* notes 29-38 and accompanying text.

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