CASE COMMENTARIES

BUSINESS ORGANIZATIONS

Board must give notice to an individual who is both a director and controlling stockholder of matters contrary to his interest. *Adlerstein v. Wertheimer*, No. 19101, 2002 Del. Ch. LEXIS 13 (Del. Ch. Jan. 25, 2002).

By M. Eric Anderson

Two members of the SpectruMedix Corporation ("SpectruMedix" or "the Company") board of directors became concerned with the Company's growing insolvency under the management of Joseph Adlerstein, who was Chairman of the Board, CEO, and controlling stockholder. In addition, the directors were concerned with other questionable actions of Adlerstein. Therefore, these two directors secretly contacted another investor to discuss the ouster of Adlerstein as both director and controlling stockholder. At a subsequent board meeting, over Adlerstein's objections, the two directors voted to give the new investor a sufficient number of shares to convey a majority of the voting power of SpectruMedix's stock. Next, the board voted to remove Adlerstein for cause as CEO of the Company and Chairman of the Board, and replaced him with the new investor. Finally, after the board meeting, the new investor, acting as the new controlling shareholder, requested the Company remove Adlerstein as a director. In filing his lawsuit, Adlerstein argued that the board meeting was not properly convened and asked the court to invalidate the actions taken at this meeting.

Although acknowledging several factors that supported not invalidating the actions taken at the board meeting, the court found that due to the lack of advance notice to Adlerstein the actions taken at the board meeting were invalid. In making its decision, the court noted that the directors were obligated to act in good faith and owed each other a duty of loyalty. The court emphasized that its decision was influenced by the ousted member's status as both a director *and* a controlling stockholder, not from either status individually. When a director is also the controlling stockholder, Delaware law disfavors withholding advance notice of information that would allow the controlling stockholder-director to protect his interest. In other cases, actions of directors accomplished by trickery and deceit have been deemed to be inconsistent with fundamental principles of fairness and a breach of duties owed to stockholders. Delaware case law supports a controlling stockholder/director's right to receive advance notice of matters contrary to his interests. This right to advance notice allows the director to take sufficient steps to

protect his interest, such as removing one or more directors from the board.

The decision emphasizes the requirement that directors conduct business in a manner consistent with fundamental principles of fairness. In this case, although the two directors felt their actions were in the best interest of the Company, their decision to keep Adlerstein in the dark resulted in litigation costs and liability.

Determinations of a church's governmental structure will determine member's ability to settle disputes with the organization. *Kim v. Lim*, 563 S.E.2d 485 (Ga. Ct. App. 2002).

By Kathryn Diack

In *Kim v. Lim*, the congregation of the Siloam Korean Church split into two rival factions, led by the plaintiffs and the defendants, after a controversial decision was made that affected both parties. A case that started with the plaintiffs filing a temporary restraining order soon led to disputes regarding other church business, such as the church's building, bank account, and a note held by the church.

Georgia recognizes two main types of church governments, congregational and hierarchical. A congregational government is defined as one that is "strictly independent of other ecclesiastical associations, and [one that] so far as church government is concerned, owes no fealty or obligation to any higher authority." Congregational churches and their local property are controlled by decisions by the majority of its congregation. Hierarchical governments are defined as "those organized as a body with other churches having similar faith and doctrine with a common ruling convocation or ecclesiastical head." Neutral principals of law, such as state statutes, corporate charters, and organizational constitutions, are used to determine whether the local church or parent church has the power to control the church property. The trial court concluded that the Siloam Korean Church was congregational and that the majority of the church members could therefore resolve the dispute over the church property. The plaintiffs appealed this determination.

In their appeal, plaintiffs relied on *Crocker v. Stevens*, a case involving a church organized as a non-profit corporation. The *Crocker* court recognized a "hybrid" (i.e. part congregational, part hierarchical) version of church governance. The plaintiffs urged the Court of Appeals to construe *Crocker* as holding that an incorporated church cannot be a congregational church.

Ultimately, the Court of Appeals agreed with the trial court's determination

that the Siloam Korean Church was organized as a congregational government. In support of the ruling, the court cited that the members maintain complete control over the decisions of the church, that the church does not report or answer to a higher authority, and that the church is not affiliated with another religious association. In addition, the court emphasized that the Siloam Korean Church was founded and operated as a "wholly independent church." In finding the church congregational, the court placed the responsibility of settling disputes back in the hands of the majority of the congregation.

Kim stresses the importance of classification of religious organizations for purposes of determining which laws will apply to disputes and who can settle them. Courts have taken the position of considering a church to be hierarchical if there is evidence in any way of a chain of command, board of directors, or outside power. Given that a hierarchical government is ruled not by majority vote of the congregation, but by neutral principals of law, the differentiation of governments could be significant to a transactional lawyer and very significant to the church membership.

A transactional lawyer needs to inform all church clients that future disputes may be affected not only by how the church is organized on paper but also by the way the church is run on a daily basis. A lawyer needs to clarify every detail of the church's organization to represent the wishes of the church whether it be as congregational or hierarchical.

When an agent is given notice of termination, an "at will" termination may change into a "for cause" termination. *In re Prof'l Ins. Mgmt.*, 285 F.3d 268 (3d Cir. 2002).

By Ennica Street

In *Professional Insurance Management v. Ohio Casualty Group of Insurance Cos.*, Professional Insurance Management ("PIM") contracted with Ohio Casualty Group of Insurance Companies ("Ohio Casualty") to sell personal and commercial insurance policies. The agreement gave Ohio Casualty permission to cancel the contract upon ninety days notice and provided for PIM's responsibility for any unpaid balance in that event. Ohio Casualty provided PIM with a notice of termination for ninety days thereafter. Nearly three months after effective termination, Ohio Casualty demanded payment for PIM's indebtedness to it.

Five months after the effective termination, PIM filed for bankruptcy under

Chapter 11, owing Ohio Casualty $252,642.40. The bankruptcy court gave PIM a right to renewals on commercial policies for several months and also granted PIM the right to collect commissions. Upon Ohio Casualty's appeal, the bankruptcy court determined that Ohio Casualty terminated PIM under the "at will" provision; therefore, PIM was entitled to renewal commissions of various types. Ohio Casualty appealed to the district court and then to the Third Circuit Court of Appeals.

Applying the New Jersey Termination Statute (N.J. Stat. Ann. § 17.22-6.14a), the Court of Appeals determined that PIM's conduct could cause an "at will" termination to become a "for cause" termination between notice of termination and effective termination. This change would only occur if Ohio Casualty recognized the conduct. Since the bankruptcy court did not inquire as to PIM's conduct during the relevant period or as to whether Ohio Casualty noticed any such conduct, the Court of Appeals vacated the order and remanded the case to the district court for remand to the bankruptcy court.

While *Professional Insurance Management* does not conclusively decide the issues before it, the decision addressed a new legal concept in the arena of agency law: the idea that an "at will" termination could become a "for cause" termination prior to the actual effective date of termination. This new possibility could present problems for transactional attorneys faced with agent terminations. The new concept brings the agent's conduct under closer scrutiny and could have serious ramifications on the rights and responsibilities of both parties.

CONTRACTS

If adequate consideration is present, an agreed-upon revision to a memorandum of understanding is binding, absent duress. *Centech Group, Inc. v. Getronicswang Co.*, No. 01-1898, 2002 U.S. App. Lexis 5329 (4th Cir. Mar. 29, 2002).

By Ryan Malone

Applying Virginia Law, the Fourth Circuit Court of Appeals held that, absent a showing of duress, an agreement intended to revise a prior contract will be binding if there is adequate consideration. The consideration requirement is fulfilled when one party takes upon itself a definite obligation that was only conditional in the prior agreement.

Centech subcontracted with I-NET to build components necessary to fulfill a naval contract. When Centech became unable to meet the terms of the naval contract, Centech and I-NET agreed to the first of two memorandums of

understanding (the "original MOU"). In part, it provided that I-NET agreed to assume liability from Centech and to provide bid and teaming opportunities. A revised MOU was agreed upon, and the bid and teaming opportunities under the original MOU were never provided. This revised memorandum expressly provided that it superceded the original MOU. Centech filed suit, claiming that I-NET breached the original MOU by failing to provide bid and teaming opportunities.

Both the trial court and the Fourth Circuit held that the suit under the original MOU was groundless because the revised MOU expressly superceded the original. Centech raised two issues on appeal. The first was that the revised MOU was invalid because it was not supported by consideration. The court determined, however, that adequate consideration was present because I-NET assumed a definite responsibility that was merely conditional under the original MOU.

The court then considered Centech's claim of duress. To invalidate a contract under Virginia law, a plaintiff must show that there is an improper threat that "leave[s] the aggrieved party without any reasonable alternative other than to assent to the contract." Since Centech had numerous reasonable alternatives, such as an anticipatory lawsuit, any threats made by I-NET could not constitute duress.

When a party revises an MOU and includes an express provision that states the new agreement supercedes all prior agreements, the parties lose all benefits not contained in the new arrangement. The benefits of prior contracts can only then be acquired by invalidating the revised agreement. Attorneys should also note that sufficient consideration can be found in a revised contract if a party took upon itself a definite obligation that was only conditional in the prior agreements.

ESTATE PLANNING

Where a trust beneficiary survives the settlor's death but dies before the trustee's distribution of the trust assets, the words of a trust's survival contingency must be specific and easily understood. *Chavin v. PNC Bank*, C.A. No. 18366, 2002 Del. Ch. LEXIS 20 (Del. Ch. Mar. 4, 2002).

By Alexandra Deas

Applying Delaware law, the Delaware Chancery Court granted summary judgment in favor of the defendant, holding that an interpretation of the phrase "if he shall then be living" must have a temporal reference in the instrument. Based on the language used in the instrument to determine the intent of the settlor, the estate vests "upon the death of the settlor."

Florence Chavin, the settlor of a trust and its sole beneficiary during her lifetime, simultaneously executed her last will and testament and a complete amendment to the trust. Upon her death, Chavin's son Leslie and her two grandsons, whose father was Chavin's other, predeceased son, survived Chavin. PNC Bank was appointed executor of Chavin's estate. Before distribution of the trust estate, Leslie Chavin died and left Harlan Miller, a collateral relative, his entire estate.

At issue in this case was the language of the trust providing for the distribution of assets. The applicable provision read: "upon the death of Settlor, Trustee shall pay over, transfer and convey whatever remains of the trust estate, discharged of the trust, to Settlor's son, Leslie S. Chavin, if he shall then be living. If Settlor's son shall then be deceased, to Settlor's then living issue, per stirpes." The question was whether Chavin intended the phrase "if he shall then be living" to refer to the time of her death or to the performance of the trustee's obligation to convey the remainder of the trust property.

PNC Bank and Miller contended that the trust's survival contingency should be construed to mean that upon Leslie Chavin's death, the right to the remaining trust assets vested in his estate and, pursuant to the provisions of his will, in Miller. In contrast, the plaintiff grandsons contended that the phrase refers to the time when the trustee "shall . . . convey whatever remains of the trust estate." The plaintiffs argued that the trust language should be interpreted to mean Leslie was required to survive not only Florence Chavin's death, but also PNC's distribution of the trust assets.

The court held that the phrase "if he shall then be living" requires a temporal reference and that the most plausible reference in the trust was found in the phrase "upon the death of Settlor." A date of death is fixed and determinable and provides a satisfactory answer to the question of when is "then." Were the plaintiffs' reasoning followed, the court explained, the trustee could influence who received the trust assets. Finally, the court bolstered its decision by noting that the law prefers interpretations favoring early vesting of estates.

The survival contingency language of a trust may become the subject of litigation when a trust beneficiary survives the settlor's death but dies prior to the trustee's distribution of the trust assets. When creating a trust, transactional attorneys should be aware that the intent of the settlor is a main factor considered in interpreting trust language. Discussions with the client regarding intent should be had in the presence of other persons. Making the beneficiaries to the estate aware of

the settlor's intent and establishing a clear evidentiary record of that intent may help avoid potential litigation.

LABOR & EMPLOYMENT

Public officials face liability for violations of the Family and Medical Leave Act. *Darby v. Bratch*, 287 F.3d 673 (8th Cir. 2002).

By Kimberly M. Jones

Applying Missouri law, the U.S. Court of Appeals held that public officials that violate the Family and Medical Leave Act ("FMLA") are subject to liability in their individual capacities the same as private sector employers.

Darby was a dispatcher for the Kansas City Police Department. She began experiencing symptoms of both thyroid and Graves's diseases and requested a job transfer into a less stressful position. In addition to her transfer request, she applied for FMLA leave. She had an agreement with her superior officer whereby her job transfer would succeed if she decreased her sick days, and she missed fewer than the allotted days. However, her transfer request was denied and was transferred to a different shift, and her superior officer suggested her termination. Darby took her leave, and while away, she was mailed an incident report that listed excessive absences. Upon returning to work, she was informed that she was not terminated but would remain at same rate of pay without a promotion. She was not placed on the work roster or schedule and ultimately resigned due to the treatment she received. Due to the pending incident reports, she was precluded from being rehired.

At issue was whether public sector employees could be held liable for violations under the FMLA for using the employee's leave as a negative factor against the employee. The Court of Appeals held that Darby's termination was a violation of the FMLA because (1) the Board of Police Commissioners was not "an arm of the state for purposes of Eleventh Amendment"; (2) Darby properly applied for FMLA leave, which leave was used as a negative factor; and (3) the police department fit the FMLA definition of "employer"—"any person who acts, directly or indirectly, in the interest of any employer to any of the employees of such employer." There is thus no distinction between private sector and public sector employers.

The decision erases the distinction between private sector employers and public sector employers that violate the FMLA. It highlights the need for attorneys

to advise all employer-clients, not just private sector employer-clients, that their violation of the FMLA can result in a discrimination action.

Borrowed servant doctrine liability does not apply in situation where contract delegates liability for negligence to employee. *NVR, Inc. v. Just Temps, Inc.*, No. 01-2029, 2002 U.S. App. LEXIS 3746 (4th Cir. 2002).

By Thomas B. Luck

The Maryland Court of Appeals held that the borrowed servant doctrine does not apply where the general employer and the borrowing employer have entered into a contract specifically allocating the responsibility for an employee's negligent acts to the general employer.

NVR, Inc. ("NVR") and Just Temps, Inc. ("Just Temps") entered into a contract where an employee of Just Temps worked under the direction of NVR, and Just Temps agreed to indemnify NVR for any and all liabilities, losses, and costs arising from any property damage connected with the work for NVR performed by the Just Temps employee. The employee subsequently caused an explosion at an NVR site damaging real property owned by NVR. Just Temps refused to compensate NVR for the damages, and NVR sued.

The District Court for the District of Maryland concluded that the borrowed servant doctrine applied because NVR exercised a high level of control over the employee; therefore, NVR was responsible for the negligent acts of the employee. However, the Fourth Circuit Court of Appeals reversed and remanded, stating that the borrowed servant doctrine did not apply because the contract between NVR and Just Temps included an indemnity provision, which was not waived by NVR. The court concluded that under the provision, NVR was responsible for any damages that could be attributed solely to NVR or its affiliates; however, any damage that was partially or entirely the fault of the Just Temps employee would be the responsibility of Just Temps. It was determined that the explosion was the result of negligence by the employee and that Just Temps was, per contract, responsible. The employee's status under the borrowed servant doctrine was thus irrelevant.

This case underscores the importance of allocating risk of responsibility for employee negligence when temporary workers are hired. The fact that the borrowing employer is exercising great control over the employee is not enough to shift the responsibility if the employee damages the property of the borrowing employer and when the governing contract addresses the issue.

Commercial lease giving a business lessee non-exclusive use rights to an area beyond the leasehold premises can create liability under the new Tennessee business liability standard. *McClung v. Wal-Mart Stores, Inc.*, 270 F.3d 1007 (6th Cir. 2001).

By Ryan Holloway

The Sixth Circuit Court of Appeals expanded business liability for the safety of business invitees to the full extent of the business' use rights over in its lease provisions. This new standard means that businesses may be liable for the foreseeable injuries sustained on or around their premises caused by the criminal acts of third parties.

In *McClung v. Wal-Mart Stores, Inc.*, the plaintiff's wife was kidnapped from a shopping center in Memphis, Tennessee, and subsequently raped and murdered. The owner of the shopping center had leased its commercial parcels to eleven stores, including Wal-Mart. Wal-Mart's lease allowed the store non-exclusive use of the shopping center's commons areas, assigned Wal-Mart a fixed ratio of total parking spaces available on the center's lot, and stated that Wal-Mart would be responsible for maintaining adequate lighting of such spaces for the duration of its lease.

The Tennessee Supreme Court had previously established the "reasonable business" standard imposing a "duty to take reasonable steps to protect customers … if the business knows, or has reason to know, either from what has been or should have been observed or from past experience, that criminal acts against its customers on its premises are reasonably foreseeable, either generally or at some particular time." The Sixth Circuit has thus sharpened and also broadened the scope of this potential liability. The court stated that a business that shares a parking lot with other businesses is not merely liable for its own designated portion of the lot as outlined in its lease.

"If a storeowner offers parking to its customers, that parking area is part of the store's premises regardless of who else might also park there." Wal-Mart's non-exclusive use of the whole parking lot for its customers extended Wal-Mart's premises to the entire lot. Accordingly, Wal-Mart could be held liable to the plaintiff for his wife's injuries.

The *McClung* court essentially held that precise lease terms do not necessarily indicate the level of liability businesses have toward customers who enter their

premises. It appears that a court may broaden a business's lease premises—and resulting liability—from what is stated on the face of the lease under certain circumstances. In *McClung*, the lease provision of non-exclusive parking lot use rights was the key factor that led to an expanded definition of "business premises" for purposes of liability. Transactional lawyers must be aware that similar lease provisions may result in additional liability exposure and advise their clients accordingly. Especially in the case of deep-pocket anchor tenants, this liability may be quite significant.

SECURITIES

Securities fraud claim that does not meet heightened pleading standard or "strong inference" requirements will be dismissed for failure to state a claim. *Spiegel v. Tenfold Corp.*, 192 F. Supp. 2d. 1261 (D. Utah 2002).

By Patrick V. Fiel, Jr.

The U.S. District Court for Utah held that a securities fraud claim does not meet the heightened pleading requirement of the Private Securities Litigation Reform Act of 1995 (the "Reform Act") if there is no proof of actual knowledge on behalf of the defendants and that allegations of motive and opportunity are insufficient to give rise to a "strong inference" that defendants act with the requisite mental state to commit securities fraud.

In *Spiegel v. Tenfold Corp.*, shareholders brought a securities suit against Tenfold Corporation ("Tenfold") and its directors alleging that the defendants: (1) repeatedly issued materially false public and financial statements, including "on time guarantee statements," despite knowledge that such statements were potentially false and misleading; (2) knowingly overstated Tenfold's technological capabilities; and (3) improperly recognized income in violation of Generally Accepted Accounting Procedures ("GAAP").

The Securities Act of 1933 and the Securities and Exchange Act of 1934 require plaintiffs to establish (1) a misleading statement or omission of a material fact that was (2) made in connection with the purchase or sale of securities (3) with intent to defraud or recklessness, (4) reliance on that statement or omission, and (5) damages. In addition, the Reform Act requires a heightened pleading standard in which plaintiffs must specify each alleged misleading statement, while stating with particularity facts giving rise to a strong inference that the defendants acted with the requisite state of mind.

The district court found that the plaintiffs failed to establish scienter and to sufficiently plead facts giving rise to a strong inference that defendants engaged in knowing or reckless misconduct. The district court noted that Tenfold attempted to inform investors of its contractual problems and that Tenfold sufficiently disclosed warnings to investors concerning its possible negative business operations. Tenfold's prompt disclosure was not indicative of reckless behavior, and it was not highly unreasonable for Tenfold to make "on time guarantee statements" before the contract period was complete. Further, the plaintiffs only alleged three (3) of the five (5) requirements under the Securities and Exchange Act of 1934, and the Defendants had not directly sold or solicited for sale securities by means of their prospectus. The court granted defendants' 12(b)(6) motion.

Legal planning for a corporation that sells or solicits the sale of its stock requires consideration of the appearance of its financial statements. When drafting or reviewing financial disclosures, a transactional attorney must be aware of the fact that such statements are subject to heightened legal and public scrutiny, especially in light of the recent swell of negative public and official sentiment regarding corporate accounting errors.

TAX

Creation of a tax shelter via a subsidiary corporation that serves no legitimate business purpose is a violation of the "sham transaction doctrine." *Syms Corp. v. Comm'r*, 765 N.E.2d 758 (Mass. 2002).

By C. Mark Anderson

Applying Massachusetts law, the Supreme Judicial Court of Massachusetts employed the "sham transaction doctrine" to disallow deductions claimed by a parent corporation. In an effort to seek shelter from some of its tax burden, Syms Corp. ("Syms") formed a subsidiary corporation ("SYL") with the sole purpose of holding its trademarks ("marks"). SYL licensed the marks back to Syms, who then paid SYL royalty payments for their use. Syms deducted the royalty payments as necessary and ordinary business expenses.

Syms deducted the royalty payments from its gross income over five tax years. Since SYL did not add any value to the marks, the Internal Revenue Service and the appellate tax board (the "Board") disallowed the deductions. On appeal to the Supreme Judicial Court, the court determined that the Board's decision not to allow the deduction under the sham transaction doctrine was supported by the record.

The sham transaction doctrine, a part of federal and state law, is most often applied to transactions that serve no business purpose other than averting taxation. The doctrine protects the spirit of the tax code by disallowing deductions resulting from transactions that are contrary to the intention of the law, even if the transactions do not run contrary to the letter of the code. The Syms court noted that a motive of escaping tax is not necessarily contrary to the spirit of the code if a legitimate business purpose accompanies the taxpayer's primary motive. Though the board did not dispute the fact that there were business expenses incurred through this transaction, it held that the expenses were not worthy of deduction because their occurrence was the result of a transaction with the sole purpose of tax evasion.

SYL's board of directors included many of the directors and officers of Syms, and SYL's only physical presence was an address rented from an accounting firm. Also, its only employee served in a part-time capacity, but worked full-time for the accounting firm. Central to the Board's decision was that Syms' royalty payments to SYL did nothing but force Syms to pay for the marks twice and then allow Syms to deduct the amount paid by it to maintain the marks.

While the sham transaction doctrine does not automatically disallow any attempt by a taxpayer to seek refuge from taxation, it does require that additional and legitimate business purposes accompany that attempt. Even if the business purposes are secondary in motive to tax avoidance, the deduction of business expenses may be allowed, so long as the expenses are the result of the business purpose and not merely the result of the taxpayer's desire to avoid paying taxes. When advising a client of the ramifications of creating a corporate vehicle for a tax shelter, the attorney should advise the client to proceed only if an alternate business purpose will be served by the formation of the subsidiary corporation.

Taxpayers seeking bad debt deductions carry the heavy burden of proving partial worthlessness of a debt. *PepsiAmericas, Inc. v. United States*, 52 Fed. Cl. 41 (Fed. Cl. 2002).

By Miles Thomas

Taxpayers seeking a bad debt reduction carry the heavy burden of proving its partial worthlessness to the Internal Revenue Service ("IRS"). The decision rests solely with the IRS Commissioner and will not be disturbed unless it can be shown to be arbitrary or unreasonable. This is the situation the court faced in *PepsiAmericas, Inc. v. United States*.

The plaintiff, the holding company for a diversified group of operating subsidiaries, established a trust to administer an employee stock ownership plan ("ESOP") as an integral part of major restructuring in the 1980s. The trust purchased stock from the plaintiff using funds loaned by the plaintiff in exchange for a secured promissory note ("ESOP Note"). Because of the plaintiff's deteriorating financial condition, it became clear that the best course of action would be to terminate the ESOP and purchase the remaining stock from the trust. The trust applied the plaintiffs purchase price to partial repayment of the loan.

The plaintiff timely filed a claim stating that it was entitled to a deduction for the partial worthlessness of the ESOP Note. After the IRS disallowed the deduction, the plaintiff filed suit with the court seeking a tax refund, alleging that the debt was partially worthless because it was never repaid in full. The IRS asserted that the plaintiff caused a solvent debtor to become insolvent and therefore could not deduct a debt made worthless by its own actions.

In order for a taxpayer to claim a bad debt deduction, the taxpayer must show that: (1) the debt for which he is claiming a deduction is business in nature; (2) the debt is bona fide; (3) the debt was partially worthless during the tax year; and (4) the debt was "charged off" on its books in the amount claimed to be uncollectible for the taxable year at issue. Here, only the third element was disputed.

Because it was the plaintiff's own conduct that rendered the trust insolvent, the plaintiff was precluded claiming a bad debt deduction. The court determined that if the trust was solvent and the plaintiff rendered it insolvent, or if plaintiff voluntarily released it from liability for reasons beneficial to itself, the IRS judgment should not be disturbed. Two accepted tests exist for determining solvency: solvency in the "equity sense" and solvency under the "balance sheet test." The former characterizes an entity as solvent if it can pay its debts as they fall due; the latter focuses on the liquidation value of the debtor's assets compared to the debtor's current liabilities.

When the court juxtaposed the results of the two tests, they were found to be in direct conflict. The balance sheet test showed the plaintiff to be insolvent because the liquidation value of the debtor's interest was less than the debtor's liability, while the equity sense test revealed that the plaintiff was still solvent because the trust was still capable of paying off its debts as they came due. There is no clear rule to determine which test should be applied. In respecting the IRS's discretion, the court chose to apply the equity sense test because it best supported the IRS's conclusions.

Where a corporation seeks to release a debtor from his liabilities and intends

to claim a bad debt deduction, transactional attorneys should advise clients to determine the solvency of the debtor at the time of release and avoid selfish and personal motives for that release.

Practitioners can rely upon the plain meaning of the Internal Revenue Code provided that the applicable section is clear and unambiguous. *Limited, Inc. v. Comm'r*, 286 F.3d 324 (6th Cir. 2002).

By Christine Vanasse

In *Limited, Inc. v. C.I.R.*, the Internal Revenue Service ("IRS") charged The Limited, Inc. ("The Limited") with a deficiency for a transaction that occurred between three of its subsidiaries: Mast Industries (Far East), Ltd. ("MFE"), MFE (Netherlands Antilles) N.V. ("MFE-NV"), and the World Financial Network National Bank ("WFNNB"). Shortly after formation, MFE contributed 175 million dollars to MFE-NV for investment purposes. MFE-NV then purchased eight certificates of deposit ("CDs") for 174.9 million dollars from WFNNB, a domestic credit card company. The IRS assessed a deficiency against The Limited, stating that the purchase of the CDs "was an investment in 'United States property'" and should be subject to taxation.

The tax court, relying on both legislative history and 12 U.S.C. §1841(c)(2)(F), which imposes restrictions on non-bank owned credit card companies, concluded that The Limited's principle purpose in structuring this transaction was tax avoidance and, consequently, upheld the deficiency assessed by the Commissioner. On appeal, the Sixth Circuit reversed. When interpreting a tax statute, the "starting point" should be "the language of the statute itself" and should be "construed liberally in favor of the taxpayer." Furthermore, courts should apply the "ordinary and natural" meaning to the statute if it is unambiguous and should not resort to extrinsic evidence or authority for interpretation. Because the Internal Revenue Code ("I.R.C.") was unambiguous in the sections relevant to this case, the Sixth Circuit found that the tax court had improperly relied on 12 U.S.C. § 1841(c)(2)(F) and legislative history to interpret them.

The Sixth Circuit's holding is consistent with the well-defined canons of statutory interpretation. This simplifies matters for transactional attorneys faced with clear and unambiguous language in the I.R.C. It bear comment, however, that "clear and unambiguous" is in the eye of the beholder and that reasonable minds may differ on the characterization.