CASE COMMENTARIES

ANTITRUST

Plaintiffs must allege facts that adequately define the relevant product and geographic market in order to state a claim for which relief may be granted under the Sherman Act. *Cupp v. Alberto-Culver USA, Inc.*, 310 F. Supp. 2d 963 (W.D. Tenn. 2004).

By Joseph Lodato

A complaint in an antitrust suit must adequately define the relevant markets in its allegations in order to state a claim for relief under §§ 1 and 2 of the Sherman Act and § 7 of the Clayton Act.

The plaintiff in *Cupp* operated a full-service hair salon. Without prior notice, BSG, one of the plaintiff's main suppliers of hair care products, informed the plaintiff that the plaintiff's supply would be discontinued unless he signed an agreement restricting the use and resale of BSG's products. The plaintiff refused to sign the agreement. As a result, his salon was unable to obtain Paul Mitchell and Redken products and suffered severe economic losses. The plaintiff filed suit, alleging violations under §§ 1 and 2 of the Sherman Act and § 7 of the Clayton Act.

In order to state a claim in an antitrust action, a plaintiff must, under §§ 1 and 2 of the Sherman Act and § 7 of the Clayton Act, define the relevant markets. The determination of the relevant markets allows the court to assess the area of competition and whether the defendant has monopolized and had an anticompetitive effect in that market. Under the Sherman Act, a § 1 claim must show the anticompetitive effects within the relevant markets; § 2 requires a plaintiff to define the relevant markets in which the monopolization occurs. Under § 7 of the Clayton Act, the threatened monopoly must be reasonably likely to restrain commerce and substantially lessen competition within the relevant markets.

The relevant markets include both the product market and the geographic market. The product market consists of similar products available as substitutes for the defendant's product, considering the product's uses and consumer responses to the product. In assessing the geographic market, the market area in which the seller operates and on which the buyer can reasonably rely for supplies is determinative.

In *Cupp*, because the plaintiff failed to allege or establish the relevant markets involved, the plaintiff failed to state a claim for relief. His complaints, therefore, did

not survive the defendants' motions to dismiss. The court held that the plaintiff failed to define a relevant product market in any meaningful way and completely ignored the geographic market. The court further found that, had the plaintiff alleged the relevant markets, his claim under § 7 of the Clayton Act might have been otherwise sufficient to survive the 12(b)(6) motion. Without the requisite information from the plaintiff, the court was unable to determine the boundaries of the market and, in turn, assess the defendants' market power. Accordingly, the court dismissed the Clayton Act claim as well.

Cupp confirms that a plaintiff whose complaint alleges violations under either §§ 1 or 2 of the Sherman Act or § 7 of the Clayton Act must allege facts that adequately define the relevant product and geographic market in order to state a claim for which relief may be granted.

BANKRUPTCY

Federal bankruptcy courts will take action against states and establish their own payment distribution schemes. *Techs. Int'l Holdings, Inc. v. Commonwealth*, No. 99-5074, 2003 Bankr. LEXIS 1541 (Bankr. E.D. Ky. Nov. 24, 2003)

By Meredith Mallard

When no remedial relief exists, a plaintiff debtor seeking prospective injunctive relief may sue State officials who implement unlawful state practices in bankruptcy court. The State itself, however, cannot be named as a defendant in an adversary proceeding unless it waives its sovereign immunity. In *Techs. Int'l Holdings, Inc. v. Commonwealth*, the court permitted action against the defendant State officials in order to enjoin the State from disregarding the Constitution and the Bankruptcy Code.

In *Techs. Int'l Holdings, Inc.*, the plaintiffs engaged in "Corrective Action Activities," or the business of moving and transporting petroleum. The defendant Fund is a governmental agency providing financial resources to landowners who would hire the plaintiffs to remove petroleum from their underground storage tanks. In consideration for the plaintiffs' services, the landowners would assign to the plaintiffs their right to receive reimbursements from the defendant Fund.

Shortly after the plaintiffs filed for bankruptcy under Chapter 11, the defendant Commonwealth adopted an Emergency Regulation that denied reimbursements from the Fund for debtors in bankruptcy proceedings. Instead of compensating the plaintiffs, the Emergency Regulation permitted the defendant

Commonwealth to directly pay the plaintiffs' creditors, some of whom may have been unsecured. As a result, the plaintiffs were unable to pay their secured and unsecured creditors through the bankruptcy process.

The plaintiffs claimed that the Emergency Regulation violated the United States Constitution and the Bankruptcy Code and sought a preliminary injunction to enjoin the defendants from applying the Emergency Regulation. The defendants filed a motion to dismiss the plaintiffs' complaint, claiming that: (1) the Commonwealth had sovereign immunity, (2) the Fund also enjoyed sovereign immunity, (3) "the plaintiffs [had] not met the requirements of Ex Parte Young," and (4) certain of the plaintiffs' claims alleged violations by the defendants pursuant to "state constitutional rights or state laws." The court began by addressing the defendants' Motion to Dismiss.

First, the court determined whether the Commonwealth defendant "enjoy[ed] sovereign immunity [pursuant] to the Eleventh Amendment to the United States Constitution." The Supreme Court held that Congress can only abrogate state immunity when they expressly intend to do so and act "pursuant to a valid exercise of power." The "majority of courts . . . have [held] that [because] the Bankruptcy Code was not enacted pursuant to the Fourteenth Amendment," Congress does not have the power to abrogate sovereign immunity in the bankruptcy court. As a result, the court dismissed the plaintiffs' claims against the Commonwealth defendants.

Second, the court examined whether the Fund was an agency of the Commonwealth and, therefore, was also immune from suit. To determine whether an entity is an "arm of the state," the court must study "the relationship between the State and the entity," the "nature and effect of the proceeding", and "whether a money judgment against [the entity] would be enforceable against the state." The court held that it did not have enough information and would need the defendants' answer and discovery filed before determining whether the Eleventh Amendment entitled the Fund to sovereign immunity.

Third, the court confirmed the survival in the Sixth Circuit of the Ex Parte Young doctrine. Pursuant to the Fourteenth Amendment, the Young doctrine grants federal courts the power to police state activities by enjoining state officials from executing unlawful state practices. In this case, the defendant State officials were the "real, substantial parties," because the plaintiffs sought prospective injunctive relief against the application of the Emergency Regulation, as opposed to retroactive monetary damages, which would implicate the Commonwealth alone. In addition, Congress has not implemented a remedial scheme for the violation, demonstrating that Congress had no intent for alternative relief.

Finally, the court determined that the claims in the plaintiffs' complaint asserting state constitutional and statutory violations must be dismissed, as the Young doctrine does not apply to state claims. State officials enjoy sovereign immunity pursuant to the Eleventh Amendment from state law "claims brought into federal court under pendent jurisdiction".

As *Techs. Int'l Holdings, Inc.* illustrates, the federal bankruptcy courts will take action against states and establish their own payment distribution schemes. This decision reinforces the exclusive federal authority over the bankruptcy courts and commands that states yield to the federal system. Further, the Sixth Circuit declared its belief that the Bankruptcy Code has not purposefully or lawfully abrogated state immunities but emphasized that the Young doctrine permits federal bankruptcy courts in the Sixth Circuit to regulate state practices by enjoining the acts of State officials. Techs. Int'l Holdings, Inc. advises bankruptcy attorneys to pursue their federal claims against State officials, in lieu of the State, when the State has implemented and exercises unlawful practices.

Court makes the already difficult process of equitable subordination more difficult. *In re Epic Capital Corporation,* 307 B.R. 767 (D. Del. 2004).

By Patrick Woodside

Affirming the Bankruptcy Court for the District of Delaware, the District of Delaware held that this case did not warrant application of the doctrine of equitable subordination because Bank of New York, the party attempting to apply equitable subordination, failed to carry the elevated burden of proof. Equitable subordination is a remedy within the courts' general equity powers, but "is applied sparingly." Thus, even though equitable subordination is a vital part of equity jurisprudence, the party arguing for its application faces a difficult burden.

In *Epic Capital Corp.*, Bank of New York was the successor indenture trustee under the Indenture dated July 8, 1998, and later supplemented on January 7, 1999, and February 3, 1999. Pursuant to the Indenture, Epic Resorts, LLC ("Epic Resorts") and Epic Capital Corp. ("Epic Capital") issued $130 million in Senior Secured Redeemable Notes, due 2005. Highland Funds holds the majority of the Bonds. The Indenture further provided that Epic Resorts and Epic Capital would grant Bank of New York a deed of trust in the Palm Springs Resort. Palm Springs Resort occupies land administered by the United States Department of Interior, Bureau of Indian Affairs ("BIA"). Consequently, BIA approval was required to grant Bank of New York a deed of trust, but BIA approval was never obtained.

Epic Resorts Palm Springs Marquis Villas, LLC ("Epic Palm Springs"), the Epic Resorts subsidiary which operated the Palm Springs Resort, borrowed $11.5 million from USA Capital two years after closing on the Indenture. To secure the loan, Epic Palm Springs granted USA Capital a security interest virtually all its assets, including the Master Lease and time shares related to the Resort. BIA approved this security interest.

Epic Palm Springs then defaulted on its loan. Epic Resorts and Epic Capital also defaulted on their obligation to make an $8.45 million interest payment to their Bondholders, Highland Funds. Highland Funds subsequently filed involuntary bankruptcy petitions against Epic Resorts, Epic Capital, and Epic Palm Springs.

Initially, Bank of New York asserted the principal argument that the Bankruptcy Court erred in failing to equitably subordinate USA Capital's claims. Bank of New York contended that it could satisfy the three-prong test for equitable subordination, and that the Bankruptcy Court erroneously fashioned a fourth element of egregious conduct. USA Capital disagreed.

Section 510(c) of the Bankruptcy Code states that the Bankruptcy Court may, after notice and a hearing, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim under the principles of equitable subordination. Generally, three requirements must be met under the Mobile Steel test: (1) the claimant must have engaged in some type of inequitable conduct; (2) the misconduct must have resulted in injury to other creditors and conferred an unfair advantage on the claimant; and (3) equitable subordination of the claim is not inconsistent with the provisions of the Bankruptcy Code.

The District Court concluded where, as in the instant case, the respondent (USA Capital) is not an insider or fiduciary of the company, the party seeking to apply equitable subordination bears an elevated burden of proof and must show egregious conduct such as fraud, spoliation, or overreaching. Thus, the District Court concluded this case did not warrant application of the doctrine of equitable subordination. Moreover, the Court found that the conduct of USA Capital was not sufficient to rise to the level required to equitably subordinate the claim of a non-insider.

This case underscores the difficulty of satisfying the elements of equitable subordination because it is an extraordinary remedy. Moreover, the Court has grafted the fourth element, egregious conduct, onto the test when the respondent is not an insider or fiduciary of the company, which makes establishing equitable subordination more burdensome. This is also true for attorneys practicing in the

Sixth Circuit. If a transactional attorney finds their client in a similar position to USA Capital prior to consummation of the transaction, the attorney should advise her client to gain reasonable assurances and documented representations of the propriety of the transaction before continuing. Otherwise, the client may end up in a position where their claim is subordinated, thereby losing considerable funds.

BUSINESS ORGANIZATIONS

Partnership duties normally considered "unwaivable" could instead become negotiable. *Hitchcock Metal Sources, Inc., et al. v. Mulford, et al.,* No. E2003-00738-COA-R3-CV, 2004 WL 178390, 2004 Tenn. App. LEXIS 68, (Jan. 29, 2004).

By Jason Gast

A business partner's death can be a surprise to the surviving partner, especially if the survivor later learns troubling things about the partnership that were unknown while the other partner still lived. In *Hitchcock Metal Sources, Inc. v. Mulford*, the court decided if a deceased partner's actions had violated the partnership agreement. The court held that the deceased partner's actions could not have violated the partnership agreement since those actions—trading outside the partnership, though in the same business as the partnership--were outside the consideration of the partners.

Prior to participating in the partnership, John D. Mulford, Jr. bought and sold steel through his corporation, Mulford Enterprises, Inc. In 1987, Mulford and James H. Hitchcock, an experienced player in the steel industry, agreed to form a partnership. Under their oral agreement, they planned to buy and sell steel together, while splitting profits and some expenses. During their partnership, both parties also bought and sold steel outside of the partnership. Mulford acted through his pre-partnership corporation with pre-partnership clients, and Hitchcock acted through Hitchcock Metal Sources, Inc. ("HMS"), a corporation he formed after joining the partnership. Hitchcock knew that Mulford traded through his own corporation, but it is unclear if Mulford knew about HMS.

When Hitchcock died in 1995, Mrs. Hitchcock allowed Mulford to review Hitchcock's account books, which fully detailed both partnership business and non-partnership HMS business. At this point, if not before, Mulford knew that Hitchcock had occasionally traded outside the partnership through his own private corporation.

For two-and-a-half years, Mulford continued to trade steel through the partnership with Mrs. Hitchcock as his new partner, as per the partner's survivorship agreement. Mrs. Hitchcock felt that Mulford abused the partnership, and she sued. Mulford counterclaimed, alleging that Mr. Hitchcock had violated the partnership agreement for years by buying and selling steel outside of the partnership, constituting actionable self-dealing. The trial court determined that a ban on buying and selling steel outside the partnership was not contemplated when forming the partnership and that, accordingly, their agreement did not prohibit this self-dealing. In short, Hitchcock could not have violated a fiduciary duty that was not considered when creating the partnership. Mulford appealed, claiming that Hitchcock violated an inherent partnership duty by self-dealing.

The Revised Uniform Partnership Act (the Act) regulates partnerships in Tennessee. This Act establishes a duty of loyalty, which explicitly includes the duty not to compete with the partnership in partnership business. The Act does not say or imply that this duty must be activated or affirmatively established.

The appeals court agreed with the trial court that the partnership had not contemplated banning steel trades outside the partnership. Because the parties did not ban trades outside the partnership, Hitchcock did not breach a duty to trade only within the partnership.

Finally, the appeals court found that the eight years of extra-partnership trades, on both sides, reflected the parties' intent to allow such trades. The appeals court dismissed Mulford's stated ignorance of Hitchcock's extra-partnership trades. The court felt that because Mulford never complained about Hitchcock's trading after he indisputably learned of the trades, his silence indicated support for the extra-partnership trades.

The court of appeals never said that the partners had no fiduciary duty against self-dealing, nor did the court say that Hitchcock's actions were insufficiently related to the business of the partnership to trigger that duty. Instead, the court found that Hitchcock did not violate the duty because the extra-partnership trades were deemed outside of the partnership agreement. Based on this rationale, partners could mutually avoid some fiduciary duties if the duties are not addressed in the partnership agreement and are also never honored during the course of the partnership. Partnership duties normally considered "unwaivable" could instead become negotiable, thus making partnerships more customizable. Consequently, transactional attorneys should carefully consider and draft partnership duties in the partnership agreement.

Employee must prove his inability to perform a wide range of jobs in order to prevail on an ADA claim. *Carruthers v. BSA Adver., Inc.*, 357 F.3d 1213 (11th Cir. 2004).

By Elizabeth Saxton

A court will consider an employee "disabled" if his employer perceives his condition as an ADA qualifying disability, even if the employee's condition does not actually meet the ADA standard. However, the employee still needs to prove that the employer views this impairment as one that restricts him from a broad range of jobs to prevail on an ADA claim.

In *Carruthers v. BSA Adver., Inc.*, BSA employed Jean Carruthers as an art director from 1993 until 2000. On February 28, 2000, Carruthers' assigned workers' compensation physician diagnosed her with a bilateral hand strain. Accordingly, he gave her several work restrictions including one which prohibited all typing and mouse usage. Unfortunately for Carruthers, ninety percent of her work at BSA involved computer usage. Carruthers alerted her supervisor of her work restriction, and by March 5, 2000, BSA had placed an advertisement her replacement. BSA terminated Carruthers on March 8, 2000. Carruthers then filed suit against BSA alleging wrongful termination in violation of the ADA. At trial, the district court granted BSA's motion for judgment as a matter of law.

On appeal, the court followed the United States Supreme Court's recent definition of "impairment" and affirmed the district court's judgment. This definition, found in *Toyota Motor Mfg., Ky., Inc. v. Williams*, 534 U.S. 184 (2002), states that an "impairment" is a "disability" only when the impairment prevents or substantially restricts one's performance of activities "of central importance to most people's daily lives." In affirming the judgment below, the court stated that Carruthers needed to display that BSA viewed her impairment as restricting her from performing either a class of jobs or broad range of jobs at the level of an average individual with compatible training, skills, and abilities. Carruthers' inability to perform one individual job did not equate to a substantial limitation in the life activity of working. Thus, Carruthers' inability to use a keyboard and mouse constituted neither an inability to perform a broad range of jobs nor showed that BSA had such perception.

In summary, the strict definition of "disability" creates a substantial hurdle for plaintiffs to clear in establishing an ADA claim. The test is not whether an employee is unable to perform his specific job, but instead whether he is unable to

perform a wide range of jobs or his employer perceives him to be unable to perform a wide range of jobs.

In the event of a cash-out merger, shareholders of a parent corporation have the requisite financial interest to maintain a derivative action for the disgorgement of profits obtained by insiders of a corporate subsidiary under § 16(b) of the Securities Exchange Act. *DiLorenzo v. Edgar*, Civ. No. 03-841-SLR, 2004 WL 609374, 2004 U.S. Dist. LEXIS 4991 (D. Del. 2004).

By Adam Smith

In a derivative action brought under § 16(b) of the Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78p(b) (the "1934 Act"), "[a] shareholder of a parent corporation has a financial interest, albeit tenuous, in the disgorgement of profits obtained by insiders of a corporate subsidiary." This "financial interest" in the outcome of a § 16(b) suit satisfies the constitutional requirements necessary for maintaining a derivative action following the cancellation of a stockholder's shares in the parent corporation's subsidiary during a cash-out merger.

On May 12, 2003, the defendants, four directors of dELiA*s Corporation ("dELiA*s"), purchased an aggregate of 7,297,298 shares of dELiA*s common stock. The common stock of dELiA*s then was registered under the 1934 Act. Shortly thereafter, in a merger with an indirect wholly owned subsidiary of Alloy, Inc. ("Alloy"), the defendants' recently purchased shares were converted into cast at a significant premium. However, before the merger closed on September 7, 2003, the plaintiff, a stockholder in dELiA*s and Alloy, instituted a derivative action alleging that the defendants obtained short-swing profits in violation of § 16(b) of the 1934 Act. Although the plaintiff's shares in dELiA*s were cashed-out and canceled in the merger, the plaintiff preserved his interest in Alloy throughout the course of litigation. In response to the complaint, the defendants filed a motion to dismiss claiming that the plaintiff lacked standing to maintain the suit because (1) he was no longer a dELiA*s stockholder and (2) he did not satisfy Federal Rule of Civil Procedure 23.1's demand requirements prior to commencing the suit.

For stockholders to bring a derivative action on behalf of a corporation under § 16(b), they must satisfy three requirements: (1) The stockholders must own a security issued by the corporation (2) the stockholders must own that security at the time the § 16(b) derivative action is instituted; and (3) the security traded by the corporate insider must be a 1934 Act registered security issued by the same corporation as the security held by the plaintiff stockholders. Once these three

requirements for standing are satisfied, the stockholders need not maintain continual ownership of the security throughout the course of litigation if they maintain a sufficient financial interest in the outcome of the litigation.

In *DiLorenzo*, the United States District Court for the District of Delaware first addressed the defendants' argument that the plaintiff lacked the necessary standing to maintain the § 16(b) suit because he was no longer a dELiA*s stockholder. The court, citing the U.S. Supreme Court's decision in Gollust v. Mendell, 501 U.S. 115 (1991), noted that if a stockholder has the proper standing at the commencement of a § 16(b) action, "an involuntary change in his status as a security holder resulting from a restructuring will not affect his standing to maintain the suit so long as minimal constitutional requirements are satisfied through the presence of some financial interest in the outcome of the litigation." Although Gollust involved a stock merger rather than a cash-out merger, the DiLorenzo court was unwilling to allow the form of corporate restructuring to frustrate § 16(b)'s "remedial purpose." Consequently, the court concluded that the plaintiff, as an Alloy stockholder, had a sufficient financial interest in the outcome of the suit to satisfy the constitutional requirements essential to maintain the derivative action.

The court next addressed the defendants' argument that the plaintiff lacked the necessary standing to maintain the suit because he failed to make a demand upon dELiA*s board of directors in accordance with Federal Rule of Civil Procedure 23.1 before instituting the action. The court summarily stated that Rule 23.1 does not apply to § 16(b) actions; rather, the demand requirement for derivative suits under § 16(b) are governed by § 16(b) itself. Furthermore, citing two New York cases, the court noted that in certain circumstances, other courts have excused § 16(b)'s demand requirement when demand would be futile.

In this case, the court found that the demand requirement should be excused as futile in light of Alloy's acquisition of dELiA*s and the defendants' control of dELiA*s board of directors. The court pointed out that the defendants represented four of eleven members (less than a majority) of the board, represented three of four of dELiA*s former officers, and collectively owned 37.8% of dELiA*s stock. In contrast, Delaware decisional law regarding derivative suits brought in accordance with Court of Chancery Rule 23.2 (a Delaware state rule of civil procedure) may require a majority—or, where there is an even number of directors, at least 50%--of the board to be "interested" or lacking in "independence" before excusing pre-suit demand as futile. Aronson v. Lewis, 473 A.2d 805, 815 n.8 (Del. 1984); In re The Limited, Inc. S'holders Litig., No. CIV.A. 17148-NC, 2002 WL 537692, at *7 (Del. Ch. Mar. 27, 2002). Considering the "short timing" of the merger, the court recognized that the plaintiff's shares in dELiA*s likely would have been canceled by the time a proper demand could have been made. Furthermore, the court noted that

the failure of dELiA*s board to commence a § 16(b) action after learning of the plaintiff's action supported the allegations of demand futility.

The *DiLorenzo* decision increases the class of potential plaintiffs that can maintain a properly initiated § 16(b) suit. Specifically, the DiLorenzo court found that a plaintiff who owns stock in both a parent corporation and its subsidiary has a continuing financial interest in the subsidiary (through the plaintiff's continued ownership of the parent corporation's shares) after the plaintiff's shares in the subsidiary are canceled as a result of a corporate restructuring. This continuing financial interest may give the plaintiff stockholder standing in a properly initiated derivative suit brought on behalf of the subsidiary under § 16(b). Transactional attorneys and corporate litigators alike should also note that federal courts may waive § 16(b)'s demand requirement—at least when ruling on a motion to dismiss—if minimal levels of demand futility arguably exist and are properly pled.

CONTRACTS

Expiration without a clause: Contracts without an express expiration date that grant an interest in a business venture can expire based upon time's passage and the parties' course of performance. *Martin v. King*, No. E2002-03055-COA-R3-CV, 2003 WL 23099677, 2003 Tenn. App. LEXIS 921 (Dec. 30, 2003).

By David Headrick

The Tennessee Court of Appeals contemplated whether parties that contracted to grant an interest in a failed business venture are bound to grant the interest in a subsequently developed successful venture in the same industry. The court held that a plaintiff suing for the grant of interest in a subsequently developed venture was not entitled to this interest because the contract, although not containing an express expiration date, had expired based upon time's passage and the parties' course of performance.

In *Martin v. King*, John Curtis King ("King") endeavored to develop a landfill in Scott County, Tennessee. R. Scott Martin ("Martin") orally expressed to King that he would procure a multi-million dollar investor. On December 15, 1990, the parties executed the following agreement ("Agreement"), "For and in consideration of services rendered . . . [King] does hereby agree to . . . convey a three (3%) percent interest in his business known as 'Roberta Sanitary Landfill' . . . to [Martin]." The project failed to gain ground. In 1992, King repurchased a 12% interest that he had

previously conveyed to his son via the agreement. The interest cost $10,000. Soon after, King and Martin completely ceased communications with each other. In 1995, King purchased an existing landfill under a new corporation called Scott County Solid Waste Disposal Company ("Scott Solid Waste"). He applied the proceeds to further pursue the Roberta Sanitary Landfill. However, the lack of capital ultimately forced King to sell Scott Solid Waste to Liberty Waste Services in 1998.

In 1999, Martin filed suit seeking 3% of the proceeds generated from the sale of Scott Solid Waste. Both the trial court and the court of appeals found that Martin had generally failed to perform, and that Scott Solid Waste was completely separate from the original Agreement. The Agreement contemplated the Plaintiff's financing assistance for Robert Sanitary Landfill, but not the sale of a subsequent business venture by the Defendant. Martin had performed "only a minimal amount of work" three years after the execution of the contract. Further, King formed Scott Solid Waste unassisted two years after the parties ceased to communicate with each other entirely. This "clear line of demarcation" between the venture covered by the Agreement and King's subsequent business venture negated Martin's claim that the sale of Scott Solid Waste was part of the original Agreement's scope. Thus, the court affirmed the trial court's $4,500 award covering attorney fee reimbursement and a pro-rated 3% interest in Roberta Sanitary Landfill synonymous with the rate Defendant had paid his son in 1992.

As *Martin* illustrates, contracts granting a business venture interest without an express expiration date can expire based upon the passage of time and the parties' course of performance. However, transactional attorneys should draft contracts with limited scopes and finite timeframes to protect their clients and to prevent later overly broad readings of contractual terms. Individuals and businesses alike tend to utilize their core competencies by staying in the same industry, thus allowing ambiguous contracts to potentially affect subsequent, unrelated transactions. Martin's usage of the original Agreement against King's later business venture highlights the necessity of greater specificity in contract drafting. Although the court found that the contract had expired, a legal question survived and, no doubt, cost the Defendant time and money.

Buy-out provisions will bar injunctive relief where the parties have agreed upon such a provision in a non-compete agreement. *Murfreesboro Med. Clinic, P.A. v. Udom*, No. M2003-00313-COA-R9-CV, 2004 WL 193049, 2004 Tenn. LEXIS 743 (Tenn. Ct. App. 2004).

By Lexi Walsh

Murfreesboro Medical Clinic v. Udom states that non-compete agreements will only upheld in Tennessee if they are reasonable under the circumstances. Udom provides elements of reasonableness and holds that temporary injunctions are only a permissible remedy for breach of a non-compete agreement where no monetary remedy exists.

In *Murfreesboro Med. Clinic v. Udom*, Dr. David Udom ("Udom") entered into an employment contract to practice internal medicine for plaintiff, Murfreesboro Medical Clinic ("MMC"), which also contained a non-compete agreement provision stating that Udom would not practice medicine within a twenty-file mile radius of Murfreesboro Public Square for eighteen months following his employment with MMC. The non-compete agreement also contained a buy-out provision that permitted Udom to practice medicine within the proscribed area if he paid MMC an amount equal to twelve times his most recent monthly salary.

After MMC chose not to extend Udom's contract, Udom violated the non-compete agreement by opening a medical practice fifteen miles from Murfreesboro Public Square in Smyrna. MMC sought to temporarily enjoin Udom's Smyrna practice. The trial court temporarily enjoined Udom from practicing at the Smyrna location unless he paid $120,000 to the court clerk. Udom appealed, raising the issues of whether the Chancery Court erred in granting MMC a temporary injunction and whether the non-compete clause was valid.

A temporary injunction is only proper where the plaintiff's threatened injury is irreparable. In Tennessee, the injury is not irreparable where there is an adequate remedy at law. The court's finding of irreparable injury was incorrect because the buy-out provision provided MMC with an adequate remedy at law. Thus, the temporary injunction was reversed.

Udom claimed that as a private physician, he should not be bound by the clause because it was "overly broad, unreasonable, not protecting a publicly recognized interest, and void as against public policy." Although Tennessee law disfavors non-compete agreements because they are restrictive of trade, they will be enforced when reasonable as applied to the facts of the case. To determine the

reasonableness of the agreement, the court considered whether there was consideration supporting the agreement, whether the threatened harm to MMC would be great without the agreement, whether the agreement placed economic hardship on Udom, and whether the agreement was contrary to public policy.

The court found that MMC's annual salary of $120,000 to Udom was fair consideration for Udom's services and adherence with the non-compete clause and that MMC's business interest was threatened by Udom's practice in Smyrna. The court also found that the economic hardship on Udom was minimal because he was able to continue his Smyrna practice and pay $120,000 to the court. Finally, the court analyzed the agreement in relation to public policy; the court recognized the public's interest in choice of healthcare providers, an interest not impeded by the clause because Udom's patients could drive outside the geographic limitation to see him and because he could continue to practice in Smyrna after satisfying the buy-out provision. Although the court emphasized the necessity of protecting MMC's legitimate business interest, they also emphasized the public's interest in the freedom to contract.

This court concluded that the non-compete agreement was valid and enforceable because the twenty-five mile geographic limitation and the eighteen-month duration of the clause were reasonable. The court remanded the case to determine the specific monetary amount that would reasonably satisfy the buy-out provision.

Udom reiterates the notion that injunctions are only proper in cases where no remedy at law exists and that a buy-out provision is an adequate legal remedy. Furthermore, Udom illustrates that reasonable non-compete agreements between private physicians and for-profit medical facilities are enforceable in Tennessee. However, Udom does not set a reasonableness standard for determining the monetary amount that will satisfy a buy-out provision. A transactional attorney should advise employee clients to insist on a concrete figure buy-out provision; employer clients should recognize that buy-out provisions will bar injunctive relief where the parties have agreed upon a buy-out provision.

Where there is no explicit language limiting the benefits of the contract to the principal parties, the intent of the principal parties to the contract determines whether a third party is an intended "third-party beneficiary" of the contract. *Charter Oak Fire Ins. Co. v. Lexington Ins. Co.*, No. M2002-01752-COA-R3-CV, 2004 WL 431488, 2004 Tenn. App. LEXIS 150 (2004).

By Jason Whitler

When parties to a contract do not explicitly limit the benefits of a promised performance to the principal parties involved, it is often difficult to determine whether a third party is an intended third-party beneficiary of the contract. Although *Owner-Operator Independent Drivers Ass'n v. Concord EFS, Inc.* established the test for determining whether a third party is an intended third-party beneficiary of a contract, applying the test and determining the intent of the principal parties remains a difficult task as evidenced by the decision in *Charter Oak Fire Ins. Co. v. Lexington Ins. Co.* In this case the court held that a third party was an intended third-party beneficiary.

In *Charter Oak Fire Ins. Co. v. Lexington Ins. Co.*, Chili's Restaurant in Nashville ("Chili"s) entered into a lease agreement with RMR Investments and Gower Center, Ltd. ("RMR/Gower"). RMR/Gower owned the property where the restaurant was located. The agreement required Chili's to insure the improvements against loss or damage by fire and to name RMR/Gower as loss payee or additional insured. Under the agreement, if the premises or improvements were destroyed by fire, Chili's could terminate the lease and RMR/Gower would receive all of the insurance proceeds except for those proceeds Chili's would receive for the loss of personal property. As required, Chili's, a corporate subsidiary of Brinker International, Inc. ("Brinker"), secured insurance coverage through Lexington Insurance Company ("Lexington"). The certificate of insurance named RMR/Gower as certificate holder and as additional insured.

A fire subsequently destroyed the restaurant, and Chili's terminated the lease. Lexington then paid the proceeds for the damage to the building to RMR/Gower, and the proceeds for loss of personal property to Chili's. However, RMR/Gower submitted an additional claim to Lexington for rental income it would have received had Chili's not terminated the lease; Lexington denied the additional claim. RMR/Gower then submitted a claim for lost rental income to its insurer, Charter Oak Fire Insurance Company ("Charter Oak"), which Charter Oak paid; however, Lexington refused to reimburse Charter Oak for the amounts it paid to RMR/Gower.

Charter Oak then sued Lexington for breach of contract under the theory that RMR/Gower was a third-party beneficiary of the contract between Chili's and Lexington. The trial court granted summary judgment in favor of Lexington.

The issue presented is whether the trial court was correct in granting summary judgment in favor of Lexington based on the theory that Lexington did not intend for RMR/Gower to be a third-party beneficiary with respect to losses of rental income?

In *Owner-Operator Independent Drivers Ass'n v. Concord EFS, Inc.*, the Tennessee Supreme Court reformulated its analysis for determining third-party beneficiary status. According to Concord, a third party qualifies as a third-party beneficiary of a contract when: (1) the principal parties had not otherwise determined the third party was not a beneficiary; (2) acknowledging the third party's right to performance is necessary to effectuate the intent of the parties; and (3) the provisions of the contract or the matters relating to performance show that either: (a) the fulfillment of the promise will meet an obligation or satisfy a duty that the promisee owes to the beneficiary; or (b) the promisee plans to give the beneficiary the benefit of the promised performance.

In reference to the first element of the Concord test, the contract did not explicitly limit contractual benefits to the principal parties, and RMR/Gower's listing as an additional insured was evidence that Chili's purchased the insurance, at least to some degree, for RMR/Gower's benefit.

The court then had to determine whether acknowledging the third party's right to performance is necessary to put the intention of the parties into effect. The policy had a page called "Rental Income Extension," whereby the principal parties agreed that the policy would "cover loss of rental income resulting from necessary untenantability, caused by damage to or destruction of the building(s) . . . ." Lexington argued that this provision only applied to situations where Brinker/Chili's did not receive rent from properties where they acted as landlord. Nonetheless, the court concluded that this coverage would apply to RMR/Gower since Lexington did not put any language in the policy limiting the provision's application.

To satisfy the last prong of the Concord test the court had to decide whether the fulfillment of the promise would satisfy a duty that the promisee owed to the beneficiary or whether the promisee planned to give the beneficiary the benefit of the promised performance. The court first noted that the lease agreement required Chili's to name RMR/Gower as additional insured under the Lexington policy. In this lease agreement, Lexington and Chili's agreed that RMR/Gower would receive "all insurance proceeds" that were paid out "by reason of the occurrence of such fire

or other casualty" except for those paid to Chili's for loss of personal property. The court indicated that this was sufficient evidence to satisfy the last prong of the Concord test. Having determined that RMR/Gower satisfied all of the elements of the Concord test, the court concluded that RMR/Gower was an intended third-party beneficiary of the loss of rental income section of the Lexington policy and reversed the trial court's grant of summary judgment.

As *Charter Oak* demonstrates, the intent of the principal parties governs whether a third party was an intended beneficiary of a contract. In the absence of explicit language limiting the benefits of the promised performance to the principal parties to the contract, a party will qualify as an intended third-party beneficiary where the fulfillment of a promise would satisfy a duty that the promisee owed to the beneficiary. Transactional attorneys should include explicit language limiting the benefits of the agreement to the principal parties involved.

INSURANCE

Credit life insurance companies can rely on health-related exclusions without initially inquiring about the applicant's health. *Osborne v. Mountain Life Ins.* Co., 130 S.W.3d 769 (Tenn. 2004).

By Darsi Newman

The Tennessee Supreme Court held that health-related exclusions in credit life insurance policies are valid even if the insurance company does not initially inquire about the applicant's health, so long as the company does not falsely represent or conceal policy information. The court also held that a new insurance policy begins each time a loan is renewed or refinanced. Thus, the time limits in the policy exclusions are triggered anew with each new loan.

In this case, Osborne signed a one-year note with Jones Tractor Company in January 1997. Osborne renewed the note each year, with the final renewal occurring on January 13, 2000. Jones Tractor immediately assigned the notes to First Community Bank. According to the beneficiary, Osborne purchased credit life insurance in connection with the original note and with each subsequent renewal. The bank acted as Mountain Life's agent in these transactions. However, Osborne's communications concerning the life insurance were only with Jones Tractor.

An endorsement to the credit life insurance policy limited Mountain Life's liability to premiums paid by the insured if, within six months of the policy's

effective date, the insured received medical treatment or advice for an injury or health condition that caused the insured's death within the same six month period. Osborne was diagnosed with cancer in November 1999 and received treatment for that disease until his death on March 21, 2000. The beneficiary filed a claim with Mountain Life. Mountain Life returned the policy premium but declined to pay any benefits based on the six-month exclusion.

The beneficiary contended that because the policy ran continuously from the time of Osborne's original note in 1997, the six-month exclusion did not apply. Mountain Life responded that each policy certificate was effective only for the life of the loan. Each time Osborne renewed the loan, Mountain Life treated it as a new obligation. As such, Mountain Life issued a new policy certificate for every renewal, thus triggering the six-month exclusion every January. Because Mountain Life issued the certificate for the year 2000 on January 13, the exclusion applied when Osborne died on March 21.

The Court of Appeals disregarded the issue of the effective date, holding sua sponte that Mountain Life was estopped from relying on the six-month exclusion because it did not inquire about Osborne's health when he purchased the certificate. The Supreme Court, in reversing the Court of Appeals, first determined that, based on state statutes and relevant policy provisions, the effective date of the certificate was January 13, 2000. It then determined that Mountain Life could rely on the six-month exclusion because all of the elements of estoppel had not been met. Equitable estoppel requires conduct that amounts to a false representation or concealment of material facts. Because Osborne had no contact with Mountain Life or its agent, the record offered no evidence that Mountain Life made any representations, false or otherwise, or that Mountain Life concealed material information with regard to policy provisions. The court distinguished this case from a previous case in which the insurance company's agent told the insured that the policy "would pay" the debt in the event of the insured's death and did not reference a "sound health" condition in the policy.

This decision reassures credit life insurance companies that they can rely on health-related exclusions in their policies, even when they do not inquire about the applicant's health. However, lawyers representing these companies should advise their clients to ensure that their agents are trained not to make blanket assurances to customers without mentioning the exclusions or conditions contained in the policy.

PROPERTY

How a third party establishes a new rental price for property previously under Lease that they purchased at a foreclosure sale. *Kokomo Grain Co. v. Collins*, No. M2003-00376-COA-R3-CV, 2004 WL 626722, 2004 Tenn. App. LEXIS 186 (Mar. 26, 2004).

By Jerry J. Fabus

Applying Tennessee law, the Tennessee Court of Appeals held that a new landlord, who acquired rental property by way of a foreclosure sale, is required to give the holdover tenant a reasonable notice of a definite and unequivocal demand before being allowed to unilaterally increase the rent.

On December 10, 2001, Randy Collins ("Collins") purchased a storage facility at a foreclosure sale that Kokomo Grain Co. ("Kokomo") was leasing for $1,500 per month from the previous owner. On January 2, 2002, Collins requested by way of letter that Kokomo pay $6,500 per month for the continued use of the storage facility. On January 7, 2001, Collins mailed a second letter to Kokomo that acknowledged the receipt of January's rent for $1,500 but stated that this rent payment was unacceptable. Neither letter contained a notice of termination of the lease or a notice to vacate. The parties continued to negotiate but did not resolve the matter. Kokomo then filed this action when Collins refused to allow Kokomo to remove its grain from the storage facility. After Kokomo posted a $25,000 bond, Collins allowed Kokomo to remove the last of its grain on March 27, 2002.

Both the trial court and court of appeals held that Collins was precluded from recovering his asking price of $6,500 per month and that the fair market rental value for the months of January, February, and March was $1,500 per month. The courts reached this conclusion based on two aspects of Tennessee law. First, a foreclosure sale terminates a lease if the mortgage was recorded prior to the lease. Therefore, Collins and Kokomo were completely free to negotiate. Second, the landlord is required to give the holdover tenant a reasonable notice of a definite and unequivocal demand before being allowed to unilaterally increase this rent. Collins never gave this type of notice. Because he did not make an unequivocal demand, Collin's actions were instead interpreted to be an attempt to negotiate new terms and conditions of a lease. Because no agreement was ever reached between the parties, the trial judge was responsible for establishing the fair market value for the months in dispute, which he set at $1,500 per month.

This decision makes clear that a new landlord who is not subject to a prior lease needs to act decisively, choosing either to give a definite and unequivocal demand to the holdover tenant or to negotiate with this tenant. Kokomo, while not creating any new law, is an excellent example of what can happen when new landowners do not undertake a decisive course of action because they are not fully aware of the legal consequences.

All Tennessee residents are considered beneficiaries of conservation easements and have standing to enforce the land use restrictions. *Tennessee Envtl. Council, Inc. v. Bright Par 3 Assocs.*, No. E2003-01982-COA-R3-CV, 2004 WL 419720, 2004 Tenn. App. LEXIS 155 (Mar. 8, 2004).

By Gennie Gieselmann

According to the Tennessee Court of Appeals, any Tennessee resident is a beneficiary of a conservation easement and has standing to sue to enforce it. Ordinarily, for a party to have standing, they must demonstrate the presence of a distinct and severable injury. However, the statutory language of Tennessee Code Annotated § 66-9-301, et. seq., states that the "holder and/or beneficiaries" of a conservation easement may enforce the easement. For purposes of standing to enforce conservation easements, the definition of "beneficiaries" now includes all Tennessee residents.

A conservation easement grants a nonprofit organization or governmental entity the authority to regulate and uphold the land use restrictions set forth in the easement. Conservation easements operate in accordance with federal and state regulations. The restrictions in a conservation easement often ban certain activities that are detrimental to the protected resources. Because the conservation easements are negotiated agreements between the landowner and the grantee, the landowner usually reserves certain land use rights, such as the ability to own, occupy, or use the property in a certain manner.

The instant conservation easement conveyed approximately forty acres along the South Chickamauga Creek in Chattanooga, Tennessee, to the City of Chattanooga in 1996. The plaintiffs alleged that the defendants' impending commercial developments would cause pollution, irreparable damage, and runoff to the creek in violation of state and federal contamination limits for a protected waterway. The defendants, owners and developers of commercially zoned property

near South Chickamauga Creek, maintained that the proposed developments would not cause irreversible harm to either the plaintiffs or the creek.

Following the issuance of a temporary restraining order to halt construction, a preliminary hearing was held to determine whether Ms. Kurtz, an individual plaintiff and private citizen in the original complaint, had standing to sue to enforce the conservation easement. The Chancellor found that Ms. Kurtz failed to establish a distinct and severable injury that was unique from the general public; therefore, she did not have standing. Moreover, the Chancellor held that the only party to have standing to enforce the easement was the City of Chattanooga, the grantee of the easement. The Chancellor then dismissed the complaint, removing the temporary restraining order. On appeal, The Tennessee Court of Appeals reversed.

According to Tennessee Code Annotated § 66-9-307, "[c]onservation easements may be enforced by injunction or proceedings in equity by the holders and/or beneficiaries of the easement, or their bona fide representatives, heirs, or assigns." The City of Chattanooga was clearly the grantee and holder of the conservation easement and had the authority to enforce the easement. However, the beneficiaries of the easement still remained undetermined.

The Tennessee Court of Appeals decided the meaning of beneficiary under a conservation easement by using statutory construction. The language "and/or beneficiaries" means that the beneficiary is someone who is not the grantee; instead, a beneficiary is one who benefits from the act of another. According to Tennessee Code Annotated § 66-9-303, a conservation easement is "held for the benefit of the people of Tennessee." Therefore, any resident of Tennessee has standing to enforce a conservation easement.

The court offered several supporting arguments to bolster their conclusion. First, the court highlighted the conformity of their interpretation to both the deed and the statute. Second, the court relied on the legal reasoning that requires courts to give liberal construction to a remedial statute. Finally, the court reasoned that the Legislature clearly intended such interpretation because the language of the statute did not mirror the Uniform Conservation Easement Act, which provides that the grantee is the only party with authority to enforce the conservation easement. Had the Legislature intended such construction of the statute, they would have inserted the proper language.

The court's decision to extend standing to all residents of Tennessee to enforce conservation easements exposes several legal issues. First, potential developers should be aware that lawsuits to enforce the land restrictions in a

conservation easement may be brought by virtually anyone living in the state of Tennessee. Second, landowners in the negotiation stage of drafting a conservation easement should consider that if they participate in an activity not permitted by the easement, any resident of Tennessee could sue to prevent them from enjoying their land. To avoid potential liability, transactional attorneys should designate who the holder of the easement is and who the beneficiaries of the easement are. Otherwise, any Tennessee resident may sue to enforce the land restrictions set forth in a conservation easement.

Personal jurisdiction required for class action suits. *Williams v. Firstplus Home Loan Owner Trust*, 310 F. Supp. 2d 981 (W.D. Tenn. 2004).

By Ted Morrissey

In class action suits involving out of state defendants, plaintiffs must establish general personal jurisdiction. Without establishing personal jurisdiction, plaintiffs have no standing to bring an action against a defendant, even a national entity allegedly in violation of state statutory law. To address alleged violations of state law, plaintiffs must establish that the entity is doing business or has ties in the jurisdiction. In *Williams v. Firstplus Home Loan Owner Trust* (Firstplus), the district court required the plaintiffs to establish jurisdiction before proceeding with alleged violations of state laws regarding home loans.

Two groups of plaintiffs, the Williams (Firstplus Plaintiffs) and the Stallings (Seacoast Plaintiffs), filed their cases as class actions in federal court; the cases were subsequently consolidated. The Firstplus Plaintiffs obtained from Firstplus Financial, Inc. (Firstplus) a second mortgage home equity loan secured by their respective residences. The Firstplus Plaintiffs claimed that after closing their loan, Firstplus consolidated the loans into a loan pool and assigned the loan pool to U.S. Bank, National Association (USBNA). The Seacoast Plaintiffs asserted similar facts against different defendants. Their loans were assigned to Empire Funding and others (Empire), who consolidated the loans into a loan pool and assigned the loan pool to USBNA. None of either group's assignments were recorded in Shelby County.

The issue presented is whether the defendants are subject to personal jurisdiction in Tennessee. Under Federal Rule of Civil Procedure 12(b)(2), the court can dismiss a claim for lack of jurisdiction over the person. The plaintiff bears the burden of establishing jurisdiction and absent an evidentiary hearing on that matter, needs only to make a prima facie showing of jurisdiction. Such jurisdiction can be

general, arising when a defendant has continuous and systematic contact with the state, or specific, arising when a defendant has minimum contacts with the forum state that arise from or are related to the cause of action.

The court ruled that the Seacoast Plaintiffs failed to meet their burden regarding general personal jurisdiction over Empire. The court found that Empire was merely an assignee of a mortgage note secured by property in Tennessee and that that fact alone was insufficient to show substantial contacts with the forum state. The court also held that the actions of the servicer of the mortgage notes did not establish general personal jurisdiction over the notes' out of state assignees based on the plaintiffs' failure to show an agency relationship warranting general personal jurisdiction.

On the issue of specific personal jurisdiction, the court ruled that the Seacoast Plaintiffs failed to show that Empire purposely availed itself of the privileges of acting in Tennessee, stating that purchasing a consolidated loan pool containing loans secured by real property located in Tennessee did not demonstrate intent to avail oneself of the privileges of acting in Tennessee.

Finally, on the issue of whether the court could exercise personal jurisdiction over USBNA, the court found that the plaintiffs met their burden of proof based on USBNA's maintenance of more than sixty branch locations in Tennessee and involvement in several foreclosures. Exercising personal jurisdiction over USBNA based on these contacts did not offend traditional notions of fair play and substantial justice because these contacts imply that USBNA conducts substantial business within Tennessee.

Thus, the court granted Empire's motion to dismiss but denied USBNA's motion to dismiss. Empire was a mere assignee of loan pools containing property in Tennessee, had no other contacts with Tennessee, and had not specifically sought loans secured by property in Tennessee. On the other hand, USBNA conducted substantial business such that the exercise of general personal jurisdiction was appropriate. Based on this holding, merely holding a loan secured by property in Tennessee is not enough to create general or specific personal jurisdiction. However, holding such loans in combination with continuous and systematic contacts is more than enough.

Unlicensed contractors who suffer from a breach of contract may recover actual damages. *Ebert v. Ekelem*, No. M2002-00842-COA-R3-CV, 2004 WL 578595, 2004 Tenn. App. LEXIS 180 (2004).

By Chad R. White

The Tennessee Court of Appeals held that even though a tradesman is required to have a license when he contracts directly with a property owner for work exceeding $25,000, his lack of a contractor's license does not limit his recovery to $25,000 if the owner breaches the contract. The tradesman may recover "actual documented expenses" under Tennessee Code Annotated § 62-6-103(b).

Dr. Ifeatu Ekelem, a property owner, contracted with Justin C. Ebert, a tradesman, to complete framing and roofing work on his house for a fee of $30,000. Dr. Ekelem was to supply all necessary materials and pay Ebert bi-weekly installments. Towards completion of the project, Dr. Ekelem breached the contract by failing to pay Ebert the money due. As a result of this breach, Ebert left the job.

Ebert filed a mechanic's lien against the property; however, he filed the lien past the deadline. Ebert then filed a complaint against Dr. Ekelem for "breach of contract, unjust enrichment, and enforcement of his lien." The trial court awarded Ebert a $6,642.81 judgment. Dr. Ekelem appealed.

The chief issue in this case dealt with the Contractor's Licensing Act of 1994. This act requires individuals who engage in "contracting" to have a license if they enter into a contract for $25,000 or more. Contractors licensing statutes, which have been revised frequently and have changed the definitions of "contractors" and "contracting," without defining "subcontractor" and "subcontracting," have greatly affected tradesmen like Ebert who only complete a portion of a project and may not believe they need a license. Section 62-6-103(a)(2)(A) excuses property owners who build their own houses from being licensed, but it does not address those who contract with such owners. The court held that tradesmen such as Ebert were required to have a license if they contracted directly with a property owner for $25,000 or more.

Dr. Ekelem argued that Ebert is not entitled to recover any further claim because the doctor already paid $25,000 for Ebert's services. The court held that Dr. Ekelem misread the statutes, and the damages that an unlicensed contractor may collect are not limited to $25,000. The court further held that § 62-6-103(b) does, however, limit the amount Ebert may recover to "actual documented expenses." The court remanded the case and held that Ebert would be allowed to present

evidence to show that his expenses exceeded the amount Dr. Ekelem had already paid him.

Ebert shows the problems that may arise when a tradesman, who lacks a contractor's license, contracts directly with a property owner for a portion of a project instead of going through a general contractor. Transactional lawyers should advise clients who are tradesmen or contractors to obtain a contractor's license prior to contracting directly with a property owner for projects where the contract price is $25,000 or more. They should further advise their clients to keep detailed records, document all expenses, and be aware of filing deadlines. Lawyers with clients who are already in a situation similar to Ebert or Dr. Ekelem should advise their clients of the applicable recovery rights an unlicensed tradesman may still possess.

TAX

Tax assessment against a partnership is enough to extend three-year statute of limitations for collection of employment taxes from individual partners even if the partnership subsequently files for bankruptcy. *United States v. Galletti*, 541 U.S. 114, 124 S. Ct. 1548, 158 L. Ed. 2d 279 (2004).

By C. Damon Gunnels

When an employment tax liability is properly assessed against a partnership and the general partners subsequently file for bankruptcy protection after the three-year statute of limitations has run, the employment tax liability automatically attaches to the individual general partners, who may be jointly and severally liable for all of the partnership's debt. The tax liability is assessed on the debt as a whole, not necessarily on an individual taxpayer, and if the tax debt was timely assessed within three years of the filing of returns, the Internal Revenue Code ("IRC") extends the time allowed to collect on the debt to ten years. Therefore, individual general partners cannot claim the tax should have been assessed against them individually, and the government has ten years to collect the debt. This was the issue decided by the United States Supreme Court in *United States v. Galletti*.

In Galletti, the Marina Cabrillo Company, a general partnership, failed to pay its federal employment tax liabilities for the years 1992 to 1995. The Internal Revenue Service ("IRS") assessed those tax liabilities against the partnership in 1994, 1995, and 1996; however, the partnership never paid the tax debt. Subsequently, the partnership's general partners, Abel and Sarah Galletti and Francesco and Angela

Briguglio, filed joint petitions for Chapter 13 Bankruptcy protection in October of 1999 and January of 2000, respectively.

During each of these bankruptcy proceedings, the IRS filed proofs of claims for unpaid employment taxes assessed against the partnership. The general partners objected to these claims, arguing that although the tax liability had been properly assessed against the partnership within the three-year statute of limitations, the resulting ten-year extension of liability only applied to the partnership. Basically, the partners asserted that since the tax assessment had not been applied to them individually, the statute of limitations had run and they were no longer liable for the partnership's tax debt. The partners claimed that since they were ultimately responsible for the partnership's debt, they were the relevant taxpayers and should have been assessed individually. Furthermore, the partners asserted that since they were jointly and severally liable for the partnership's debt under California law, they were primarily responsible for the debt and thus the relevant taxpayers. The trial and appellate courts agreed with the partners.

Internal Revenue Code § 6501(a) provides that any tax liability imposed under the Code must be assessed within three years of the filing of the tax return. However, any liability that was properly assessed within that three-year limit expands the statute of limitations for that liability to ten years.

Section 6303 of the IRC requires the Secretary of the Treasury to give notice to each person liable for the unpaid tax within sixty days of the assessment, "stating the amount and demanding payment thereof." Since the partners were ultimately liable for the partnership's unpaid tax debt and they never received notice individually, the partners argued that the statute of limitations had run.

The United States Supreme Court reversed the lower courts' decisions and held that the only relevant taxpayer was the partnership and the properly assessed tax liability against the partnership was sufficient to extend the ten-year statute of limitations for collecting tax liability to the general partners who were liable for the partnership's debt.

The Court ruled that the tax assessed was an employment tax and thus it was specifically assessed against the employer. Although the individual partners may have been liable for the partnership's debts, they were not themselves the employer. The Court analyzed the tax assessment function, pointing out that companies usually assess their own tax liability and file returns with the government. In some cases when such self-assessment is incorrect or fraudulent, the Secretary of the Treasury can reject the incorrect assessment and record the correct tax liability in the books. The IRS can then use various enforcement devices to collect the tax. The proper

interpretation of the assessment function is that it is the amount of the tax that is assessed, not the taxpayer.

Citing *United States v. Updike*, 281U.S. 489 (1930), the Court noted that the ten-year extension of the statute of limitations applied to the debt as a whole, not the individual taxpayer assessed. The IRS is not required to separately assess the same tax against individuals who may be liable for the tax but are not the actual taxpayers. The consequences of the tax assessment attach to the tax debt regardless of the "special circumstances of the secondarily liable parties."

As the Court declined to consider whether a tax assessment against a partnership is sufficient for the IRS to enforce collection through a lien or levy against an individual partner's property, this ruling appears to be extremely narrow. In fact, the ruling addresses only the liability that attaches to employment tax in a judicial proceeding such as bankruptcy. The Court did not address other liabilities general partners may incur because of a partnership's default.

As the *Galletti* case illustrates, individuals or entities that are secondarily liable for the debts of another entity are not themselves employers and are neither required nor entitled to individual assessment for the employment tax liability assessed against the entity. However, these parties remain liable for the tax debt assessed against the entity. In smaller, closely held entities such as general partnerships, the secondarily liable parties should have little trouble determining the extent of their liability resulting from a default by the larger entity. To avoid unpleasant surprises, partners and others secondarily liable for debt in general—and employment tax debt specifically—should stay abreast of any outstanding debt the larger entity incurs.

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