

CASE COMMENTARIES

BANKRUPTCY

BAPCPA Amendment to the Bankruptcy Code: An Unconstitutional Restriction on an Attorney’s Right of Free Speech. *Hersh v. United States*, 347 B.R. 19 (N.D. Tex. 2006).

By Matthew A. Petrie

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) amended the Bankruptcy Code to include provisions that arguably apply to consumer bankruptcy attorneys and the manner in which they advise potential clients. The BAPCPA amendments added a definition for “debt relief agency” in section 101(12A). BAPCPA further added section 526, which places restrictions on the advice that a debt relief agency can provide to its client, as well as section 527, which requires certain disclosures by the debt relief agency. The Northern District of Texas in *Hersh v. United States* was the first court to address whether an attorney is a “debt relief agency” under the Bankruptcy Code and, if so, whether the restrictions and required disclosures under sections 526 and 527 are constitutional.

The plaintiff, Susan Hersh (“Hersh”), was an attorney whose practice included counseling clients on matters of bankruptcy law in exchange for a fee. As a result, she was potentially subject to the regulations of debt relief agencies; therefore, she sought a declaratory judgment that BAPCPA does not apply to attorneys and that both sections 526 and 527 violate the First Amendment of the United States Constitution. The government moved to dismiss Hersh’s claims. Hersh raised three primary issues in this case.

As a threshold matter, the first issue that the court had to decide was whether the term “debt relief agency” includes attorneys. The court concluded that under a plain reading of the statute, attorneys are debt relief agencies under the Bankruptcy Code. A debt relief agency is “any person who provides any bankruptcy assistance to an assisted person in return for the payment of money or other valuable consideration.” 11 U.S.C. § 101(12A) (2007). Moreover, the definition of “bankruptcy assistance” in section 101(4A) includes giving advice. Because only attorneys are authorized to provide legal advice, and attorneys were not listed as one of the five exceptions to the definition, the court found that bankruptcy attorneys such as Hersh must fall within the definition of “debt relief agency.” As such,

attorneys are subject to the regulations set forth in sections 526 and 527 for debt relief agencies.

The second issue decided by the court was whether section 526(a)(4), which prohibits debt relief agencies from advising clients to take on more debt in contemplation of bankruptcy, was an unconstitutional restriction on speech. While Hersh argued that the provision should be subject to strict judicial scrutiny, the court held that the section was over-inclusive and therefore could not survive even under intermediate scrutiny, thereby avoiding the issue of determining which standard applies. Both tests, however, require that a restriction on speech be narrow. Section 526(a)(4), however, was not narrow because it prevented attorneys from advising clients to take actions that are entirely lawful, even after BAPCPA, and it extended beyond abuse to restrict advice to take prudent actions. Because section 526(a)(4) prevented lawyers from advising clients to take action that is lawful and extended beyond what is narrow and necessary to serve the government's asserted interest in preventing abuse of the bankruptcy system, the court held that it was facially unconstitutional.

The third and final issue before the court was whether the numerous disclosures required by section 527 unconstitutionally compelled speech. Section 527 requires attorneys to provide clients or potential clients with written notice of specific information regarding the bankruptcy process. The court found section 527 constitutional because it did not unduly burden either the attorney-client relationship or the ability of the client to seek bankruptcy relief. The court relied on a line of Supreme Court decisions addressing statutes that required a member of a profession to provide customers with information regarding the services that would be provided. The court also found that the government "clearly has a legitimate interest in attempting to ensure that a client is informed of certain basic information" because consumer debtors are often at an informational disadvantage. Furthermore, nothing in section 527 prevented an attorney from providing further specific explanations concerning the general required statements. Because the content-neutral statements required by section 527 were a sufficiently narrow means to ensure that clients are aware of general information regarding bankruptcy, this section did not violate the First Amendment.

Although the court in *Hersh* determined that attorneys are debt relief agencies under the Bankruptcy Code and that section 526(a)(4) is unconstitutional, it is only one of a handful of district courts to address these issues; other courts may not answer these important questions the same way. The Code provides for recovery of fees and for damages for even negligent violations of these sections. It is therefore important, not only for consumer bankruptcy attorneys, but any attorney who advises clients or potential clients on any bankruptcy related matter (and therefore is

a debt relief agency) to ensure that he or she complies with the requirements set forth in the Bankruptcy Code for debt relief agencies.

The *Till* Rate is the Proper Rate of Interest to be Paid on Secured Claims under Section 1325(a)(5)(B)(ii) of the Bankruptcy Code. *In re Shaw*, 341 B.R. 543 (Bankr. M.D.N.C. 2006).

By Drew H. Reynolds

In order to determine whether to confirm a debtor's Chapter 13 plan, bankruptcy courts must examine section 1325 of the Bankruptcy Code. Section 1325(a) provides that the court shall confirm a plan if the plan meets the requirements of nine numbered paragraphs and one unnumbered paragraph. One of these paragraphs, section 1325(a)(5)(B)(ii), requires that creditors' claims be paid in full, either at the time of confirmation of the plan, or over time with interest. The paragraph does not, however, specify what rate of interest debtors must pay in order to satisfy the confirmation requirements of the Bankruptcy Code. Consequently, this question came before the United States Bankruptcy Court for the Middle District of North Carolina, Durham Division, in *In re Shaw*.

On November 29, 2005, Shaw ("Debtor") filed a petition for bankruptcy protection under Chapter 13 of the Bankruptcy Code. Some time before filing her petition, the Debtor purchased an automobile. In order to finance the purchase, the Debtor borrowed from Allegacy Federal Credit Union ("Creditor") and, as security for repayment, granted the Creditor a lien on the automobile. Both parties agreed that this purchase took place within the 910 days prior to the Debtor's filing. The Chapter 13 trustee filed a Notice and Proposed Order of Confirmation of the Debtor's Chapter 13 Plan, which proposed bifurcating the Creditor's claim into secured and unsecured portions and did not require the Debtor to surrender the automobile. The Creditor objected to the plan because of the proposed bifurcation.

The parties disputed only one issue: What rate of interest, if any, must the Debtor pay on the amount owed to the Creditor in order to satisfy the confirmation requirements of the Bankruptcy Code? While the Creditor argued that the contract interest rate was the proper rate, the Debtor argued that no interest was due on the claim. Both parties agreed, however, that if the court did not accept their arguments, the Bankruptcy Code would require interest to be paid at "the *Till* rate," an interest rate established according to procedures outlined by the Supreme Court in *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004).

In order to resolve the issue at hand, the court first had to determine the relationship among sections 1325(a) and 506 of the Bankruptcy Code and the “Hanging Paragraph”—an unnumbered paragraph at the end of section 1325(a). According to section 1325(a), the court shall confirm a Chapter 13 plan if the plan meets the requirements of nine numbered paragraphs, as well as the Hanging Paragraph. The Hanging Paragraph provides, in relevant part:

For purposes of [section 1325(a)(5)], section 506 shall not apply to a claim described in that paragraph if . . . the debt was incurred within the 910-day [sic] preceding the date of the filing of the petition, and the collateral for that debt consists of a motor vehicle . . . acquired for the personal use of the debtor

Both parties agreed that the Hanging Paragraph applied to the Creditor’s claim; consequently, they agreed that section 506, which permits bifurcation of the creditor’s claim into secured and unsecured portions, did not apply. The parties disagreed, however, on the effect of the inapplicability of section 506. The Debtor argued that the Hanging Paragraph, by making section 506 inapplicable, made all the provisions of section 1325(a)(5) inapplicable, creating a new class of claims which would be paid in full with no interest. The Creditor argued that without the valuation method provided for in section 506(a), secured claims covered by the Hanging Paragraph were required to be paid with the interest rate provided for in the original contract.

The court did not agree entirely with either argument. It dismissed the Debtor’s argument that the Hanging Paragraph made section 1325(a)(5) inapplicable to certain secured claims, reasoning that, to agree with the Debtor’s point, it would have to conclude that a creditor could not be truly secured under the Bankruptcy Code. Furthermore, the court found that state law initially determines a creditor’s rights, which may then be altered by a relevant portion of the Bankruptcy Code. State law, therefore, determines a creditor’s secured status, while the Bankruptcy Code determines the treatment of secured claims. In making section 506 inapplicable to certain claims, then, the Hanging Paragraph did not strip secured claims of their status. Thus, the court held, section 1325(a) continued to apply to such claims.

The plan did not meet the requirements of section 1325(a)(5)(C) because it did not call for the Debtor to surrender her vehicle, and it did not meet the requirements of section 1325(a)(5)(A) because the Creditor did not accept the plan. Therefore, the court found, the relevant portion of section 1325(a)(5) was subsection (B). Section 1325(a)(5)(B)(ii) states that the creditor is to receive “the value, as of the effective date of the plan, of property to be distributed under the plan on account of

such claim” and such value may not be “less than the allowed amount of such claim.”

According to the Supreme Court’s analysis in *Till*, this paragraph requires the creditor’s claim to be paid in full, either at the time of confirmation of the plan or over time with interest. In *Till*, the Court provided detailed instructions on how courts should calculate the appropriate rate of interest. When Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”), it did not change the language of Section 1325(a)(5)(B)(ii). Because of Congress’s presumed knowledge of the *Till* decision and its decision not to change the relevant language when it enacted BAPCPA, the court held that the *Till* rate remained the interest rate that must be paid to meet the requirements of section 1325(a)(5)(B)(ii). Consequently, the confirmation of the Debtor’s plan was denied.

The court’s holding in *Shaw* provides several valuable lessons for transactional attorneys. As *Shaw* illustrates, the Hanging Paragraph does not strip claims of their secured status; therefore, section 1325(a) continues to apply to such claims. Section 1325(a)(5)(B)(ii) requires that the creditor’s claim be paid in full, either at the time of confirmation or over time with interest. Furthermore, the court’s holding in *Shaw* demonstrates that the *Till* rate is the proper interest rate with which secured claims must be paid in order to meet the requirements of section 1325(a)(5)(B)(ii).

BUSINESS ASSOCIATIONS

Corporate Veil . . . or Bulletproof Vest? *Canter v. Ebersole*, No. E2005-02388-COA-R3-CV, 2006 Tenn. App. LEXIS 401 (Tenn. Ct. App. May 13, 2006).

By Kevin Dean

In *Canter v. Ebersole*, the Tennessee Court of Appeals affirmed the Hamilton County Chancery Court’s dismissal of Mr. Canter’s action to pierce the corporate veil of Windward Pointe Townhomes, LLC (“WPT”) and hold its sole member, Richard Ebersole, personally liable for a breach of contract judgment. This case demonstrates the difficulty an attorney in Tennessee faces when attempting to pierce the corporate veil.

In the underlying breach of contract suit, the Chancery Court of Hamilton County awarded Canter a \$67,515.79 judgment against WPT. WPT did not pay the judgment, and Canter filed suit to pierce the corporate veil and hold Ebersole personally liable on the judgment.

Canter introduced several arguments for piercing the corporate veil in this case. First, he cited the fact that WPT was administratively dissolved on March 16, 2001 (prior to this lawsuit) and was not reinstated until after the judgment was awarded for breach of contract. The court found these facts irrelevant because, under TCA 48-217-101(b), limited liability “continues in full force regardless of any dissolution, winding up, and termination of an LLC.” Second, Canter cited the fact that Ebersole failed to follow customary company formalities to document loans he personally made to WPT. However, the court held this argument irrelevant as well, since failure to follow normal company formalities “is not a ground for imposing personal liability” on LLC members under TCA 48-217-101(e). Third, Canter argued that WPT was undercapitalized (WPT’s initial capitalization was only \$1,000), but this argument failed because the court found WPT was adequately capitalized after taking into consideration the loan funds that were personally guaranteed by Ebersole.

Canter’s fourth argument was that Ebersole dominated WPT. After WPT’s only other member withdrew in April of 2001, Ebersole had sole ownership of WPT and exclusive authority to write checks on WPT’s account and borrow funds on its behalf. Ebersole was operating the business out of his home and using his personal cell phone for WPT business. This dominance argument failed as well because the court found that, although the facts indicated dominance, no evidence was presented showing Ebersole used his dominance to defraud or conduct an illegal operation.

Finally, Canter argued that Ebersole’s management of WPT should weigh heavily in favor of piercing the corporate veil. He emphasized that debts of creditors other than Canter were paid, and Ebersole even used WPT’s last \$20,000 to pay debts the LLC owed to him. The court held Ebersole’s payment of WPT’s debts while he was personally liable does not establish an ulterior motive to defraud creditors. The court also emphasized that Ebersole loaned WPT a total of \$369,556.99 and was repaid less than half—\$146,697.07. Additionally, nothing in the record indicated Ebersole used WPT to engage in any unlawful acts.

The *Canter* case demonstrates the uphill battle a practitioner faces when attempting to pierce the corporate veil. Here, the court emphasized that piercing the corporate veil is only appropriate in extreme circumstances, that no single factor is conclusive, and that it should only be used “to prevent the use of a corporate entity to defraud or perform illegal acts.” See *Muroll Gesellschaft M.B.H. v. Tenn. Tape, Inc.*, 908 S.W.2d 211, 213 (Tenn. Ct. App. 1995). To succeed in an action to pierce the corporate veil, practitioners must be able to show that a corporate entity was used to defraud or perform illegal acts in order; however, following *Canter*, the corporate veil appears to be very nearly a bulletproof vest.

Deepening Insolvency in Delaware: Corporate Directors Can Sink the Ship as Deep as They Want . . . as Long as They're Not Trying To. *Trenwick Am. Litigation Trust v. Ernst & Young, L.L.P. et al.*, 906 A.2d 168 (Del. Ch. 2006).

By Christopher B. Kelly

In *Trenwick America v. Ernst & Young*, the Delaware Chancery Court held that causes of action for deepening insolvency are not recognized under Delaware law. Considering a claim by the litigation trust of an insolvent corporation against its directors and advisors, the court recognized that the business judgment rule presumes the business decisions of directors are proper and that the presumption may not be rebutted simply by a showing that deeper corporate insolvency resulted from the challenged corporate decisions.

Trenwick Group, Inc. ("Trenwick") was a publicly-traded insurance holding company comprised of various international subsidiaries. From 1998 to 2003, Trenwick adopted a growth strategy that resulted in the acquisition of various other publicly-traded insurance companies. A subsequent reorganization made Trenwick's top U.S. subsidiary, Trenwick America Corporation ("Trenwick America"), the intermediate parent of all of Trenwick's U.S. operations and significantly increased the percentage of Trenwick's overall debt assigned to Trenwick America as guarantor.

Unfortunately for Trenwick, it underestimated the potential claims exposure of many of the insurance companies it acquired during its growth. As a result, the claims made by Trenwick's insureds eventually exceeded Trenwick's capacity to pay the claims and its debt. By 2003, Trenwick and Trenwick America had become insolvent, and both filed for bankruptcy within the year. In response to the companies' filings, a litigation trust was created and was assigned all causes of action owned by Trenwick America.

In 2006, the litigation trust filed suit in Delaware Chancery Court against former directors of Trenwick, former directors of Trenwick America, and some of Trenwick's former advisors, challenging two of Trenwick's significant acquisition transactions. In its suit, the litigation trust made claims of breach of fiduciary duty, fraud, and a somewhat unconventional claim of "deepening insolvency." With the litigation trust's case suffering from multiple pleading deficiencies, including a complaint lacking facts to support an inference that Trenwick was actually insolvent at the time of the transactions, the Chancery Court decided the case on the pleadings and elected to dismiss all of the litigation trust's claims for breach of fiduciary duty and fraud. The court's dismissal of the litigation trust's deepening insolvency claim,

however, required no such examination of the facts; Delaware law simply does not recognize deepening insolvency as a cause of action.

As evidenced by the countless number of companies it incorporates, Delaware has long been a leading authority on corporate law in America. A fundamental principle codified in its corporation law is the business judgment rule, which operates as a judicial presumption that, in any given case, corporate directors have acted in the best interest of their corporation, on a fully informed basis, and in good faith. This presumption is based on the court's recognition that the directors of a corporation are generally in the best position to make informed business decisions and that, absent evidence of fraud or a breach of fiduciary duty, courts should not judge those decisions in hindsight, regardless of their financial outcome. Vice Chancellor Strine recognized in *Trenwick America v. Ernst & Young* that this rule should apply to corporate directors not only in their efforts to increase company profitability in times of success, but also in efforts to move out of insolvency in times of despair. By the same logic, Delaware law does not recognize deepening insolvency as a cause of action.

In *Trenwick*, the litigation trust claimed that Trenwick and Trenwick America were insolvent when their directors elected to acquire other insurance companies and that the acquisition resulted in financial loss and deeper corporate insolvency. The flaw in the claim is that it is predicated on the result of the directors' business decision (deeper insolvency) and not on the propriety of the decision itself (good faith and full information). The deeper insolvency claim demands compensation for the negative outcome of the decision, disregarding the presumptions of the business judgment rule. The litigation trust essentially asked the court to assume that, because the acquisitions made by Trenwick resulted in deeper insolvency, the directors must have engaged in some sort of actionable conduct. Under Delaware law, the legal presumption is the opposite. Delaware courts assume that directors of a corporation acted in good faith and on a fully informed basis unless the plaintiffs can rebut those presumptions with particularized facts. The litigation trust failed to do so, and, as the court stated, "may not cure that deficiency simply by alleging that the corporation became more insolvent as a result of the failed strategy."

The court focused on the nature of the business decision and noted that, "even when the company is insolvent, the board may pursue, in good faith, strategies to maximize the value of the firm." In relegating the litigation trust to traditional causes of action such as breach of fiduciary duty and fraud, the court supported the legal principle that the directors of a corporation should be positioned to make informed business judgments, but not to be guarantors of a particular business strategy's success. Further, this principle does not waver in times of insolvency. Delaware law "requires the directors of an insolvent corporation to consider, as

fiduciaries, the interests of the corporation's creditors." Such directors cannot be said to have breached that duty simply by implementing a business plan that proves to be unsuccessful.

The *Trennick* decision does not modify or reinterpret any rule of Delaware law but makes clear that the business judgment rule should be applied equally to corporate directors operating profitably as well as struggling business enterprises. Regardless of the company's financial situation, the business decisions of the directors must be presumed proper. As Vice Chancellor Strine put it, "the fact of insolvency does not render the concept of 'deepening insolvency' a more logical one than the concept of 'shallowing profitability.'"

The Board's Failure to Take Action Regarding Board Member Misconduct May Result in a Derivative Action Against Board Members for Violation of Their Fiduciary Duties to the Corporation. *Memphis Health Ctr., Inc., v. Grant*, No. W2004-02898-COA-R3-CV, 2006 Tenn. App. LEXIS 498 (July 28, 2006).

By Charles R. Frazier

The Board of Directors' fiduciary duty to the corporation requires it to do what is in the best interest of the corporation, even when that requirement may harm the Board or its individual members. On appeal, the court in *Memphis Health Center, Inc., v. Grant* affirmed the trial court's decision to remove the Board for its failure to remove or investigate the Board Chairman for conduct unbecoming of a Board member, in violation of company bylaws and the Board's fiduciary duty.

Chief Executive Officer Holman ("CEO"), Sadie Davis, and Cornelia Berry of Memphis Health Center (collectively, "Plaintiffs"), filed a verified complaint against the Board members of Memphis Health Center ("Defendant" or "Board"). The complaint sought injunctive relief, both temporary and permanent, prohibiting the Board from, *inter alia*, violating the bylaws of Memphis Health Center, violating the rules and regulations of the United States Department of Health and Human Services ("HHS"), violating Holman's employment contract with Memphis Health Center, and interfering with the day-to-day operations of Memphis Health Center.

The Chancellor subsequently entered an order directing the Board to conduct a meeting to determine whether Holman should be suspended with pay during the prosecution of the instant derivative suit. A court appointed Special Master reported on the Board's resolution, which claimed that Holman had "covered up" sexual harassment complaints and had not informed the Board of the matter.

The Special Master stated that the suspension with pay was “not to be construed . . . as termination” of Holman’s employment.

In its answer, Defendants argued that Plaintiffs did not meet the requirements for a derivative action, in part because Holman, as an *ex officio* non-voting member of the Board of Directors, did not qualify as a “director” within the meaning of the applicable statutes. The Defendants also asserted affirmatively that the Board had acted appropriately, exercising sound business judgment.

The trial court concluded that Holman was a member of the Board for the purposes of Tennessee’s derivative action statute. The court also found that Plaintiffs Davis and Berry were members of the Board, and that the amended complaint stated sufficient justification for excusing the demand. Consequently, the trial court denied the Defendants’ motion to dismiss.

The trial court found that the Board had an affirmative obligation to address conduct unbecoming a Board member, and a particular obligation to at least investigate the judgment of violation of the federal False Claims Act against Chairman Grant. The trial court also found that the bylaws authorized the Board to select as well as dismiss the CEO, but that it had no authority to suspend the CEO with pay. On this basis, the trial court found that the suspension of Holman with pay was a violation of the injunctive order. The Defendants were found in contempt and they appealed.

Generally, the proper party to bring a lawsuit on behalf of a corporation is the corporation itself, acting through its directors or a majority of its shareholders. The derivative action is a limited exception to this rule. “Essentially, a derivative action is a suit brought by one or more members, directors, or shareholders of a corporation, on a corporation’s behalf to redress an injury sustained by or to enforce a duty owed to, a corporation.”

To guard against misuse of the derivative action, preconditions to such lawsuits are imposed. Section 48-56-401 of the Tennessee Code Annotated sets forth the requirements for a derivative action filed on behalf of a nonprofit corporation. The court reviewed only those provisions relevant to the instant action. First, to bring a proceeding on behalf of a domestic or foreign corporation to procure a judgment in the corporation’s favor, the plaintiff must be a “director” of the corporation. Second, each plaintiff must be a director at the initiation of the proceeding. In addition, several pleading requirements must be fulfilled. The complaint must be verified and must allege, with particularity, the demand made to obtain action by the directors. It must explain either why the action sought from the

directors was not obtained or why no demand was made on the directors. This is known as the demand requirement.

Here, the Defendants contended that Holman was not a “director” of Memphis Health Center, as required in Tennessee Code Annotated section 48-56-401(a)(2), and therefore had no authority under the statute to bring a derivative action on behalf of Memphis Health Center. Tennessee Code Annotated section 48-51-201(10) defines “director” as “natural persons, *designated in the charter or bylaws* or elected by the incorporators . . . to act as members of the board, irrespective of the names or titles by which such persons are described.” Article III, section 3, subsection d (read in conjunction with other provisions) of the Memphis Health Center bylaws governs the composition of the Board of Directors; it states that the CEO is an “ex-officio non-voting member to the Board.” The court concluded that, considering all of the bylaw provisions, an *ex officio* member of the Memphis Health Center Board of Directors falls within the meaning of the term “director” in section 48-51-201(10) and therefore has standing to maintain a derivative action against the corporation.

Section 48-56-401(c) of the Tennessee Code Annotated requires a derivative action complaint to “allege with particularity the demand made, if any, to obtain action by the directors . . . or why [the plaintiffs] did not make the demand.” Tennessee case law provides that the demand requirement may be excused. Typically, in a “demand excused” case, a plaintiff claims that a demand would be futile because the board is interested and not independent, and, consequently, the court examines the interest and independence of the corporate decision-makers.

In this case, the amended complaint alleged that any demand “would be futile in that the Defendants have a direct interest in continuing to breach their fiduciary duty and violate the Bylaws and federal rules and regulations, and, therefore, are not independent.” The trial court heard this argument as part of the Defendants’ oral motion to dismiss; it noted that while the evidence at trial might show that the demand should not be excused, the allegation in the amended complaint was sufficient to survive the motion to dismiss. Thus, the court found no error in the trial court’s conclusion on this issue.

The Defendants next argued that the trial court erred in denying the motion to dismiss because the derivative action was brought without being verified. Tennessee Code Annotated section 48-56-401(c) provides that a complaint in a derivative action must be verified. The Defendants acknowledged that the original complaint was verified by Plaintiff Holman, but contended that she was not competent to do so because, as only an *ex officio* Board member, she had no standing to file the derivative action. As noted above, the court concluded that, under the

circumstances of this case, Holman had standing to file the lawsuit, and therefore her verification of the original complaint was sufficient. Thus, the court found no error in the trial court's holding on this issue.

Without citation to authority, the Defendants asserted that a violation of the bylaws of a corporation, a violation of an employment contract, and a violation of federal rules and regulations are not recognized causes of action on behalf of a corporation in Tennessee. From the court's review of the amended complaint, however, the Plaintiffs primarily alleged a breach of the Board members' fiduciary duty to the corporation. It is undisputed that the directors of a corporation owe a fiduciary duty to the corporation to "faithfully pursue the interest of the organization, and its nonprofit purpose, rather than his or her own financial or other interests, or those of another person or organization." If the directors breach their fiduciary duty, they may be held jointly and severally liable to the corporation. Consequently, this argument was held to be without merit.

Here, one of the Plaintiffs' primary allegations was that the Board Chairman was found to have committed thousands of violations of the federal False Claims Act, and that the Board refused to take action to remove him or even to investigate, and that this inaction was a violation of their fiduciary duty to Memphis Health Center. This allegation was clearly actionable. Consequently, this argument was also held to be without merit.

As the *Memphis Health Center* case illustrates, a Board of Director's fiduciary duty requires it to pursue the interests of the corporation, even when corporate interests conflict with the interests of the Board or its individual members. *Ex officio*-type provisions can be used as a check and balance against a self-serving Board, thus promoting integrity in corporate governance. Because the unchecked power of a Board of Directors could harm a corporation, transactional lawyers should advise corporate clients to include provisions in their bylaws that will give corporate officers standing to bring a derivative suit on behalf of the corporation.

Negligence Claim Cannot Sustain Deepening-Insolvency Cause of Action. *In re CitX Corp.*, 448 F.3d 672 (3rd Cir. 2006).

By D. Leigh Griggs

Under Pennsylvania law, only fraudulent conduct is sufficient to support a deepening-insolvency claim; allegations of negligent conduct do not qualify. This

was the issue decided by the United States Court of Appeals for the Third Circuit in *In re CitX Corp.*

In *In re CitX Corp.*, a debtor-Internet company (“CitX”) was involved in an illegal Ponzi scheme and used its financial statements, compiled by its accounting firm, to attract investors. CitX’s only significant customer, Professional Resources Systems International, Inc. (“PRSI”), was a fraudulent enterprise and was shut down by the Florida Attorney General. At the time that PRSI’s business was terminated, it owed CitX 2.4 million dollars. The PRSI receivable remained an asset on CitX’s balance sheet long after PRSI was shut down, thus permitting CitX to show a positive balance sheet. Thereafter, CitX was able to raise more than one million dollars in equity, thereby prolonging its existence. Within eighteen months, CitX spent the investors’ money, incurred millions more in debt, and subsequently filed bankruptcy. A bankruptcy trustee was appointed; the trustee sued the accounting firm and the accountant responsible for compiling the financial statements for, among other things, “deepening insolvency.” The district court granted summary judgment in favor of the accounting firm. The trustee appealed

In determining whether summary judgment on the deepening-insolvency claim was proper, the court of appeals first examined the trustee’s complaint. The trustee alleged that the accounting firm missed many “red flags” and that it should have known about the errors in the financial statements that eventually caused harm to the company. The court noted that the complaint scarcely made out, and the evidence fell short in sustaining, any claim of fraudulent conduct on the accounting firm’s part. Without fraud, the trustee had to depend solely on his claim that the accounting firm negligently deepened the company’s insolvency. Thus, the court had to determine whether a claim of negligence could support a deepening-insolvency cause of action.

In addressing this question, the court returned to its only other opinion dealing with “deepening insolvency”: *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340 (3rd Cir. 2001). In *Lafferty*, the court defined “deepening insolvency” as an injury to the debtor’s company property from the “fraudulent expansion of corporate debt and prolongation of corporate life.” While noting that certain cases support the contention that a claim of negligence could suffice to sustain a deepening-insolvency cause of action, the court rejected this position, stating that *Lafferty* held only that fraudulent conduct would sustain a deepening-insolvency claim under Pennsylvania law. The court found no reason to extend the scope of deepening insolvency. Holding that a claim of negligence could not support a deepening-insolvency cause of action, the court affirmed the judgment below, maintaining that the trustee failed to establish a genuine issue of material fact to support the allegation that the accounting firm engaged in fraudulent conduct.

Although popular belief following the *Lafferty* decision was that Third Circuit courts were more receptive to the deepening-insolvency issue than other courts, the *In re CitX Corp.* case signals a willingness of the Third Circuit to reconsider *Lafferty*'s holding that "deepening insolvency" is a cause of action under Pennsylvania law. At the very least, it appears clear that *In re CitX Corp.* has made future claims of deepening-insolvency harder to plead and maintain. Before bringing future deepening insolvency claims, plaintiffs should determine which state's law applies and review the case law to determine the particular elements that must be pled to allege fraud. In defending a claim of deepening insolvency, one should question the validity of the claim as a separate cause of action in the state in which the complaint is brought, and also question whether it is duplicative of an existing cause of action under state law, such as fraud or breach of fiduciary duty.

The Business Judgment Rule Expanded in *Disney*. *In re the Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006).

By Rachel O. Park

Delaware law presumes that, in making a business decision, the directors of a corporation act on an informed basis, in good faith, and in the honest belief that the actions taken are in the best interest of the company. In *In re the Walt Disney Company Derivative Litigation*, the Delaware Supreme Court considered whether the Board of Directors of the Walt Disney Company were entitled to this presumption when they (1) drafted and agreed to the Ovitz Employment Agreement ("OEA"); (2) fired Michael Ovitz, president of the company, without cause; and (3) paid Ovitz the contracted-for severance payment, valued at approximately \$130 million, even though he had only worked at Disney for 14 months.

In 1994, the Disney Board of Directors decided to name a president and future successor to the late President Frank Wells and interim President Michael Eisner. The prime candidate for the position was Michael Ovitz, the leading partner and one of the founders of Creative Artists Agency ("CAA"), a premier talent agency.

Because of the income Ovitz received from CAA, Disney's Board realized that several financial assurances would have to be promised to Ovitz in order to assure that he would leave CAA and join the Disney team. As such, Irwin Russell, a Disney director and chairman of the compensation committee, began negotiating the financial terms of Ovitz's employment agreement ("OEA").

The first draft of the contract was modeled after Eisner's and Frank Well's employment contracts. In addition to the draft, Russell prepared a "case study" for Ovitz and Eisner to explain the terms of the OEA, including the extraordinary level of compensation that Ovitz would be receiving. Russell also hired an executive compensation consultant to help him evaluate the financial terms of the OEA. Concerned with the annual income Ovitz would receive over the course of his five-year OEA, approximately \$23.9 million, and his ability to receive an additional windfall of \$50 million under the current wording of the OEA, Russell began rewording the draft OEA.

However, before Russell and the compensation consultant were able to determine a reasonable compensation package, Eisner and Ovitz agreed to a separate OEA. On August 14, 1995, Eisner and Ovitz signed an agreement, which outlined the basic terms of the OEA, and stated that the agreement would be subject to the approval of Disney's compensation committee and Board of Directors. After the agreement was signed, Eisner and Russell called the members of the Board and the compensation committee to inform them of the impending new hire, to explain Eisner's friendship with Ovitz, and to detail Ovitz's qualifications. That same day, public reaction to Ovitz's hiring was extremely positive. Disney was applauded for the decision, as its stock price rose 4.4% in a single day, thereby increasing Disney's market capitalization by over \$1 billion.

On September 26, 1995, the Disney compensation committee met to discuss the proposed terms of the OEA. The topics included the historical comparables of Ovitz's contract to that of Eisner and Wells, as well as the size of the option grants. The committee unanimously concluded that it had enough information to approve the terms of the OEA.

Immediately after the compensation committee meeting, the Disney Board met to discuss the OEA. Eisner led the discussion relating to Ovitz. Raymond Watson, a member of the compensation committee, discussed the financial analysis used by the committee in approving the OEA. Both Watson and Russell answered questions from the Board. After further deliberation, the Board voted unanimously to elect Ovitz as President.

Ovitz's tenure as President of the Walt Disney Company officially began on October 1, 1995. The initial reaction was positive. However, over time opinions towards Ovitz began to change. By the fall of 1996, the Disney directors were resigned to the fact that Ovitz would most likely have to be terminated.

On September 30, 1996, the Disney Board met to discuss Ovitz and his future employment with Disney. Eisner told the board members of the continuing

problems that he and others were having with Ovitz, of his own personal lack of trust of Ovitz, and of Ovitz's failures to adapt to Disney's culture. After this meeting, Eisner began searching for ways to relieve Disney of its obligations to pay Ovitz his severance payout under the OEA. He began negotiations with Sony to "trade" Ovitz. These negotiations, however, quickly dissolved. Additionally, Eisner began working with Sanford Litvack, Disney's General Counsel, to explore whether the company could terminate Ovitz "for cause," thus relieving Disney of its severance payout obligation under the "non-fault termination" provision in the OEA.

After consulting Val Cohen, co-head of Disney's litigation department, Joseph Santaniello in Disney's legal department, and "anybody else that [Eisner] could find that had a legal degree," it was determined that no basis existed to terminate Ovitz "for cause." Moreover, Litvack believed that attempting to avoid legitimate contractual obligations by forcing Ovitz to negotiate for a smaller non-fault termination severance payout would harm Disney's reputation as an honest business partner and would affect its future business dealings.

Following a Board meeting on November 25, in which the Board determined that Ovitz's termination was inevitable, Eisner set up a meeting with Ovitz to discuss his termination. After discussing several concessions, all of which Eisner rejected, Ovitz walked off the Disney property for the last time on December 11, 1996. Ovitz's termination was memorialized in a letter, dated December 12, 1996 and a press release was issued that same day. Shortly thereafter, Disney paid Ovitz what was owed under the OEA for a non-fault termination.

One month after that payment, shareholders of the Disney Corporation brought derivative actions on behalf of the Disney Corporation against Eisner and the board of directors ("Defendants") claiming, among other things, that because Defendants breached their fiduciary duties under the Delaware General Corporation Law, their actions should not be protected under the business judgment rule. The Court of Chancery for the County of New Castle ruled in favor of the Defendants, finding that the director Defendants did not breach their fiduciary duties and, as such, were protected by the business judgment rule. Disney's shareholders timely appealed.

The Delaware Supreme Court affirmed the decision of the lower court, holding that the Defendants did not breach their fiduciary duties because no reasonably prudent fiduciary would have acted differently. Thus, the court concluded that the Defendants' decisions to approve Ovitz's employment agreement, to hire him as president, and then to terminate him on a no-fault basis were protected business judgments made without any violation of a fiduciary duty.

In so holding, the court explained that Delaware law presumes that, in making a business judgment, the directors of a corporation act in an informed basis, in good faith, and in the honest belief that the action taken is in the best interests of the company. Those presumptions can only be rebutted if the plaintiff shows that the directors breached their fiduciary duty of care or loyalty or acted in bad faith. If that is shown, the burden then shifts to the defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders.

On appeal, Plaintiff shareholders argued that Defendants violated their fiduciary duties by approving the OEA with a non-fault termination provision that resulted in an enormous payout without informing themselves, at the time the OEA was drafted, of the full magnitude of that payout. The trial court and the Delaware Supreme Court, however, rejected this argument and held that the Board was reasonably informed when it made its decision. Despite the imperfections, the court stated, the evidentiary record was sufficient to support the conclusion that the compensation committee, Eisner, and the entire Board had adequately informed themselves of the potential magnitude of the entire severance package, including the options that Ovitz would receive in the event of an early non-fault termination. Although not in compliance with corporate governance “best practices,” the court concluded that there was still enough evidence in the record to support the trial court’s finding that the Board was reasonably informed. Moreover, the Delaware Supreme Court concluded that, even if Defendants were grossly negligent in their decision to hire Ovitz, grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith.

Because Plaintiff shareholders were unable to carry the heavy burden of showing that the Defendant directors of the Walt Disney Company breached their fiduciary duty of care or acted in bad faith, the business judgment rule protected the actions of the Board.

CONTRACT LAW

Enforceability of Liquidated Damages Provision in Employment Contract Determined Using Prospective Approach. *Anesthesia Med. Group, P.C. v. Buras*, 25 I.E.R. Cas. (BNA) 441, 2006 WL 2737829 (Tenn. Ct. App. Sept. 25, 2006).

By Jennifer G. Rowlett

A liquidated damages provision in an employment contract will be upheld if it satisfies enforceability requirements when analyzed from a prospective approach. In *Anesthesia Medical Group, P.C. v. Buras*, the Tennessee Court of Appeals reaffirmed

the prospective approach established in *Guiliano v. Cleo, Inc.*, 995 S.W.2d 88 (Tenn. 1999) with its decision to enforce the liquidated damages provision of a medical group employment contract against a breaching employee.

In *Anesthesia Medical Group, P.C. v. Buras*, Paul Buras, a registered nurse, applied and was accepted into a sponsorship program with Anesthesia Medical Group (“AMG”) in which AMG sponsored the education of students seeking to become certified registered nurse anesthetists (“CRNAs”) in exchange for their future employment with AMG. Buras executed a contract with AMG on March 24, 1999. The contract provided that AMG loan Buras up to \$22,500 for tuition in exchange for Buras’s promise to work for AMG at the conclusion of his CRNA training and certification.

By entering the contract, Buras promised to begin full-time employment with AMG within thirty days of CRNA certification and promised to work for AMG for a period of three years. Successful completion of the three-year commitment resulted in forgiveness of the tuition loan. Alternatively, the contract provided that failure to satisfy the three-year commitment to AMG at the conclusion of the CRNA program obligated Buras to repay the tuition loan as well as additional payments. The additional payments enumerated in the contract were \$15,000 if he resigned or was terminated for cause within the first twelve months of employment; \$10,000 if the same occurred during the second twelve months; and \$5,000 if it occurred during the third twelve months.

Buras borrowed the entire \$22,500 available from AMG, completed the CRNA program, and started work for AMG on November 7, 2001. However, on July 18, 2002, Buras sent a letter of resignation to AMG, declaring his intention to pursue work as a *locum tenens*, a temporarily employed CRNA who receives a daily wage instead of an annual salary. Buras’s last day of work with AMG was on August 16, 2002.

AMG filed suit on October 25, 2002 seeking to enforce the contract against Buras. Breach of contract was not at issue because Buras admitted his breach. Thus, the trial court awarded AMG partial summary judgment and ordered Buras to repay the tuition loan as well as some other fees and costs. The liquidated damages issue went to trial. The trial court found the \$15,000 liquidated damages provision unenforceable as a penalty to the breaching party.

On appeal, the court analyzed the enforceability of the liquidated damages provision by applying the Tennessee Supreme Court’s holding in *Guiliano v. Cleo, Inc.* In *Guiliano*, the Court adopted a prospective approach to the fundamental requirements of a valid liquidated damages clause. Those requirements are (1) that

the amount of damages must bear a reasonable relationship to the amount of actual damages that would likely be sustained in the event of a breach and (2) that the actual amount of damages must be difficult to determine. Also, a liquidated damages provision will not be enforced if it is found to be a penalty to the breaching party as opposed to a reasonable way to ensure that the non-breaching party will be compensated for damages. The *Guiliano* holding calls for these requirements to be evaluated at the time the parties entered the contract.

Thus, the court examined the AMG employment contract using the prospective approach and ultimately held that the liquidated damages provision was enforceable. First, the court determined that AMG would suffer foreseeable damages if Buras failed to complete the three-year employment commitment because of the significant costs involved in finding temporary and permanent replacements to cover Buras's duties. Second, the court held that it would be difficult to estimate the actual amount of damages that AMG would suffer at the time of contract formation because of unpredictable facts such as the timing of breach. Finally, the court determined that the agreed amount of liquidated damages specified in the contract (\$15,000) was a reasonable prediction of the amount of potential damages that AMG would incur in replacing Buras if he failed to complete his employment commitment. Hence, by utilizing a prospective method of analysis, the court determined that the liquidated damages clause was valid, and by enforcing the clause, the court was adhering to the parties' original intentions. The court awarded judgment to AMG in the amount of \$15,000 in liquidated damages based upon the contract provision.

As *Anesthesia Medical Group, P.C. v. Buras* illustrates, Tennessee courts determine the enforceability of a liquidated damages provision in an employment contract based upon its reasonableness at the time of contract formation. Thus, the continuing challenge for drafters of employment contracts is to prepare liquidated damages provisions that are reasonable predictions of potential damages in the event of breach.

Joining the Majority: Tennessee Changes Its Statute of Frauds. *Blair v. Brownson*, 197 S.W.3d 681 (Tenn. 2006).

By Scott Griswold

The Tennessee Supreme Court and General Assembly have amended the statute of frauds to provide that the "party to be charged" is the party against whom enforcement of the contract is sought. This amendment modifies the previous rule that the "party to be charged" is limited merely to the seller of real property. This

modification brings Tennessee in line with the majority view. Tennessee's statute of frauds, which is consistent with many other jurisdictions, states that "no action shall be brought, . . . upon any contract for the sale of lands, . . . unless the promise or agreement, upon which such action shall be brought, or some memorandum or note thereof, shall be in writing, and signed by the party to be charged." Prior to the Supreme Court's and legislature's policy shift, the lower courts were bound to an antiquated and minority view that the statute was a "defensive tool for the owner of real property."

In *Blair*, Rena Mae Blair, the plaintiff/appellee, sold improved real property to Rollin and Mary Ann Brownson, the defendants/appellants, at a foreclosure auction conducted by a local attorney. Following the sale, the attorney drafted a deed conveying the property in fee simple to the Brownsons. Ms. Blair's lawfully authorized agent signed the deed, but did not deliver it to the Brownsons. The Brownsons never signed the deed. Subsequently, the Brownsons had the property appraised; however, the appraiser's report stated the house was worth significantly less than the purchase price. As a result, the Brownsons reduced their offer for the property to match the appraised value. Ms. Blair demanded the original purchase price, but the Brownsons refused to close the transaction, announcing that they no longer wanted the property.

Ms. Blair sued and sought specific performance of the contract for sale of the land. In their answer, the Brownsons asserted that the statute of frauds provided an affirmative defense since the agreement was for the sale of real property and only the seller had signed the deed. The trial judge granted Ms. Blair's request for specific performance. The Brownsons appealed the order and raised the following issue for review: "whether the deed, which was drafted after the foreclosure sale and signed only by [Ms. Blair's agent], suffices to satisfy the statute of frauds." Judge Susano, writing for the Eastern Section of the Tennessee Court of Appeals, affirmed the trial court and held that, "in light of our precedent, we find the deed has been signed by a lawfully authorized agent of the party to be charged" and, therefore, the statute of frauds was satisfied. While the Court of Appeals noted there was relatively little case law concerning the matter, it asserted that any changes in public policy had to come from either the Supreme Court or the legislature.

In the wake of the intermediate appellate court's ruling, the General Assembly amended Tennessee's statute of frauds to expressly state that the "party to be charged is the party against whom the enforcement of the contract is sought." This statutory change bolstered the Supreme Court's rationale, which stated that "buyers and sellers should receive equal protection in the process of the sale of land so that neither stands to be unduly benefited or disproportionately burdened by the fact that the contract has not been reduced to writing." The Supreme Court

expressly overruled previous precedents that construed the “party to be charged” as the seller and reiterated the new rule stated in the statutory modification.

Consequently, sellers of real property will not be able to sign a deed and then use it as a sword to force buyers into specifically performing oral contracts. Seeing the potential for abuse in the real property market, Tennessee’s policy makers reacted quickly and concisely to return the statute to its intended defensive position. The new interpretation of the “party to be charged” clarifies this important area of the law and adds predictability for practitioners in advising their clients.

INSURANCE

Unambiguous Language is Necessary for Insurance Subrogation Rights.

Allstate Ins. Co. v. Watson, 195 S.W.3d 609 (Tenn. 2006).

By Nicholas C. Zolkowski

Insurance companies may utilize subrogation rights to “step into the shoes” of an insured party in order to inherit that party’s payment rights. *Allstate Insurance Company v. Watson*, however, illustrates the importance of language and intent in contracts, and how they can ultimately affect the insurance company’s subrogation rights.

Kevin Williams (“Williams”), the owner of a duplex, leased a unit of the residence to Robert Watson (“Watson”). The lease contained a clause that stated Watson would be “responsible for all damages to the apartment, intentional or non-intentional.” Williams later procured a fire insurance policy through Allstate Insurance Company (“Allstate”) in case of fire damage.

In June 1995, a fire occurred and damaged the duplex unit. Williams was neither intentionally nor negligently responsible for the fire. The amount of damages was \$25,788.47. Allstate paid Williams the cost of the damages. Allstate then sued Watson under a subrogation claim, as Watson would have been liable to Williams had no fire insurance policy existed.

The trial court construed the “intentional or non-intentional” language of the lease clause to mean that Watson was strictly liable for all damages to the duplex, and ruled in favor of Allstate’s subrogation request. On appeal, the Tennessee Court of Appeals reversed the trial court and held that Williams and Watson were co-insureds and therefore had no hierarchy of rights for Allstate to subrogate.

The Supreme Court analyzed the issue of subrogation based on the language of the contract. In order for Allstate to have a subrogation right, its insuree, Williams, would need to be entitled to payment from Watson, and that right would be construed from the lease contract. The court stated that it would usually interpret a contract to discern the parties' intent based on the literal meaning of the language used, unless the language was ambiguous. If the language was found to be ambiguous and to potentially have more than one meaning, then parole evidence could be used to determine the true intent of the parties.

The court found the lease clause ambiguous because the term "non-intentional" could be interpreted as meaning either "strictly liable" or "negligently." Therefore, parole evidence was necessary to ascertain what Watson and Williams intended the clause to mean, and the contract drafter was brought to testify. The drafter stated that Watson and Williams had not intended to hold Watson strictly liable, but only for negligent or intentionally caused damages. Watson would have needed to be responsible to some degree of fault in order to be liable to Williams. The court therefore held, based on this clarified construction of the lease, that Watson was not liable. Since Watson was not liable to Williams, Allstate was barred from subrogating, and the case was dismissed.

This case demonstrates the importance of using precise and clear language in contracts that explains conditions thoroughly. While the intended meaning may be obvious to the drafters, third parties may misconstrue slight ambiguities into unintended meanings. This case also demonstrates that if a party desires to use any subrogation rights, it should take precautions to ensure it is entitled to do so.

INTELLECTUAL PROPERTY

Absent Allegations of Fraud, State Law Claims Based on Activities that Occurred During Federal Patent Prosecution will be Preempted by Federal Patent Law. *Coker v. Purdue Pharma Co.*, No. W2005-02525-COA-R3-CV, 2006 Tenn. App. LEXIS 757 (Tenn. Ct. App. Nov. 30, 2006).

By Melissa C. Hunter

Any state cause of action that conflicts with federal patent laws is preempted by virtue of the Supremacy Clause of the United States Constitution. Nevertheless, claims derived from state laws that overlap with federal patent laws may escape preemption if the laws do not stand as an obstacle to the accomplishment of federal patent objectives. State laws that impose liability on patent-holders who obtained the patent through deliberate fraud before the Patent and Trademark Office do not

interfere with the purposes of federal patent laws; as such, lawsuits based on these laws will not necessarily be preempted. The Tennessee Court of Appeals affirmed dismissal of a complaint that sought to impose state tort liability based on actions protected by federal patent laws in *Coker v. Purdue Pharma Co.*

The lawsuit in *Coker* followed on the heels of an opinion rendered in the United States District Court for the Southern District of New York. The defendant Purdue Pharma Company (“Purdue”) holds patents for the drug OxyContin. After Purdue learned that a generic drug company sought to manufacture and sell a drug equivalent to OxyContin before the expiration of Purdue’s patents, Purdue filed a patent infringement suit against them in the district court. The district court held that Purdue committed inequitable conduct before the Patent and Trademark Office (“PTO”), which rendered their OxyContin patents unenforceable. Based on that decision, *Coker* filed a class action suit against Purdue in a Tennessee state court alleging three causes of action: Tennessee Trade Practices Act violations, Tennessee Consumer Protection Act violations, and common law monopolization. Purdue filed a motion for judgment on the pleadings before the state trial court. The trial court granted Purdue’s motion and dismissed *Coker*’s complaint. *Coker* appealed, asserting that the complaint was sufficient to avoid federal preemption and that the trial court erred in dismissing the complaint.

The Supremacy Clause of the United States Constitution requires that state laws conflicting with federal law must be preempted. In determining whether preemption is appropriate, a court must look to the congressional purposes to determine if the state law serves as an obstacle to those federal purposes. The United States Supreme Court has held that laws punishing individuals for fraud in obtaining a patent do not interfere with federal patent law objectives; however, the Federal Circuit has held that federal patent law prevents state tort law liability based on actions occurring before the PTO unless “the conduct amounted to fraud or rendered the application process a sham.” Accordingly, the Tennessee Court of Appeals held that *Coker*’s complaint must be dismissed unless it alleges fraudulent conduct before the PTO. The appellate court in *Coker* determined that the complaint did not contain allegations that Purdue engaged in fraud before the PTO when it was prosecuting its patents for OxyContin. *Coker* argued that the United States District Court’s determination that Purdue acted inequitably establishes the requisite fraud to avoid preemption. The court of appeals rejected this argument, noting the difference between inequitable conduct and fraudulent conduct. Next, the *Coker* court examined the complaint itself. The complaint alleged that Purdue made “material misrepresentations” before the PTO, but these allegations fell short of fraud, defined as an intent to deceive.

Lawyers drafting complaints for claims arising from a patent-holder's representations before the PTO should not file suit in a state court unless the complaint contains sufficient allegations of fraudulent conduct. Since the Tennessee Rules of Civil Procedure contain heightened pleading requirements for fraud, the alleged fraudulent conduct must be stated with particularity. As *Coker* illustrates, to avoid preemption and dismissal of a suit, complaints alleging state law claims that overlap with federal patent laws must be written carefully to demonstrate that the state law claims do not interfere with federal patent law objectives.

INTERNET

Defamation in Cyberspace: Who Is Immune From Liability Under The CDA and What Constitutes A "User" Under the Act? *Barrett v. Rosenthal*, 146 P.3d 510 (Cal. 2006).

By Jessica A. Webb

The Communications Decency Act of 1996 ("CDA") often has been interpreted as conferring broad immunity against defamation liability for those who publish information on the Internet that originated from another source. The CDA provides in 47 U.S.C. § 230(c)(1) that "[n]o provider or user of an interactive computer service shall be treated as the publisher or speaker of any information provided by another information content provider." The Act further provides in section 230(e)(3) that "[n]o cause of action may be brought and no liability may be imposed under any State or local law that is inconsistent with this section." The court in *Barrett v. Rosenthal* ruled on three issues: (1) whether section 230 of the CDA applies to distributors as well as publishers; (2) the definition of the statutory term "user;" and (3) whether the immunity provision of section 230 made a distinction between active and passive users of the Internet. The court held that section 230 prohibits distributor liability for Internet publications and that there is no distinction between active and passive use of the Internet.

The plaintiffs in *Barrett* operated web sites devoted to exposing health frauds; the defendant operated an Internet discussion group. The plaintiffs alleged that the defendant committed libel by maliciously distributing defamatory statements via e-mails and Internet postings that impugned the plaintiffs' character and competence and disparaged their efforts to combat fraud. The trial court granted the defendant's motion to strike under an anti-strategic lawsuit against public participation statute, but the court of appeals vacated the order insofar as it applied to one of the plaintiffs. The court of appeals held that section 230 did not shield the defendant from liability under the common law of defamation as a "distributor."

The Supreme Court of California held that the CDA immunity provision applied to distributors, that the term “user” in the CDA immunity provision applied to an individual such as the defendant, and that there is no distinction between active and passive users of the Internet. Further, the court noted that the plaintiffs were limited to pursuing the originator of the allegedly defamatory publications.

The court took into account two main considerations in determining whether distributors were liable under section 230. First, the court started its analysis by evaluating the leading case on section 230 immunity: *Zeran v. America Online, Inc.*, 129 F.3d 327 (4th Cir. 1997). The court agreed with the decision in *Zeran* and held that allowing distributor liability would dramatically impact Internet service providers. Congress did not intend to create a distributor exemption to the immunity provided in section 230. Second, the court rejected the court of appeals’s use of three factors in its analysis: the meaning of “publisher,” the legislative history of the CDA, and the practical implications of notice liability.

The court next considered the definition of the term “user.” First, the court noted that the court of appeals’s “distributor” liability theory did not distinguish between Internet service providers and individuals; the court then made comparisons between the two. The court noted that the term “user” is not defined in the statute and proceeded to determine the meaning of the term by using the rules of statutory construction. The court also noted that Congress consistently referred to “users” of interactive computer services and specifically included “individuals” in section 230(b)(3). The court stated there was no reason to believe that Congress meant the term to have a different meaning in section 230(c)(1) and concluded that the defendant, although an individual, was therefore a “user” under the CDA.

Finally, the court analyzed whether there was a distinction between active and passive Internet use since one of the plaintiffs urged the court to restrict the statutory term “user” to those who engage in passive use. The plaintiff contended that passive users would include those who merely receive offensive information, along with those who screen and remove such information. The plaintiff further contended that active users are those who actively post or republish information on the Internet and that they are “information content providers” unprotected by the statutory immunity. The court held that Congress intended the term “user” in the CDA to refer to “anyone using an interactive computer service, without distinguishing between active and passive use.”

The court’s holding in *Barrett* establishes that Internet intermediaries are exempt from defamation liability for republication. This is an important holding for a modern society where electronic media such as Internet forums, newsgroups, and chat rooms are becoming increasingly prevalent in everyday life. As this trend

continues, business practitioners need to be concerned with whether they could be held liable for their participation in this developing medium.

LABOR AND EMPLOYMENT

The Scope of the Anti-Retaliation Provision of Title VII of the Civil Rights Act of 1964 Extends Beyond Employers' Workplace or Employment-Related Actions Against Employees. *Burlington Northern & Santa Fe Ry. Co. v. White*, 126 S.Ct. 2405 (2006).

By Matthew Avery

The Supreme Court recently held that the anti-retaliation provision of section 704(a) of the Civil Rights Act of 1964 is not coterminous with the substantive discrimination provision and, therefore, is not limited to employer's actions affecting an employee's terms, conditions, or status of employment that occur at the workplace. Specifically, the Court held that a reassignment of duties without a demotion, as well as a thirty-seven-day unpaid suspension (though later rescinded with back pay), could potentially constitute retaliatory discrimination within the provision's scope. The Court also held that the anti-retaliation provision requires showing that a reasonable employee would have found the employer's challenged action materially adverse—the action could well have dissuaded a reasonable employee from taking protected action against his or her employer.

In September 1997, Sheila White was working as a forklift operator in the Maintenance of Way department at Burlington Northern & Santa Fe Railway Company's Tennessee Yard. White, the only female in her department, complained to company officials that her immediate supervisor had repeatedly told her that women should not be working in that department and made inappropriate and insulting remarks to her in front of the men in her department. Burlington disciplined the supervisor and simultaneously removed White from forklift duty, assigning her to dirtier and more arduous track laborer tasks. White filed a complaint with the Equal Employment Opportunity Commission ("EEOC"), asserting that her reassignment amounted to unlawful gender-based discrimination and retaliation.

Several days after filing her complaint with the EEOC, White had a disagreement with her immediate supervisor, and White was immediately suspended without pay. White invoked internal grievance procedures, which resulted in Burlington concluding that she had not been insubordinate. White was then reinstated and awarded back pay for the 37 days she was suspended.

White subsequently filed a claim in the United States District Court for the Western District of Tennessee, asserting that the reassignment and thirty-seven-day unpaid suspension amounted to unlawful retaliation in violation of Title VII of the Civil Rights Act of 1964. A jury found in favor of White, awarding her compensatory damages. On appeal, a Sixth Circuit panel initially reversed and found for Burlington on the retaliation claims, but the full court of appeals, later hearing the matter *en banc*, affirmed the district court's judgment in White's favor.

In deciding the matter, the members of the Sixth Circuit Court of Appeals differed in opinion as to the proper standard to apply in determining retaliatory discrimination. Several circuit courts disagreed on how close a relationship must exist between the retaliatory action and employment for it to be actionable under the provision. The Sixth Circuit majority applied the same standard for retaliation that they applied to a substantive discrimination offense, holding that the challenged action must result in an adverse effect on the terms, conditions, or benefits of employment.

The Supreme Court granted certiorari to resolve this dispute among the circuit courts. The Court held that the anti-retaliation provision of Title VII was not to be construed as narrowly as the substantive discrimination provision because the limiting words found in the latter provision are conspicuously absent from the former. The Court held that the purposes of the two provisions differ, and the intended result of the substantive discrimination provision is a workplace free from discrimination. The intended result of the anti-retaliation provision, on the other hand, is the prevention of employer interference with employees' efforts to secure or advance enforcement of the Act; there are many effective forms of retaliation that would not be precluded under a narrower interpretation of the provision.

The Court also held that the anti-retaliation provision covers only employer actions that would have been materially adverse to a reasonable employee or applicant. This holding requires a plaintiff to show that the challenged action "may well have dissuaded a reasonable worker from making or supporting a charge of discrimination." The standard is phrased generally because the significance of any retaliatory act may depend entirely on the particular circumstances surrounding the act.

Employment law practitioners should take note that the definition of "retaliation" under Title VII's anti-retaliation provision has been interpreted to cover employer actions that are not directly work-related. The standard of a "reasonable employee" for the materiality requirement is a very general one that is highly susceptible to such factors as the individual employee's history and circumstances.

Accordingly, employers should be advised to exercise caution and to follow established procedures to avoid adverse actions.

Where a Management Retention Agreement Provides for Voluntary Termination of Employment for Changes in the Nature and Scope of Authority, Justification of Such Changes does not Present a Dispute in Material Fact Such that Summary Judgment may be Avoided. *Gray v. Shoney's, LLC*, No. M2005-00923-COA-R3-CV, 2006 Tenn. App. LEXIS 710 (Tenn. Ct. App. Oct. 31, 2006).

By Jonathan W. Robbins

At issue in *Gray v. Shoney's, LLC*, is whether an executive who voluntarily terminates his employment based on conditions contained in a Management Retention Agreement (“MRA”) is entitled to severance compensation. This case was decided by the Court of Appeals of Tennessee, Middle Division, upon appeal from summary judgment from the Chancery Court for Davidson County.

While experiencing financial difficulties and facing the prospect of a change of control, Shoney's, Inc. secured MRAs with certain executive employees in order to induce their loyalty through the turbulent times. Bernard Gray, then Chief Information Officer, entered into one of these MRAs, which provided a liberal severance package if, within two years of a change in control, he voluntarily terminated his employment for good reason. Among the various descriptions of what would constitute “good reason” under the MRA was the provision that a “significant change in the nature or scope of Executive’s authority” constituted good reason.

After a 2002 change of control, Gray’s entire department was moved from being directly under the control of Shoney’s, Inc., to being under the control of a wholly-owned subsidiary, Captain D’s Restaurants. After the change, Gray reported to the Operations President of Captain D’s rather than directly to the Chairman of the Board of Shoney’s, Inc., as he had previously done. Furthermore, Gray was no longer allowed to begin or to control research and development projects without prior approval, to make any expenditures without prior approval, to sell used equipment without prior approval, to control the customer comment line and Mystery Shopper programs, or to exercise discretion in certain personnel matters. Based on all these changes, Gray submitted his resignation, claiming “good reason” as defined by the MRA and seeking the severance package also contained in the MRA. Shoney’s, Inc. declined his severance package. At trial, the Chancellor

concluded that significant changes had occurred and granted summary judgment on behalf of Gray.

At issue before the court of appeals is whether genuine disputes regarding material facts exist as to the “good reasons” for which Gray contends he is entitled to terminate his employment and receive severance compensation. Finding that no material facts were in dispute as to whether Shoney’s had made a significant change in the nature or scope of Gray’s authority, the grant of summary judgment was affirmed.

In interpreting the MRA, the court accorded the contractual term “significant” its natural and ordinary meaning, which it defined as a change that has meaning or is likely to have effect on the nature or scope of his authority. In Gray’s motion for summary judgment, evidence was provided of significant changes in his research and development authority, spending authority, authority to sell used equipment, authority over programs, personnel discretion, and changes in the structure of his department and the reporting tier. However, Shoney’s provided no material facts bearing on whether the changes in the nature or scope of Gray’s authority were significant. Shoney’s response provided many persuasive justifications for these changes based on the troubled financial structure of the company; however, these arguments did not address whether the changes were significant. Describing the arguments provided by Shoney’s as a “factual detour, like a trip through the soup and salad bar,” when more substance, “like a healthy portion of country fried steak,” was required, the court found that there were no material facts in dispute concerning whether a significant change occurred and upheld the grant of summary judgment.

Based on the holding in this case, it is clear that, while justifications for corporate actions are persuasive, they are only a “factual detour” where an active MRA provides that good cause can be shown based simply upon significant change in nature or scope of authority. Where there is no provision that allows for temporary or justified changes, the nature of these changes is not important. Thus, when drafting and negotiating a MRA, the practitioner should always remain mindful of exactly what type of provision is desired and under what circumstances and conditions voluntary termination of employment will result in severance compensation.

TAXATION

D.C. Circuit Stuns Tax Lawyers by Declaring I.R.C. § 104(a)(2) Unconstitutional for Taxing Compensatory Damages for Emotional Distress.
Murphy v. I.R.S., 460 F.3d 79 (D.C. Cir. 2006).

By John L. Fuller

In August 2006, the D.C. Circuit Court of Appeals stunned both the tax bar and constitutional lawyers alike with its opinion in *Murphy v. IRS*. A unanimous panel declared unconstitutional the application of I.R.C. § 104(a)(2) that excludes from personal income damages received as compensation for “personal physical injuries or physical sickness,” while permitting the taxation of damages awarded for mental distress and loss of reputation. The opinion firmly questions the income taxing authority of Congress as well as the scope of the Sixteenth Amendment itself. Needless to say, many in the legal community are bewildered by the D.C. Circuit’s conclusions. For now, however, any potential effects of *Murphy* have been put on hold. On December 22, 2006, the D.C. Circuit, *sua sponte*, vacated its previous opinion and scheduled the case for oral argument on April 23, 2007. Though the ultimate outcome is uncertain, a summary of the facts of the case and an analysis of this extraordinary opinion is useful to illustrate how a common understanding of our income taxing mechanism can be called into question by a clever argument and a ready court.

Murphy v. IRS arose out of a suit to recover income taxes paid on compensatory damages awarded in an employment discrimination suit. In 1994, while employed by the New York Air National Guard (“NYANG”), Marrita Murphy alerted state authorities to environmental hazards on a NYANG air base. As a result, Murphy was allegedly “blacklisted” and received unfavorable references from the NYANG to potential employers. Murphy subsequently filed a complaint with the Department of Labor which found in her favor and remanded the case to an Administrative Law Judge (“ALJ”) to determine appropriate compensatory damages.

During the damages phase, Murphy presented evidence of “somatic” and “emotional” injuries, including bruxism, an involuntary grinding of the teeth associated with stress causing permanent tooth damage. After finding that Murphy had suffered from “physical manifestations of stress’ including ‘anxiety attacks, shortness of breath, and dizziness,” the ALJ awarded compensatory damages totaling \$70,000, including \$45,000 for “emotional distress or mental anguish” and \$25,000 for “injury to professional reputation.” These findings and awards were affirmed by the Department of Labor Administrative Review Board in 1999.

In 2000, Murphy reported the \$70,000 on her tax return and paid \$20,665 in income taxes on the award. Soon thereafter, she filed an amended return seeking a refund for the taxes previously paid on the damages award. Murphy based her claim on her belief that she had received her award “on account of personal physical injuries” and, therefore, the award was excluded from gross income under section 104(a)(2). Ms. Murphy presented her medical records in support of her position. The IRS denied her claim on the basis that her medical records were not sufficient to prove her damages were awarded for “physical injury” in light of the ALJ’s decision citing “emotional distress or mental anguish.” Murphy then sued the IRS and the United States in the District Court for the District of Columbia.

Murphy argued, first, that her compensatory award was received for “personal physical injuries” and should be excluded from gross income under section 104(a)(2). In the alternative, she argued that section 104(a)(2) was unconstitutional in its application by excluding from gross income compensation for “physical injuries” while permitting compensation for “emotional distress” to be taxed. The District Court denied Murphy’s claims on the merits and granted summary judgment for the Government and the IRS. The D.C. Circuit Court accepted the case for *de novo* review.

The circuit court first determined that the district court did not have proper jurisdiction over the IRS as a defendant. Citing federal agency immunity statutes, the circuit court held that the IRS could not be sued as an agency under these circumstances and should have been dismissed. The United States remained a proper defendant.

The court then evaluated section 104(a)(2) and its application to Murphy’s awards. Murphy again contended that her award, regardless of the ALJ’s characterization, should fall within the meaning of section 104(a)(2) because of the physical attributes of her injuries. The Government countered by pointing out that the statute’s language had been consistently interpreted by courts to require a “strong causal connection” between damages to be excluded and a personal physical injury or physical sickness upon which the underlying suit was based. In other words, only damages awarded *because of* personal physical injuries or physical sickness could be excluded from gross income. Though the ALJ considered the physical manifestations of Murphy’s injuries, the damages awarded were expressly “for emotional distress or mental anguish” and “for injury to professional reputation.” These causations, argued the Government, were expressly non-physical and, therefore, did not fall under the exclusionary language of section 104(a)(2). The circuit court agreed and affirmed for the government on this first substantive claim.

The circuit court then, after a lengthy discussion of Murphy's constitutional claim, concluded that Murphy's award was in fact not income and, therefore, the failure of section 104(a)(2) to exclude Murphy's award from gross income resulted in an unconstitutional taxation. The circuit court held that, because compensation for personal injuries of any kind are awarded in order to make a person whole, they are not awarded "in lieu of" something not ordinarily taxed—to wit, one's well being—and, therefore, cannot be considered income under the Sixteenth Amendment. The circuit court arrived at its conclusion through an originalist interpretation of the Sixteenth Amendment supported by the earliest versions of the Internal Revenue Code that did not distinguish between physical and non-physical injuries. Offered as additional support were an opinion of the Attorney General and a decision of the Department of the Treasury, both issued in 1918, that suggested compensation for personal injuries was not considered taxable income at that time.

The Government strongly disagreed, claiming that the historical exclusion of compensation for personal injuries did not suggest a boundary of Congress's taxing authority. Instead, it represented merely a policy of not taxing a certain form of compensation. Furthermore, the Government stated that Congress could repeal section 104(a)(2) altogether and tax compensation for all personal injuries while remaining within its taxing authority under the Sixteenth Amendment. This position is derived from the understanding that the Sixteenth Amendment granted Congress broad authority to "tax all gains except those specifically exempted," and the conclusion that monetary compensation received for whatever reason represents a taxable "undeniable accession to wealth." *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 430 (1955) (interpreting the predecessor of I.R.C. § 61(a)).

The circuit court responded to this argument stating, "[W]e reject the Government's breathtakingly expansive claim of congressional power under the Sixteenth Amendment . . . [which] simply does not authorize the Congress to tax as 'incomes' every sort of revenue a taxpayer may receive." This statement, demonstrating the extent of the Court's opposition to the Government's position, appears to indicate a serious conflict over the most fundamental of tax questions: What is income?

It is difficult to predict the outcome of *Murphy v. IRS* "Part II" when the case is revisited later this year. In the meantime, "Part I" raises some serious questions about the current tax code and its attendant mechanisms. Was this unexpected decision an extreme result of overly complex code language? Will it encourage the IRS or Congress to review and revise ambiguous code sections? And, ultimately, will *Murphy v. IRS* conclude with a decisive Supreme Court opinion refining the definition of income, something the Supreme Court has done little of since *Glenshaw*

Glass? We eagerly await the answers to these and other questions raised by *Murphy v. IRS*.