

CASE COMMENTARIES

BANKRUPTCY

A bankruptcy debtor need not be insolvent to file a Chapter 11 petition. *In re Marshall*, 300 B.R. 506 (C.D. Cal. 2003).

By Joseph W. Ballard

In an opinion by Judge Samuel Bufford, the United States Bankruptcy Court for the Central District of California held that a debtor need not be insolvent under either the balance sheet or the liquidity test to file a Chapter 11 petition. Further, the Court held that Congress has the Constitutional power under the Bankruptcy Clause of the Constitution to adjust a debtor's rights before the debtor's insolvency. Finally, the Court held that a solvent debtor filing for Chapter 11 relief would not violate a judgment creditor's Fifth Amendment economic substantive due process rights.

In *Marshall*, a trustee of three family trusts opposed confirmation of the Chapter 11 plan proposed by the debtors, his brother, and his brother's wife. The trustee argued that this case falls outside the bankruptcy jurisdiction of the federal courts under the Bankruptcy Clause of the United States Constitution, because the debtors were solvent under a balance sheet test and the Constitution requires a debtor in a bankruptcy case to be insolvent.

In analyzing the trustee's argument, the Court noted the difficulty and vast amount of time potentially consumed in ascertaining whether a debtor is solvent under a balance sheet test. Next, the Court thoroughly examined United States Bankruptcy Laws and English Bankruptcy Laws to determine that the framers of the Constitution could not have established the Bankruptcy Clause with a requirement of a debtor being insolvent because as of that time insolvency was an unknown concept. Further, Supreme Court cases have not mandated that a debtor be insolvent in order to receive the protections of bankruptcy. Therefore, the Court concluded, the trustee erred in interpreting the Bankruptcy Clause to require that a debtor be insolvent for a valid bankruptcy filing and the Court found that the Constitution's Bankruptcy Clause is not limited by a debtor's solvency under the balance sheet test found in 11 U.S.C. § 101(32)(A).

The trustee's final contention was that the debtor's bankruptcy petition would deprive him of his Fifth Amendment substantive due process rights to his

judgment from a state court if the reorganization was carried out. The Court held that the trustee's judgment is neither a property right nor a contract right, and a Bankruptcy Court ultimately is within its power to discharge the trustee's judgment if the Chapter 11 reorganization plan is confirmed. Therefore, the Court found an insufficient basis for a violation of the trustee's Fifth Amendment substantive due process rights.

The United States Bankruptcy law is designed to provide relief from creditor pressures for debtors with cash flow difficulties, even where they are clearly solvent. If a debtor must wait until it becomes insolvent to invoke the reorganization provisions under the bankruptcy law, substantial economic values will often be irretrievably lost. Congress has legitimately decided that it is best for the United States economy to permit solvent debtors to reorganize under the bankruptcy law to preserve economic values.

Professionals retained in bankruptcy proceedings may have their fees capped and be required to rely on the work product of adverse parties. *In re Fed. Mogul-Global, Inc.*, 300 F.3d 368 (3d Cir. 2003).

By Edward W. Collins

Interpreting 11 U.S.C. §§ 328(a), 1103(b), the Third Circuit held that Bankruptcy Courts may set limits on the compensation of professionals engaged in Chapter 11 proceedings and may also require a financial advisor retained in Chapter 11 proceedings to rely on the financial data compiled by another party to the proceedings in lieu of duplicating the effort.

Federal Mogul-Global, Inc., a manufacturer of automotive parts, filed for Chapter 11 protection in October 2001. The United States Trustee appointed a committee to represent the interests of the stockholders of the company in the proceedings ("Equity Committee"), as well as a committee to represent the unsecured creditors ("Creditors Committee"), and a third committee to represent a group of individuals with potential asbestos claims against the company ("Asbestos Committee"). The Equity Committee applied to the Bankruptcy Court for permission to hire Deloitte & Touche LLP ("D & T") to analyze and compile Federal Mogul's financial data as well as to serve as financial advisors in the proceedings. The Bankruptcy Court approved the Equity Committee's application regarding the retention of D & T, but capped D & T's expenses at \$30,000 per month. The court also found no need for D & T to duplicate the research already

performed by other parties to the proceedings and directed D & T to rely on the financial compilations of the other financial advisors.

11 U.S.C. § 328(a) authorizes a court to set caps on the services of professionals retained in bankruptcy proceedings. The fees to be paid under an employment application are terms and conditions of the application as contemplated by section 328(a). Thus, the Bankruptcy Court maintains the ability to adjust the compensation to be paid to professionals in the application; the court need not reject the application in its entirety simply because it is unhappy with the fee structure.

11 U.S.C. § 1103(b) allows a court to require a committee to rely upon the data compiled by adverse parties in the proceeding. The Equity Committee argues that D & T, by receiving the financial data from the debtor, will, in essence, be “representing” the debtor. The Court dismisses this claim of an “adverse interest” created between D & T and the debtor. The Court first examines the word “represent” and finds that it does not apply to a simple sharing of data, and then explains that the debtor actually possesses an interest that the Equity Committee receive as much value as possible from the reorganization. Finally, the Court believes duplicating the financial compilation is an unnecessary expense that would serve only to deplete the debtor’s already scant resources.

This case provides important lessons for the transactional attorney representing a party in bankruptcy. First, if a compilation of data already exists and an adverse party petitions the court for permission to have its own advisors perform the same compilation, counsel may ask the court to require that party to rely on the existing compilation – preserving resources. Second, and in a similar vein, a court can be petitioned to cap the fees of an adverse party’s retained professionals at the application hearing. By utilizing either or both of these tactics, an attorney may be able to save a bankruptcy estate substantial amounts of money that could otherwise constitute allowed administrative expenses.

Debtors may discharge student loan debt in bankruptcy when the court finds that repayment would cause undue hardship. *Oyler v. Educ. Credit Mgmt. Corp. (In re Oyler)*, 300 B.R. 255 (B.A.P. 6th Cir. 2003); *Marks v. Educ. Credit Mgmt. Corp. (In re Marks)*, No. C-02-3213 PJH, 2003 WL 22004844 (N.D. Cal. Feb. 13, 2003); *Adler v. Educ. Credit Mgmt. Corp. (In re Adler)*, 300 B.R. 740 (Bankr. N.D. Cal. 2003).

By Michael L. Penley

Faced with three separate debtors seeking discharge of student loan debt owed to the Educational Credit Management Corporation (“ECMC”), the United States District Court for the Northern District of California, the United States Bankruptcy Court for the Northern District of California, and the United States Bankruptcy Appellate Panel of the Sixth Circuit each applied Section 523 of the Bankruptcy Code and found that student loan debts were dischargeable where the court finds that the debtor would be faced with undue hardship if required to repay some or all of the student loan debt.

In *Adler*, the bankruptcy court granted relief to a debtor who had accrued over \$200,000 of educational debt in obtaining a Ph.D. in 1991 and had, despite diligent attempts, been unable to find a job which paid enough money to repay the debt. In *Marks*, the District Court reviewed the Bankruptcy Court’s decision to grant a discharge of \$205,000 of student loan debt accrued by the debtor in obtaining a Ph.D. in 1998. After 5 years, the debtor remained unable to find a job in his field and, as a result, could not earn enough money to repay his debt. In *Oyler*, the bankruptcy court discharged \$40,000 of student loan debt accrued while attending seminary, where the debtor was a 48 year old pastor with household income of \$10,000 per year and four children. Despite numerous transferable skills, the debtor voluntarily chose to devote his life to the ministry and live well below the poverty level thereby preventing himself from being able to repay his debt.

Section 523 of the Bankruptcy Code allows discharge of student loan debt only where the debtor would experience undue hardship. Since Congress has not defined “undue hardship,” the courts looked to judicially created tests. Both California courts applied the three-prong *Brunner* test for “undue hardship.” The *Brunner* test requires proof that the debtor be unable to maintain a minimal standard of living, that the situation will persist throughout the repayment period, and that the debtor has made a good faith effort to repay the loans. However, the Sixth Circuit Panel applied a modified version of the *Brunner* test adopted in *Cheesman* that expanded the three-prong analysis of the *Brunner* test to include other factors such as the debt amount, the interest accrual rate, and the debtors expenses, with a focus on

whether the debtor has minimized his or her standard of living adequately. In each case, the court determined that the debtor would experience undue hardship if required to repay student loans. Interestingly, the court in *Oyler* found that the debtor met the standard for good faith effort to repay when the debtor had not maximized his potential income because of his devotion to his ministry, while the courts in *Adler* and *Marks* clearly focused on the debtor's inability to increase his income so that he could satisfy the debt.

In each of the cases the court found that the debtor satisfied the test for "undue hardship" and then determined whether to discharge all or part of the debt. Both California courts acknowledged the equitable authority of the bankruptcy court to discharge only a portion of the student loan debt. However, only the District Court in *Marks* truly considered the effect of partial discharge of the debt and remanded the case to the bankruptcy court to determine the amount of debt that should be discharged. The court in *Oyler* did not even consider the possibility of partial discharge and the *Adler* court claimed to consider partial discharge but quickly dismissed the idea.

Together the three cases outline the applicable standard for discharging student loan debt under chapters 7 and 13. Practitioners should look to these cases when assessing whether to seek a discharge of an individual debtor's student loan debt.

Bankruptcy courts may refuse to compel arbitration of claims that fall within their core jurisdiction if failure to refuse would adversely affect the purposes of the Bankruptcy Code. *Videsh Sanchar Nigam Ltd. v. Startec Global Communications Corp.* (*In re Startec Global Communications Corp.*), 300 B.R. 244 (D. Md. 2003).

By Ryan Russell

The United States District Court for the District of Maryland applied federal bankruptcy law and held that a bankruptcy court may refuse to compel arbitration. This discretion exists if (1) the dispute in question is uniquely related to a bankruptcy proceeding or directly affects a core bankruptcy function and (2) arbitration would adversely affect an objective of the Bankruptcy Code. The use of such discretion can prevent arbitration agreements from inefficiently decentralizing disputes that are more efficiently resolved when centralized in the bankruptcy court.

Startec Global Communications (“Startec”) filed a petition for relief under Chapter 11 of the United States Bankruptcy Code. Startec then sought authorization from the bankruptcy court to satisfy the pre-petition claim of Videsh Sanchar Nigam Limited (“VSNL”), Startec’s most important supplier. The bankruptcy court granted Startec authority to repay some of its pre-petition debts to VSNL on the condition that VSNL continue to supply post-petition services to Startec. Pursuant to this order, Startec paid VSNL roughly one million dollars.

A month later, VSNL filed a proof of claim with the bankruptcy court stating that Startec owed VSNL nearly five million dollars. Startec asserted that VSNL’s filing breached a post-petition agreement between the two companies. In this agreement, Startec promised to make a second payment of roughly one million dollars and remain current on its post-petition obligations to VSNL. In return, VSNL promised to refrain from blocking its supply of services to Startec and from using pre-petition letters of credit against Startec. Startec initiated an adversary proceeding against VSNL and argued that VSNL had breached the post-petition agreement by filing a proof of claim and by denying its services to Startec. Startec also argued that VSNL violated the bankruptcy court’s order by refusing to supply post-petition services. VSNL responded by filing a motion to dismiss or to stay the adversary proceeding and compel arbitration pursuant to a pre-petition service agreement. The bankruptcy court dismissed VSNL’s motion after asserting its right to refuse to compel arbitration and concluding that Startec’s claims should be kept within the bankruptcy court. VSNL appealed this decision to the district court.

Quoting *In re Winimo*, the district court stated that when a bankruptcy court considers a motion to compel arbitration it must conduct a “two-stage inquiry: (1) ‘the court must determine whether it has discretion to refuse arbitration’ and (2) if such discretion exists, the court must determine whether ‘any underlying purpose of the Bankruptcy Code would be adversely affected by enforcing [the] arbitration clause.’” Both prongs must be satisfied before a bankruptcy court may refuse to compel arbitration. The first prong is usually decided by determining whether the dispute involves a core proceeding. Quoting *In re U.S. Lines*, the district court defined a core proceeding as one “either (1) . . . unique to or uniquely affected by the bankruptcy proceedings, or (2) . . . directly affect[ing] a core bankruptcy function.” Also, Section 157(b)(2) of the Bankruptcy Code provides a non-exhaustive list of core proceedings. If the dispute involves a core proceeding, the court next considers the second prong. If the bankruptcy court then decides that arbitration will adversely affect an objective of the Bankruptcy Code, this decision will be given deference.

The district court held that all of Startec's claims fell under the core jurisdiction of the bankruptcy court, thus the first prong was satisfied. This holding was primarily based on three rationales: (1) those claims that arose from the post-petition agreement automatically fell under core jurisdiction, (2) the remaining claims invoked "numerous provisions of the Bankruptcy Code" and thus fell under the bankruptcy court's exclusive jurisdiction, and (3) VSNL subjected itself to the equitable jurisdiction of the bankruptcy court when it filed its proof of claim. The district court also held that the second prong was satisfied because arbitration would adversely affect the Bankruptcy Code's objective to efficiently centralize disputes. Thus, the district court concluded that the bankruptcy court did not abuse its discretion by refusing to compel arbitration.

This case affirms the use of a bankruptcy court's discretion to prevent arbitration agreements from disorganizing the efficient centralization of disputes within a single forum. In today's legal environment, many business contracts involve arbitration agreements. These might require a business to arbitrate in a different part of the nation or even in another country. Although there are times when arbitration is efficient, allowing a debtor to be subjected to the extra expense of numerous arbitration proceedings places an unnecessary burden on the debtor's already limited resources and will likely reduce any recovery to be received by creditors. Thus, all parties benefit when the bankruptcy court uses its lawful discretion to protect the debtor from needless arbitration.

BUSINESS ORGANIZATIONS

In a derivative suit, the plaintiff must retain its status as a stockholder in the corporation throughout the entirety of the lawsuit to hold its standing to bring the suit. *Denver Area Meat Cutters and Employers Pension Plan ex rel. Clayton Homes v. Clayton, et al.*, 120 S.W.3d 841 (Tenn. Ct. App. 2003).

By Ashley W. Beck

In *Denver Area Meat Cutters and Employers Pension Plan v. Clayton*, the Tennessee Court of Appeals faced a number of issues under Delaware law relating to a merger between two corporations. The court focused on the effective date of the merger and how an allegation of fraud by the plaintiff stockholders might influence that determination. The court held that the date and time stamp by the Delaware Secretary of State on the certificate of incorporation is conclusive as to the effective date of the merger in the absence of actual fraud. It construed the phrase, "in the

absence of actual fraud” to refer to fraud in the endorsement by the Secretary of State, not fraud in the merger itself.

In April of 2003, Clayton Homes, Inc. (“Old Clayton Homes”) and B Merger Sub Inc., a wholly owned subsidiary of Berkshire Hathaway, Inc., entered into a plan of merger agreement which contemplated a transaction in which B Merger Sub, Inc. would merge into Old Clayton Homes. The surviving company (“New Clayton Homes”) would operate under the name of Clayton Homes, Inc. The plan also outlined the cash payment that Berkshire Hathaway would make to each stockholder of Old Clayton Homes, so that following the merger, New Clayton Homes would be a wholly owned subsidiary of Berkshire Hathaway.

In June of 2003, Old Clayton Homes sent out a letter to its stockholders informing them of the proposed merger as well as a notice of a special stockholders’ meeting on July 16, 2003, for the purpose of voting on the merger agreement. The board held the July 16, 2003, meeting as planned, but did not hold a vote on the proposed merger. The board adjourned the meeting until July 30, 2003, to give another company, Cerberus, the chance to explore the possibility of submitting a bid for Old Clayton Homes before the stockholders voted on the Berkshire Hathaway transaction. On July 28, 2003, Cerberus informed the board of Old Clayton Homes that it was no longer interested in submitting a bid.

On July 25, 2003, the plaintiff stockholder sued the directors of Old Clayton Homes derivatively on behalf of Old Clayton Homes and also filed a class action claim in the Circuit Court of Blount County. The plaintiff sought damages for breach of fiduciary duty as well as an injunction to prevent the proposed merger. Additionally, the plaintiff sought a temporary restraining order to prevent the board from postponing the vote on the proposed merger again. On July 29, 2003, the trial court issued the temporary restraining order, directing the board to hold a vote on the merger. The board held the July 30, 2003, meeting and the stockholders approved the merger by a margin of 52.35 percent to 47.65 percent.

On August 6, 2003, the trial court held a hearing on the plaintiff’s motion to prevent the consummation of the merger. The trial court also considered a motion by the defendants to stay the plaintiff’s suit because of similar suits pending in Delaware. The court denied the plaintiff’s motion to prevent the merger from going forward and also entered an order staying the plaintiff’s derivative and class action suits. At 9:29 a.m. on August 7, 2003, the plaintiff filed an application for extraordinary appeal in the Tennessee Court of Appeals. At 7:29 a.m. the same day,

the Delaware Secretary of State certified the Certificate of Merger of B Sub Merger, Inc. with and into Clayton Homes, Inc.

The main issue before the Tennessee Court of Appeals was whether the plaintiffs still had standing to bring the derivative suit following the Delaware Secretary of State's certification of the merger between Old Clayton Homes and B Merger Sub. The court considered the language of Delaware Code Annotated Title 8, Section 103 to determine the effective date of the merger. The language of the statute indicates that the Secretary of State's date and time stamped is conclusive as to the filing date for the certificate of incorporation "in the absence of actual fraud." The plaintiff argued that its complaint alleged fraud and therefore the filing date and time stamp by the Secretary of State was not conclusive of the time the merger became effective.

The Tennessee Court of Appeals then remanded the case to the trial court so that the parties could further explore the meaning and application of the phrase at issue. The court also ordered the defendants not to take any steps to further the merger between Old Clayton Homes and Berkshire Hathaway until the trial court made a determination. The trial court found that the plaintiffs made a *prima facie* case for its fraud claim and allowed its derivative and class action suits to continue. The trial court denied defendants' motion to stay and ordered defendants to refrain from any action that would change the status quo of the merger until further order from the circuit court or a higher court. The defendants applied for an extraordinary appeal to the Tennessee Court of Appeals; it was granted.

Applying Delaware law, the Tennessee Court of Appeals held that the merger between Old Clayton Homes and B Merger Sub, Inc. was effective on the date and time stamped on the certificate of merger by the Delaware Secretary of State. The phrase "in the absence of actual fraud" refers to fraud in the endorsement by the Secretary of State, not to an allegation of fraud in the merger itself. Therefore, after 7:29 a.m. on August 7, 2003, Old Clayton Homes no longer existed and the plaintiff stockholders lost standing to pursue a derivative suit. The court did note two exceptions under Delaware law where a former stockholder retained standing to pursue a derivative suit on behalf of the merged corporation. One of those exceptions, where the merger is in reality a reorganization that does not affect plaintiff's ownership of the business enterprise, did not apply to this case. The other exception applies when the merger itself is the subject of a claim of fraud in that the motive of the board in approving the merger was to eliminate the stockholder's standing to bring a derivative suit. The court held that the plaintiff did not make this

allegation, so the exception did not apply and the plaintiff lost standing to bring a derivative suit.

Litigators and transactional lawyers should be aware of the standing requirements in a derivative suit. The stockholder achieves the requisite standing by remaining a stockholder of the corporation throughout the suit. If a merger occurs in the middle of a derivative suit and the plaintiff is no longer a stockholder, the plaintiff loses standing to bring the suit and the right of action passes to the current stockholders.

Selling your corporation's stock amidst an insider-trading scandal? It's a good thing.

Beam v. Stewart, 833 A.2d 961 (Del. Ch. Sept. 30, 2003).

By Sneha Channabasappa

The Chancery Court of Delaware applied long-standing Delaware law and held: (1) that a board of directors has no fiduciary duty to monitor the personal affairs of an officer or director; (2) that without fact-specific pleadings, officers and directors do not necessarily usurp a corporate opportunity when they sell their privately held shares in the corporation; (3) that claims challenging a board's business judgment must be plead with particularity; and (4) that a shareholder must investigate and plead with particularity to excuse a pre-suit demand upon the board of directors.

In *Beam v. Stewart*, a shareholder brought a derivative action against the officers and directors of Martha Stewart Living Omnimedia, Inc. ("MSO"), the founder, Martha Stewart ("Stewart"), and the corporation, for breach of fiduciary duty resulting from insider trading accusations against Stewart. The suit claims that Stewart and a former MSO director, John Doerr ("Doerr"), improperly sold sizeable private shares of MSO stock in the wake of the accusations.

The allegations against Stewart regarding the sale of her shares of ImClone Systems, Inc. ("ImClone") arise out of her longstanding personal relationship with Samuel D. Waksal ("Waksal"), the former CEO of ImClone. Waksal received information on December 26, 2001, that the Food and Drug Administration had plans to reject ImClone's application to market its cancer treatment drug, Erbitux. The next day, Waksal tried to sell his own shares of ImClone and tipped off family members to do the same. Stewart also sold her shares of ImClone that same day. After barely two months of public speculation over the allegations, MSO's stock

price had declined by more than 65 percent. MSO remained uncertain about its earning prospects late into 2002; however, Stewart already sold three million privately held shares of MSO stock in January 2002 to certain entities designated in the complaint as “ValueAct,” and Doerr sold almost two million shares of MSO to ValueAct in March of the same year.

In dismissing the plaintiff’s breach of fiduciary duty claim regarding Stewart’s sale of her ImClone shares, the Chancery Court followed the rule, established by the Delaware Supreme Court in *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963), that “absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.” The Chancellor held that the plaintiff failed to assert facts giving the board reason to suspect Stewart of any illegal activity prior to the allegations of insider trading becoming public. Moreover, although MSO is closely identified with Stewart, she is not the corporation, and it is unreasonable to impose a duty upon the Board to monitor Stewart’s personal affairs.

The Delaware Supreme Court in *Broz v. Cellular Information Systems, Inc.*, 673 A.2d 148 (Del. 1996), articulated a balancing test to establish the usurpation of a corporate opportunity. A corporate officer may not take a business opportunity for herself if:

- (1) the corporation is financially able to exploit the opportunity;
- (2) the opportunity is within the corporation’s line of business; (3) the corporation has an interest or expectancy in the opportunity; and
- (4) by taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position [inimical] to his duties to the corporation.

Id. (Alteration in original). The Chancery Court concluded that MSO had the financial ability to sell stock to ValueAct, but decided that failure to meet the other three factors disposed of the issue. Without an interest or expectancy in the sale, the actions of Stewart and Doerr did not place them in a position inimical to their duties to MSO. Deciding otherwise, felt the Chancellor, would place directors everywhere at risk for breach of the duty of loyalty anytime they sold shares of the corporation on whose board they sit.

To excuse pre-suit demand upon the board, “there . . . [must be] . . . reasonable doubt that a majority of the Board would be disinterested or independent in making a decision on demand.” The Chancellor admonished the plaintiff for

“pleading demand futility on the basis of precious little investigation beyond perusal of the morning newspapers [Without specific allegations,] . . . failure to make demand and filing the derivative action results in a waste of the resources . . .” of all parties involved, including the court. Absent well-pled allegations, the court’s hands are tied to protect the rights of shareholders. The court noted that a more careful investigation of the facts may have led to a different outcome.

Shareholder derivative litigation requires a thorough investigation of the facts in order to survive the motion to dismiss. When investigating and drafting the complaint on behalf of a shareholder, an attorney must be careful to plead specific allegations of corporate misconduct in order to protect the client’s legal rights. Further consideration must be given when representing directors of corporations closely associated with a public persona. Advice regarding questionable personal transactions, as well as how to quell shareholder fear in the wake of Martha Stewart-like allegations, belongs on every corporate attorney’s “advice checklist.”

A majority shareholder in a member-managed LLC stands in a fiduciary relationship to the minority shareholders, owing duties in good faith both to the LLC and other members. *Anderson v. Wilder*, No. E2003-00460-COA-R3-CV, 2003 Tenn. App. LEXIS 819, 2003 WL 22768666 (Tenn. Ct. App. Nov. 21, 2003).

By Michael A. Wall

The Tennessee Court of Appeals held that a majority shareholder of an LLC owed a fiduciary duty to the minority shareholders. The court of appeals decision vacated and remanded the Circuit Court’s finding that granted the defendant majority members summary judgment against the plaintiff minority shareholders. The plaintiff minority shareholders were expelled from the member-managed LLC by a vote by the defendant majority shareholders and the plaintiffs alleged that the defendants’ actions violated their fiduciary duty and duty of good faith. The court found the fiduciary duty existed in the LLC after squaring the plaintiffs’ claims with the Tennessee Limited Liability Company Act, T.C.A. § 48-201-101 *et seq.* (the “LLC Act”), the Tennessee Revised Uniform Partnership Act, and Tennessee’s common law precedent (most notably in *McGee v. Best*, 106 S.W.3d 48 (Tenn. Ct. App. 2002) and *Nelson v. Martin*, 958 S.W.2d 643 (Tenn. 1997)).

The parties involved in *Anderson v. Wilder* created FuturePoint Administrative Services, LLC on January 1, 2000, and executed its operating agreement. The shareholders set up the company as a member-managed LLC and divided its

ownership rights into “ownership units.” The shareholders successfully managed the company for twenty-one months, and as a result, the members received two offers from third parties to purchase ownership units at \$250.00 per unit on September 10, 2001. In response to these offers, one of the defendants developed a scheme to expel 30 percent of the members and buy their shares at the operating agreement price of \$150.00 and sell them for \$250.00 per unit to one of the third-party offerors.

The defendant gathered a 53 percent majority of members together and held a meeting without the plaintiffs where the majority decided to expel the plaintiffs and purchase their respective ownership units at \$150.00 each. The meeting complied with the LLC’s operating agreement and the LLC Act because the members present held a majority of the company’s ownership shares and owned governance rights with voting power equal to the voting power that would be required to take the same action at a meeting where all members were present. However, the majority shareholders’ actions did not comport with the LLC Act because it requires that the members discharge all of their duties in “good faith.”

The minority shareholders sued, asserting that the defendants, as majority shareholders, breached their fiduciary duty and duty of good faith when the defendants carried out their September 14, 2001; the majority made an easy profit at the expense of the minority by selling the minority’s forfeited ownership units bought at a low price of \$150.00 to a third party at a higher price of \$250.00 per unit on October 11, 2001. The majority defended their actions because they complied with the literal terms of the LLC’s operating agreement.

The defendants also asserted that they did not owe a fiduciary duty to the minority members because the company is an LLC (a “creature of statute”) and the LLC Act does not impress a fiduciary duty upon majority shareholders to a minority in an LLC. The defendants cited *McGee v. Best* in support of their argument. In *Best*, the Tennessee Court of Appeals interpreted the LLC Act to only require members of a member-managed LLC to adhere to a fiduciary duty to the LLC itself and not to other individual members. The statute, and its language in question, states “[a] member of a member-managed LLC shall discharge such member’s duties . . . including *all duties* . . . in good faith . . .” Tenn. Code Ann. § 48-240-102(b) (2004) (emphasis added).

Since a typical LLC is a hybrid of partnership and corporation law, the court analyzed Tennessee’s partnership and business corporation statutes and common law to determine whether a fiduciary duty existed amongst LLC members. Turning first to corporate law because the defendants cited *Best*, the court addressed the

Tennessee Supreme Court's holding in *Nelson v. Martin*. *Nelson* found that the majority shareholders of a corporation owe a fiduciary duty to the minority shareholders. *See Nelson*, 958 S.W.2d at 647 (Tenn. 1997). The *Nelson* holding illustrates precisely how Tennessee courts are willing to find that majority shareholders owe fiduciary duties to minority shareholders as a matter of common law even though the governing statute, in this case, the Tennessee Business Corporation Act (T.C.A. § 48-11-101 *et seq.*) mentions nothing about any fiduciary duty owed by majority shareholders to minority shareholders. The court, in a brief discussion, essentially limited *Best* to its facts regarding employment disputes and followed the Tennessee Supreme Court's holding in *Nelson*.

Next, and in contrast to the court's discussion in *Best* a year earlier, the court considered member-managed LLCs to be governed more like partnerships than conventional corporations. Thus, the court analyzed the state's partnership laws. The court found another well-established rule, this time opined by the Tennessee Court of Appeals in *Lightfoot v. Hardaway*, 751 S.W.2d 844, 849 (Tenn. Ct. App. 1988). *Lightfoot* found that all partners, not just the majority, owe each other a fiduciary duty. The court determined that the Revised Uniform Partnership Act reinforced these fiduciary duties. *See* Tenn. Code Ann. § 61-1-404 (2003) (partners owe each other a duty of loyalty and the duty of care and they shall discharge their duties with the obligation of good faith and fair dealing).

After analyzing the corporate and partnership statutory and common law precedent in Tennessee, the court held that the majority shareholders in a member-managed LLC stood in a fiduciary relationship and owed a fiduciary duty to the minority shareholders. In reaching this conclusion, the court determined that the plaintiffs' asserted fiduciary duty did not conflict with the LLC Act as it is consistent with the statutory requirement that each LLC member discharge all of his or her duties in "good faith." The court also determined that the holding logically follows the corporate and partnership precedent in Tennessee. The court concluded that even if the LLC Act did not expressly mention a fiduciary duty, it would still be within the legislature's intent if it applied the common law good faith and fair dealing requirement on the majority shareholders, which in essence prescribes a fiduciary duty on the majority to the minority.

Anderson illustrates that Tennessee courts hold member-managed LLCs to be more comparable to general partnerships than corporations when the issue concerns fiduciary duties. This new view of member-managed LLCs provides a much stronger measure of protection for an LLC's minority members and allows such minority plaintiffs to escape the harshness of *Best*. In the same spirit, this holding

waves a caution flag for all majority shareholder members of LLCs in Tennessee. Majority members must be sure to couch all of their business transactions within the common law good faith and fair dealing.

COMMERCIAL

The rule of “priority of jurisdiction” applies to actions pending in different Ohio courts that have concurrent jurisdiction; it does not apply when an action is pending in another state. *Long v. Grill*, 799 N.E.2d 642 (Ohio App. 2003).

By Mike Baisley

The Court of Appeals for the Tenth District of Ohio recently held that a California-based seller of vending machines had sufficient “minimum contacts” with Ohio to satisfy due process concerns and to support the exercise of personal jurisdiction over the seller and its president, where both the seller and its president had a continuous business relationship with an Ohio-situated buyer over a period of three months, during which the seller and its president repeatedly supplied the buyer with vending equipment for shipment to locations in Ohio, and where many of the allegedly defective machines were located in Ohio.

More importantly, the court also held that the rule of “priority of jurisdiction” only applies to actions pending in different Ohio courts that have concurrent jurisdiction, and it does not apply when an action is pending in another state. Therefore, as in this case, even where a California court had properly invoked jurisdiction before the Ohio trial court did, the pendency of the action in California, involving the same subject matter and parties, did not preclude the Ohio court’s exercise of jurisdiction to adjudicate the buyer’s action for fraud and breach of contract.

The plaintiff, a sole proprietor and resident of Ohio, entered into a series of purchase contracts with defendant corporation and its president. The defendant corporation is incorporated and has its principal place of business in California, and its president also resides in California. The contracts were for the purchase of numerous toy vending machines and for licenses to place the vending equipment at various retail establishments in five different states. The plaintiff alleged that: 1) the vending equipment he received was defective; and 2) that the seller and its president breached various contractual agreements and personal promises regarding both the exclusivity of the placement licenses and the quality of the vending equipment.

The defendants filed a motion to dismiss, asserting that the trial court did not have personal jurisdiction over the nonresident defendants because they did not have sufficient minimum contacts with Ohio to subject them to Ohio's long-arm jurisdiction. In the alternative, the defendants also invoked the rule of "priority of jurisdiction," asserting that the Ohio court did not have jurisdiction because the defendants had already filed a similar suit against the plaintiff in California.

The trial court sustained the defendants' motion on both grounds, finding that: 1) the defendants did not have sufficient "minimum contacts" with Ohio; and 2) pursuant to the rule of "priority of jurisdiction," the Ohio trial court was precluded from asserting jurisdiction over the instant lawsuit because the California court had already invoked jurisdiction over the matter.

The Court of Appeals reversed and remanded, holding that: 1) even though the defendants did not travel to Ohio or solicit any business in Ohio, they nonetheless "transacted business" in Ohio and therefore established sufficient minimum contacts to subject themselves to Ohio jurisdiction; and 2) the rule of "priority of jurisdiction" only applies to actions pending in different Ohio courts that have concurrent jurisdiction, and it does not apply when an action is pending in another state.

With regard to "priority of jurisdiction," the Court of Appeals held that the trial court was essentially limited to two options in this case. First, the trial court could grant a stay of the Ohio action, pending the California court's resolution of its action; or secondly, the trial court could simply maintain the action in Ohio.

Practitioners should take note that, pursuant to the Court of Appeals' decision, it is now clear that a foreign defendant in an Ohio action will not prevail on a motion to dismiss premised on insufficient contacts, where the defendant has "transacted business" in Ohio. More importantly, it is also clear that the rule of "priority of jurisdiction" only applies to actions pending in different Ohio courts, and does not apply when an action is pending in another state. Therefore, a defendant in an Ohio action will not prevail on a motion to dismiss because of "priority of jurisdiction," where a similar action involving the same parties is pending in a sister state.

A state seeking to restrict foreign trade in the form of a “Buy American” statute may have to seek Congressional approval. *Antilles Cement Corp. v. Calderon*, 288 F. Supp. 2d 187 (D. P.R. 2003).

By Nicholas J. Chase

The United States District Court for the District of Puerto Rico held that, absent express Congressional approval, state legislation that violates the Dormant Foreign Commerce Clause is unconstitutional. Furthermore, the court refused to extend the market participant exception to the foreign commerce context.

In 1985, the Puerto Rico Legislature (“Legislature”) enacted “Law 109” which required that all construction projects funded by either the United States Government or the Government of Puerto Rico use cement manufactured in Puerto Rico. Sixteen years later, in 2001, the Legislature passed “Law 132” which required that all foreign bags of cement contain a warning statement. The statement was to inform the user of the cement that use of foreign cement on any government-funded project violated both federal and Puerto Rico law. The Legislature’s stated goal was to improve the Puerto Rico economy by creating domestic jobs and building local capital.

Antilles Cement Corporation (“Antilles”) is a foreign company who imports and distributes foreign cement in Puerto Rico. Antilles challenged Laws 109 and 132, alleging that the two laws violated the Dormant Foreign Commerce Clause and that Law 109 conflicted with the Surface Transportation Act of 1982 thereby violating the Supremacy Clause of the United States Constitution. The District Court addressed these claims in Antilles’ motion for summary judgment.

While the District Court found that Antilles had suffered palpable economic harm, a basis for standing, the court noted that Antilles only had standing where there could be a showing of injury in fact. Antilles, as a foreign corporation, could only show injury in fact arising from Laws 109 and 132 as to how they affected foreign commerce. Thus, the District Court limited their inquiry to the aspects of Laws 109 and 132 that affected foreign commerce. Furthermore, the court found that any conflict with the Supremacy Clause could only occur within the ambit of domestic commerce.

Turning its analysis to the impact of Laws 109 and 132 on foreign commerce, the court noted that a state (including United States territories) acting as a market participant is not subject to the Commerce Clause, however, the court recognized

that state interference with foreign commerce deserves a higher level of scrutiny than does state interference with domestic commerce. Interference with foreign commerce warrants this higher level of scrutiny because of the potential effect on United States foreign policy. Relying on substantial precedent, the court found that the stated interest of the legislature was not a compelling state interest and declared unenforceable any language contained in Laws 109 and 132 that interfered with foreign commerce.

In reaching this decision, the court noted that the Third Circuit has extended the market participant exception to the foreign commerce context. This extension of the market participant exception enabled legislatures in the Third Circuit to enact certain “Buy American” statutes. Though the court may not have intended to do so, it has made it virtually impossible for Puerto Rico to enact similar legislation. The fundamental problem with Laws 109 and 132 was that they were over-restrictive. Despite the District Court’s declaration that they would not examine the domestic ramifications of the statutes, they paid particular attention to the fact that the statutes forbade the use of cement from other states. Where the court indicated that other “Buy American” statutes passed Constitutional muster, they created a strict scrutiny test that makes the implementation of such statutes exceedingly difficult. Regardless of what influenced their decision, there is no market participant exception to the foreign commerce clause in the District of Puerto Rico. Thus, enacting a “Buy Domestic” or “Buy American” clause that passes the District Court of Puerto Rico’s constitutional test may require skillful draftsmanship.

Charitable organizations given greater latitude to solicit funds when faced with state “do-not-call” registry. *Fraternal Order of Police v. Stenehjem*, 287 F. Supp. 2d 1023 (D.N.D. 2003).

By Derrick A. Free

Applying First Amendment precedent, the District Court for the District of North Dakota held that a recently enacted statute passed by the North Dakota legislature establishing a “do-not-call” registry and disallowing calls from charitable organizations that use professional fundraisers to solicit funds was too broad, and therefore, unconstitutional.

During the 2003 North Dakota Legislative Session, the legislature passed a law that prohibited “telephone solicitors” from calling North Dakota residents who registered for the state “do-not-call” registry. However, certain categories of calls

were not included in the defined term “telephone solicitors.” Exempted from inclusion in “telephone solicitors” were calls made by volunteers or employees of charitable organizations, provided that these volunteers or employees identified their first and last name, address, and telephone number of their charitable organization when they called potential donors.

Plaintiffs, the Fraternal Order of Police (North Dakota State Lodge) and the Veterans of Foreign Wars (Department of North Dakota) are both nonprofit corporations with tax-exempt status under Internal Revenue Code Section 501(c)(8). However, since these two charitable organizations did not use volunteers or employees to solicit donations via the telephone and instead used paid fundraisers, their calls were classified as being made by “telephone solicitors” and they were not allowed to call residents that had signed up for the “do-not-call” list.

The district court held that the provisions of the law that applied to charitable organizations were subject to strict scrutiny and failed to meet federal constitutional standards. The court also examined the commercial speech provisions because of the facial challenge the Plaintiffs brought against the entire law. Since commercial speech is not afforded the same protection as charitable speech, the two sections were deemed severable and the charitable portion of the law was rendered invalid while upholding the commercial speech provisions as constitutional, leaving those provisions intact.

The district court noted that the law at issue was content-based as applied to charitable organizations. Since the law was deemed content-based, it was presumptively invalid and could only withstand constitutional challenge if it met the heightened standard applied to charitable solicitations as set out in *Sec’y of State of Maryland v. Joseph H. Munson Co.*, 467 U.S. 947 (1984) and *Vill. of Schaumber v. Citizens for a Better Env’t*, 444 U.S. 618 (1980). A court must determine whether the statute constitutes a direct and substantial limitation on free speech. If it does, then the law will only be upheld if (1) it serves a sufficiently strong, subordinating interest that the government is entitled to protect, and (2) it is narrowly drawn to serve that interest without unnecessarily interfering with First Amendment freedoms.

The court held that while the privacy interest that the government was entitled to protect was sufficiently strong, the law was not narrowly tailored enough to satisfy the second prong of the test. Using a broad brush instead of a fine scalpel, the law could easily interfere with First Amendment freedoms.

With the ever increasing popularity of “do-not-call” lists being instituted across many states, this case serves as a big win for charitable organizations who hire professional solicitors. While the commercial speech provisions were upheld, the heightened standard used to gauge charitable speech saved the day. At least for now, charitable organizations may continue to use not only volunteers and employees, but also professionals to help them fight for dollars in the tight market for charitable contributions.

CONTRACTS

Was the September 11 World Trade Center attack one occurrence or two? Does it matter? It does to Silverstein Properties, Inc. and its insurers who could be responsible for either \$3.5 or \$7 billion in insurance coverage. *World Trade Ctr. Prop., L.L.C. v. Hartford Fire Ins. Co.*, 345 F.3d 154 (2d Cir. 2003).

By Nathaniel A. Earle

Applying New York law, the U.S. Court of Appeals for the Second Circuit affirmed the district court’s ruling that the events of September 11, 2001, resulting in the destruction of the World Trade Center (“WTC”), constituted only one “occurrence” as a matter of law according to the terms of the temporary insurance binder in effect on that tragic date.

In the spring of 2001, Silverstein Properties, Inc., along with several related entities (“Silverstein”), was the successful bidder on a 99-year lease of the WTC property from the Port Authority of New York and New Jersey. The lease required Silverstein to obtain first-party insurance on the WTC property. Silverstein engaged a broker, Willis of New York (“Willis”), to set up a multi-layered insurance program. The program consisted of one layer of primary insurance with eleven excess insurance layers for a total coverage of approximately \$3.5 billion, payable on a “per occurrence” basis.

During the process of soliciting participants for the insurance program, Willis provided prospective insurers with a Property Underwriting Submission containing relevant information about the WTC property along with the coverage its client desired. In addition, Willis distributed a specimen copy of its own “broker” form (the “WilProp” form), which it offered as a “starting point” for negotiations. The WilProp form defined an “occurrence” as:

all losses or damages that are attributable directly or indirectly to one cause or to one series of similar causes. All such losses will be added together and the total amount of such losses will be treated as one occurrence irrespective of the period of time or area over which such losses occur.

While each insurer had bound coverage in various layers of the insurance program well before September 11, no insurer had issued a final policy as of that date. This action arose when one insurer filed for a judicial declaration that the damage to the WTC constituted only one insurance loss under the terms of its binder. The insurers moved for summary judgment on the basis of the definition of “occurrence” contained in the WilProp document.

In their appeal from the district court’s grant of summary judgment in favor of the excess insurers, Silverstein argued that the definition of “occurrence” under the binder was ambiguous. Silverstein rested its argument on the assertion that each excess insurer had agreed to “follow the form” of a “lead insurer,” Travelers Insurance Company (“Travelers”), and had thereby incorporated into its binder the language of the standard Travelers policy, not that of the WilProp form. According to Silverstein, unlike the WilProp form, the Travelers form left the term “occurrence” undefined, rendering the Travelers form ambiguous and therefore an improper candidate for summary judgment.

New York courts generally look to two factors to determine the contents of a binder. First, the court will examine the specific terms contained in the binder or incorporated by reference. Then, and only to the extent necessary to fill in the gaps, the court will take into account the terms contained in the insurer’s typical policy currently in use or, if necessary, those required by statute. As with contracts generally, the court’s focus is on what the parties intended to incorporate into the binder. Thus, the court will give special weight to “any policy form that was exchanged in the process of negotiating the binder, together with any express modifications to that form,” since this information “is likely the most reliable manifestation of the terms by which the parties intended to be bound”

The Second Circuit carefully reviewed the pre-binder negotiations between the broker and each excess insurer. On the basis of this analysis, the court rejected the possibility that any insurer had bound coverage on the basis of the Travelers form. The WilProp form (furnished by the broker), not the Travelers form, had formed the basis of the parties’ pre-binder negotiations. While Silverstein introduced evidence that the excess insurers had agreed to follow the Travelers form in issuing

their final policies, the question of what the final policy would have looked like was deemed legally irrelevant since no policy had been issued prior to September 11. While an excess insurer might indeed agree voluntarily to bind itself to another insurer's policy form, the law will not impose liability on the basis of another insurer's policy form that has not been issued and, therefore, that the excess insurer has never had the opportunity to review. Thus, the court concluded as a matter of law that the insurers had bound coverage on the basis of the WilProp form.

Having concluded that the language in the WilProp form was controlling, the court proceeded to analyze that form's definition of "occurrence," and held that, as a matter of law, the damage caused on September 11 was the result of one occurrence, entitling the Silverstein Parties to no more than a single policy limit on each of the insurers' policies.

World Trade Center Properties illustrates the importance of maintaining a clear understanding about the terms of the binder agreement. While binders are often regarded as mere formalities or place holders, their terms will become controlling if the event insured against occurs before a final policy is issued. While the courts, if necessary, will imply the terms of a binder from extrinsic sources, such as pre-binder negotiations, this result can be avoided by the exercise of simple foresight. Before binding, be careful to have the other party agree clearly and in writing to the document or other understanding that forms the basis of the binder agreement so that your client will be protected in any subsequent dispute.

Innovative stretches in insurance law snap in 2003 – contract interpretations continue to govern the often-litigated coverage issues (a three case analysis). *Cal. Auto. Ins. Co. v. Hogan*, 5 Cal. Rptr. 3d 761 (Cal. Ct. App. 2003); *Westfield Ins. Co. v. Galatis*, 797 N.E.2d 1256 (Ohio 2003); *Amex Assurance Co. v. Allstate Ins. Co.*, 5 Cal. Rptr. 3d 744 (Cal Ct. App. 2003).

By Hannah M. Kiser

Fatal Road Rage Beating Insured?

Cal. Auto. Ins. Co. v. Hogan, 5 Cal. Rptr. 3d 761 (Cal. Ct. App. 2003).

After uninsured motorist Lionetti collided with insured motorist Hogan, both men exited their vehicles, presumably to survey the damage. After Hogan inquired as to Lionetti's well being, he then asked whether Lionetti was insured. At this point, Lionetti became enraged and punched Hogan. Hogan hit his head on the

street as he fell to the ground. Although Hogan survived the attack, he died in the hospital five days later.

Following Hogan's death and Lionetti's incarceration for manslaughter, the estate attempted to recover for Hogan's injuries under the uninsured motorist provision of his automobile insurance policy. The California Court of Appeal for the Second District, Division 2, held that the insurer was not liable where an "intervening intentional act breaks the causal connection between the use of an uninsured vehicle and an injury [to the insured]." Thus, in cases where injury is intentionally inflicted upon the insured, recovery under an uninsured motorist provision is limited to circumstances in which the uninsured vehicle itself is intentionally used to cause harm. This decision determines insurance recovery under uninsured motorist provisions based on a direct causation test and prevents such insurance provisions from being used as general liability insurance.

Expanding CGL Coverage to Non-Employees – Was This Really Covered?

Westfield Ins. Co. v. Galatis, 797 N.E.2d 1256 (Ohio 2003).

Jason Galatis died as a result of an uninsured driver's negligent operation of the motor vehicle in which both were riding. After Galatis's estate settled its uninsured motorist claim against the parents' insurer, the estate brought claims against both parent's employer's commercial insurers. The father's insurer settled; however, the mother's insurer litigated the case, and the insurance issue was certified to the Ohio Supreme Court.

Ohio law allowed recovery under commercial auto policies by employees of the corporation regardless of whether the circumstances causing injury occurred within the scope of the employment. *Scott-Pontzer v. Liberty Mut. Fire Ins. Co.*, 710 N.E.2d 1116 (Ohio 1999). This rule was based upon reasoning that insuring a corporation for general liability was effectively insuring the employees of that corporation, due to the inability of the corporation to "occupy an automobile." *Id.* Subsequently, commercial insurance coverage was extended to cover a "resident relative of an employee of a corporate policyholder." *Ezawa v. Yasuda Fire & Marine Ins. Co. of Am.*, 715 N.E.2d 1142 (Ohio 1999). When the Galatis estate tried to recover under this extension, the Ohio Supreme Court took advantage of the opportunity to reverse this much criticized approach by limiting recovery under commercial insurance contracts to employees who are within the scope of employment. Despite multiple dissenting opinions, Ohio has now fallen into line with the majority of states that have decided this issue against coverage.

Off-Duty Plumbers . . . the New Professional Service Provider?

Amex Assurance Co. v. Allstate Ins. Co., 5 Cal. Rptr. 3d 744 (Cal Ct. App. 2003).

After plumber Cox gratuitously installed a propane water heater in a friend's home, the home burned to the ground. When the friend sought coverage from her homeowner's insurance policy, the insurer, Amex Assurance, denied coverage and asserted that Cox was negligent in installing the water heater and that this negligence caused the fire. In the friend's settlement agreement with Amex Assurance, Amex acquired the friend's right to sue third parties. Subsequently, Amex sued Cox who then failed to show up for judicial proceedings on more than one occasion. After a default judgment was entered against him, Amex attempted to recover from Cox's homeowner's insurance carrier, Allstate Insurance Company, which is the subject of the current case.

This policy permitted recovery with an exception for "professional services [] and damages for any premises but the insured premises." The court then expansively defined a professional service as "an activity done for remuneration." Thus, even though Cox did not receive payment for his installation of the propane water heater, his admission that he completed the work hoping to be compensated proved decisive, and Amex Assurance was denied recovery under Cox's policy. In this case, the realistic approach adopted by the court in expanding the meaning of professional services beyond learned professions will likely increase the number of cases in which recovery is denied if a similar provision is found in the homeowner's insurance policy.

COPYRIGHT

Full federal copyright protection hinges on the law's "originality standard;" failing to meet it could entirely prohibit or only allow "thin" protection for the applicant. *Satava v. Lowry*, 323 F.3d 805 (9th Cir. 2003).

By Daniel R. Goodge

Few artists are able to survive financially by selling only original pieces of their work. As such, many artists must rely on the sale of duplicates of their original pieces to generate remainder income. In many cases, federal copyright protection helps to buoy the price of such duplicates. However, as is demonstrated in *Satava v. Lowry*, 323 F.3d 805 (9th Cir. 2003), where a court holds that a piece of artwork

lacks originality, the protection afforded it by federal copyright law is inconsequential at best.

In *Satava v. Lowry*, the court faced the issue of whether “glass-in-glass sculptures of jellyfish” are protected under federal copyright law. The plaintiff, Richard Satava, inspired by an aquarium exhibit, had created a realistic jellyfish sculpture that appeared to float in a mold of clear glass.¹ Between 1990 and 2002, Satava developed a lucrative business, selling hundreds of similar jellyfish sculptures every month. In an attempt to protect his sculptures from imitation by other glass artists, Satava registered several of his works with the Register of Copyrights.

Satava arose after the defendant, Christopher Lowry, having personally observed one of Satava’s sculptures, began to make and sell similar glass-in-glass jellyfish sculptures. Seeking to enjoin Lowry from making imitation sculptures, Satava filed suit against Lowry accusing him of copyright infringement. Satava received a preliminary injunction against Lowry from the United States District Court for the Eastern District of California.

On appeal, the Ninth Circuit Court of Appeals stated that while copyright protection is available for certain works of art, the types of artwork protected and the scope of those protections are less than infinite, and the “expression must be ‘original.’” This “originality standard” is “low” but not “negligible.” “Objective ‘facts’ and ideas are not copyrightable” and “expressions that are standard, stock, or common to a particular subject matter or medium” are not either.² However, the court recognized, a “combination of unprotected elements may qualify for copyright protection.”

Applying these standards, the court found that Satava’s jellyfish sculptures were not original because his sculptures closely simulated real jellyfish in color, anatomical characteristics, and vertical swim pattern. The court further stated that Satava’s jellyfish sculptures had some copyrightable qualities such as the “distinctive curls or particular tendrils; the arrangement of certain hues; and the unique shape of the jellyfishes’ bells.” However, these qualities supported only a “‘thin’ copyright,

¹ Mr. Satava described his sculptures as “vertically oriented, colorful, fanciful jellyfish with tendril-like tentacles and a rounded bell encased in an outer layer of rounded clear glass that is bulbous at the top and tapering toward the bottom to form roughly a bullet shape”

² The court noted that in *Aliotti v. R. Dakin & Co.*, 831 F.2d 898, 901 (9th Cir.1987), it had denied copyright protection to a stuffed tyrannosaurus rex toy posed with its mouth open because a tyrannosaurus rex is “commonly pictured with its mouth open.”

which protects against only virtually identical copying.” Finally, while it recognized that the underlying public policy basis for copyright protection of artwork was to encourage artistic expression, the court stated that no artist is to receive sole financial benefit from what is rightly part of the public domain and reversed the district court’s grant of a preliminary injunction.

In sum, an artist may be the first to depict a certain subject in a particular medium, yet, if that piece of artwork fails to satisfy the “originality standard,” it may not receive federal copyright protection or, if protected, this protection may be “thin” or minimal at best.

INTELLECTUAL PROPERTY

Holders of drug patents may bring inducement of infringement actions against chemical manufacturing and distributing companies when they assist generic drug producers. *SmithKline Beecham Corp. v. Geneva Pharmaceuticals, Inc.*, 287 F. Supp. 2d 576 (E.D. Pa. 2002).

By Emily S. Kaderly

A plaintiff that brings a patent infringement action against a generic drug producer may also bring an action for inducement of infringement against a party who provides chemicals, information, and technical assistance to the alleged infringer. Although a generic drug producer actually submits the drug application, a party who aids the generic drug producer in preparing its drug application may be subject to an infringement action brought by a patent-holding drug producer.

In *SmithKline Beecham Corp. v. Geneva Pharmaceuticals, Inc.*, plaintiff SmithKline brought a patent infringement action against defendants Geneva Pharmaceuticals, Inc. (“Geneva”) and Zenith Goldline Pharmaceuticals, Inc. (“Zenith”), two generic drug manufacturers. SmithKline owns a series of patents on the widely-prescribed anti-depressant Paxil. Geneva and Zenith submitted Abbreviated New Drug Applications (“ANDAs”) to the Food and Drug Administration seeking approval to market a generic form of Paxil.

The 1984 Drug Price Competition and Patent Term Restoration Act (the “Drug Act”) requires that generic drug manufacturers applying for ANDAs also submit certifications which confirm that applicable patents relevant to the applications are “invalid or will not be infringed upon by the manufacture, use or sale of the new drug for which the ANDA is submitted.”

Upon learning of Geneva and Zenith's ANDA applications, SmithKline filed a lawsuit alleging infringement of several Paxil-related patents. SmithKline then sought to amend their complaint to add Sumika Fine Chemicals Co., Inc. ("Sumika"), a chemical manufacturing and distribution company. SmithKline alleged that Sumika provided chemicals, information, and technical assistance to Geneva and Zenith which formed the basis of the generic drug manufacturers' ANDAs. SmithKline alleged that Sumika was aware of the existing patents and that Sumika should be liable because it submitted reports with the ANDAs and would make and sell the generic medication upon approval of the ANDAs.

SmithKline insisted that Sumika's actions amounted to infringement and inducement of infringement and sought to add Sumika as a defendant in the action. Geneva and Zenith opposed SmithKline's motions for leave to amend arguing that Sumika could not be held liable for infringement, making any such amendments futile. In reviewing the motions of the parties, the court noted that the standard for granting leave to amend was a liberal one. However, it recognized that leave to amend can be denied if an amendment would be futile and would fail to state a claim for which relief could be granted. After reviewing the proposed claims against Sumika, the court found that enough evidence existed to allow SmithKline to amend its complaint to include an inducement of infringement claim against Sumika, but not a direct infringement claim.

In its analysis, the court first reviewed the statutory provisions of the Drug Act. The court found that the Drug Act allows manufacturers to make, use, or sell a patented invention for purposes related to development and submission of ANDAs. However, the Drug Act also provides safeguards against patent infringement by prohibiting applications of ANDAs if the submitting party intends to manufacture, use, or sell the drug before the expiration of applicable patents. Anyone violating these safeguards may be subject to injunctive relief, damages, and a delay in ANDA approval.

In analyzing SmithKline's direct infringement allegation, the court found that the specific language of the Drug Act made such a claim applicable only to parties actually filing ANDA applications. Therefore, the court found that a claim against Sumika for direct infringement was futile. However, the court did see a basis for a claim of inducement of infringement against Sumika. The court referenced several actions that supported SmithKline's claim such as Sumika's involvement in the preparations of Geneva and Zenith's ANDAs and its active collaboration with the

generic drug manufacturers. The court then allowed SmithKline to amend its complaint to allege an inducement of infringement claim against Sumika.

The decision in *SmithKline Beecham Corp.* supports the proposition that the holder of a drug patent may bring an inducement of infringement action against a company who collaborates with a generic drug manufacturer on an ANDA submission. The patent holder may not, however, have a viable claim for direct infringement.

TAX

Sales tax credits are only available to the entity who originally paid the tax and not to the subsequent buyer of the entity that serviced the accounts. *Hollingsworth, Inc. v. Johnson*, 2003 Tenn. App. Lexis 799, 2003 WL 22668849, Tenn. Ct. App. (Nov. 12, 2003).

By Anthony M. Caldwell

Interpreting the plain meaning of Tennessee Code Annotated Section 67-6-507(e)(1), providing for bad debt tax credits, the Tennessee Court of Appeals held that sales tax credits under this statute are only available to the entity who paid the tax.

Long Health Enterprises, Inc. (“Long Health”) operated health clubs. An individual wanting to become a health club member would sign a membership contract with Long Health, make a down payment, and pay monthly dues. Long Health remitted all state and local taxes due on the membership contracts to the Department of Revenue (“Department”) upon signature of the individual contracts.

Later, Long Health filed for Chapter 11 bankruptcy protection and Hollingsworth, Inc. (“Hollingsworth”) acquired the assets of Long Health including the health clubs and the associated memberships from the Long Health estate.

Hollingsworth determined that certain assumed memberships were bad debts; as such, it began taking bad debt credits on its Tennessee State and Local Sales and Use Tax Returns. The Department denied these credits and Hollingsworth challenged that ruling in the Chancery Court for Anderson County.

The Chancery court found that “the transfer of Long Health’s assets to Hollingsworth during the bankruptcy proceeding included transfer of the right to

receive the bad debt tax credits upon default membership.” The court of appeals, however, reversed. Using recognized rules of statutory construction, the court of appeals assigned the natural and ordinary meaning of the statutory language under Tennessee Code Annotated Section 67-6-507(e)(1), which prescribes that sales tax credits are only available to the entity who paid the tax. The court found that “[t]his language is unambiguous and cannot reasonably be construed to include the assignees of [entities] who have paid the sales tax.”

The decision highlights the importance of careful due diligence, consideration, and planning in the process of asset acquisition and valuation. Long Health was the only entity that could appropriately take these sales tax credits for the membership contracts. Thus, if Hollingsworth wanted the benefit of these credits, it either had to structure its acquisition as an acquisition of Long Health itself, rather than its assets, or ask for a reduction in the sale price of Long Health to compensate for the inability to take the credits relating to bad debts.

However, hope may be on the horizon for those entities in Hollingsworth’s situation. As described earlier, the court of appeals heavily focused on the following language of Tennessee Code Annotated Section 67-6-507(e)(1):

A *dealer* who has paid the tax imposed by this chapter on any sale as defined in § 67-6-102 may take credit in any return filed under the provisions of this chapter for the tax paid by the *dealer* on the unpaid balance due on accounts which, during the period covered by the current return, have been found to be worthless and are actually charged off for federal income tax purposes. (emphasis added).

Hollingsworth was not the “dealer” who paid the sales tax; as such, Hollingsworth may not take the sales tax credits related to subsequent bad debt accounts. The court of appeals interpreted this statute similarly in *Suntrust Bank, Nashville v. Johnson*, 46 S.W.3d 216 (Tenn. Ct. App. 2000), and this interpretation is a fair reading of the statute as written at the time when both *Suntrust* and *Hollingsworth* were decided.

All of this may change with a 2003 Amendment, which will become effective July 1, 2004. The beginning of Tennessee Code Annotated Section 67-6-507(e) will read as follows: “A deduction from taxable sales shall be allowed for bad debts *arising from a sale on which the tax imposed by this chapter was paid.*” (emphasis added). This amended version removes any discussion of “dealer” and allows sales tax credit from bad debts related to earlier sales, irrespective of what

entity paid the original sales tax. Thus, entities in Hollingsworth's dilemma will be in a much stronger position after July 1, 2004.

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