CASE COMMENTARIES

ARBITRATION

When Suing on Behalf of Its Membership, a Medical Association Is Bound by Its Members' Compulsory Arbitration Agreements. *Tenn. Med. Ass'n v. Bluecross Blueshield of Tenn.,* No. M2005-01278-COA-R3-CV, 2007 Tenn. App. LEXIS 16 (Tenn. Ct. App. Jan. 9, 2007).

By Jennifer Gower

The recent boom of litigation involving managed care entities has forced courts to make important distinctions between direct claims for relief filed by medical associations and those claims filed on behalf of their memberships. Medical associations bringing derivative claims on behalf of their memberships are generally bound by the same limitations as the members they represent. This prevents the members from requesting that the association sue on their behalf simply to avoid their contractual commitments. This "nationwide attack on the actions of managed care entities" also leaves courts to determine what types of injury affords these medical associations the protection provided by statutes such as the Tennessee Consumer Protection Act (the "Act"). In *Tennessee Medical Association v. Bluecross Blueshield of Tennessee,* the Tennessee Court of Appeals addressed the standing of the Tennessee Medical Association ("TMA") to sue under the Act and the binding effect of its members' compulsory arbitration agreements on determining the proper forum.

In 2002, TMA filed a lawsuit against Bluecross Blueshield of Tennessee ("BCBST") asserting that BCBST violated the Act by "bundling, downcoding, and otherwise underpaying TMA members." TMA also alleged that BCBST breached its contract and violated the Tennessee Prompt Pay Act. The trial court granted BCBST's motion to dismiss TMA's complaint on the following grounds: (1) TMA did not have a contractual relationship with BCBST; (2) TMA cannot assert a claim of derivative breach of contract when it is not the third-party beneficiary of the contract; (3) TMA is not the submitter of claims as is required for claims brought under the Tennessee Prompt Pay Act; (4) if TMA did meet the above qualifications the matters should be resolved through arbitration; and (5) TMA is not entitled to remedies under the Act because it did not identify a "trade, commerce, or consumer transaction" that satisfies the terms of the Act.

On appeal, TMA raised two issues. The first was whether the trial court correctly held that TMA was not "affected" and did not suffer a loss due to BCBST's

violations of the Act, thus failing to bring TMA within the scope of the Act. The second issue was whether TMA's private enforcement action is subject to arbitration when TMA and BCBST did not enter a binding arbitration agreement.

The Tennessee Legislature enacted the Act to protect persons or organizations "affected" by a violation of its terms. A party seeking the protection of the Act must prove not only that it has suffered injury due to a violation, but also that the violation was in "connection with some 'trade, commerce or consumer transaction.'" The connection between the parties, with respect to the trade or commerce, cannot be "too remote to qualify for the protections of the Act." Remoteness is determined by "the directness or indirectness of the asserted injury." For example, in *Holmes v. Securities Investor Protection Corp.*, the United States Supreme Court denied the plaintiff's recovery because the link between the alleged injury and the defendant's conduct was too remote. Claims brought under the Act are governed by the same proximate cause standard applied in *Holmes*. In *Holmes*, the court recognized that "a central element of proximate cause is the requirement of a direct injury." Tennessee courts have held that injuries are "clearly indirect" when such the injuries are purely contingent on harm to third-parties. In *Tennessee Medical Association,* the trial court ruled that TMA's connection to the trade between BCBST and its membership was too remote because TMA was "not a party to this arrangement, and [TMA did] not perform services nor consume services." The Tennessee Court of Appeals affirmed this ruling and held that TMA's injuries were too remote to establish that BCBST's alleged wrongful conduct proximately caused TMA's injuries.

Medical associations suing on behalf of their memberships "generally are bound by the same limitations and obligations as the members that they represent." To hold otherwise "would permit those physicians to escape their commitments merely by having a representative sue on their behalf." Thus, in *Tennessee Medical Association,* the trial court held that "even if TMA did have a derivative contract claim, . . . TMA's member physicians are required to arbitrate such claims." The Federal Arbitration Act and case law provide that "an arbitral forum is the preferred forum when parties have agreed by contract to compulsory arbitration." The Tennessee Court of Appeals affirmed the trial court's ruling because all of TMA's physician-providers had compulsory arbitration provisions in their contracts with BCBST. The court held that the physician-providers "cannot escape their commitments to arbitrate by having a representative sue on their behalf." As a result, the claims brought by TMA against BCBST, which depended solely on the contractual relationship between the physician-providers and BCBST, were subject to the arbitration provisions of the providers' contracts.

The *Tennessee Medical Association* decision demonstrates the lack of tolerance

Tennessee courts have for providers' attempts to avoid contractual limitations by soliciting medical associations to bring suit on their behalf. If a medical association fails to allege a claim based on a separate contractual relationship and instead piggybacks its claims on a contract to which it is not a party, then it will be bound by any limitations set forth in the contract. Otherwise, the value of the contract would plummet, and providers could easily escape their contractual commitments to the detriment of the other party.

Courts May Not Enforce an Arbitration Agreement upon a Non-Signatory Party, even if the Non-Signatory Party Is a Related Party or a Subsidiary of a Signing Party. *Nitro Distrib., Inc. v. Alticor, Inc.,* 453 F.3d 995 (8th Cir. 2006).

By Shelton C. Swafford

Although arbitration agreements may be enforced between two signatory parties, such agreements may not be enforced against a separate entity established by one of the parties. Even if the separate entity was formed to benefit from the contractual relationship between the original two parties, the court will not bind a non-signatory party absent proof of further understanding, such as a principal-agent relationship. The Eighth Circuit addressed this issue in *Nitro Distributing, Inc. v. Alticor, Inc.*

Alticor, Inc., Amway Corp., and Quixtar, Inc. (collectively "Amway"), are multinational companies, which sell a variety of consumer goods. Amway distributes products through a "network marketing" method. To distribute Amway products, a distributor must be sponsored by another distributor. Amway encourages distributors to sponsor other distributors by giving awards based on how well each distributor and those it sponsors perform.

Motivational tools aid the sponsoring process by encouraging current distributors to recruit new distributors. Nitro Distributing, Inc. and four other companies (collectively "Nitro") are motivational tools businesses owned by distributors of Amway. Amway prohibits its distributors from operating in the motivational tools business; therefore, the distributors created separate entities for that purpose. While each distributor signed arbitration agreements with Amway, the separate entities did not.

The separate entities brought suit against Amway in federal district court, and Amway sought to enforce the arbitration agreement. The district court refused because the separate entities had not signed the arbitration agreements and did not act as agents of the distributors who had signed the agreements. The Eighth Circuit affirmed the district court's decision.

Amway argued that the arbitration agreement should be enforced against Nitro on one of three grounds: estoppel, agency, or the "community interest" doctrine. First, Amway asserted that Nitro was bound by estoppel because (1) it received a direct benefit from Amway and (2) the affiliated distributor conducts business according to the Amway Rules of Conduct. However, the court held that Nitro received only an indirect benefit. Additionally, the Amway Rules of Conduct do not apply to disputes involving the separate entities. Thus, the indirect benefit alone is insufficient to bind Nitro under a theory of estoppel.

Second, Amway argued that Nitro should be bound by the arbitration agreement as the distributor's agent. The court disagreed holding that Amway did not show that Nitro had actual or apparent authority to act on behalf of the distributors. In addition, the Amway Rules of Conduct demanded that the motivation tools and product distribution businesses remain "separate and unconnected activities." Thus, the court refused to enforce the arbitration agreement against Nitro on the basis of agency theory.

Finally, Amway argued that Nitro should be bound by the arbitration agreement under the "community of interest" doctrine because Nitro's interests "are directly related to Amway's interests." However, the court held that the "community of interest" doctrine applies when a party who has not signed the arbitration agreement attempts to enforce the agreement against a signing party. Because Nitro never signed the arbitration agreement and arbitration is solely a matter of contract, Nitro cannot be bound by the agreement. Specifically, the court refused to mandate arbitration when one party has not agreed to arbitrate.

As *Nitro Distributing, Inc.* illustrates, it is important for a company entering into a business relationship with others, whether directly or indirectly, to have all parties sign the arbitration agreement if it is to be enforced against them. To do otherwise runs the risk of giving the non-signing party the opportunity to avoid arbitration yet be able to force a signing party to arbitrate. *Nitro Distributing, Inc.* did not settle disputes between signing parties and non-signing parties of other types of documents. However, the *Nitro Distributing* Court emphasized that arbitration agreements are "a matter of contract" and should be open for negotiation between both parties rather than forced upon an unwilling party. When advising clients who are entering into business relationships with others, especially indirectly, transactional attorneys should advise their clients to have all parties involved sign the arbitration agreement if the client wishes to enforce it.

BANKRUPTCY LAW

Creditor Banks May Challenge Actions Taken Against Bankruptcy Property in Violation of an Automatic Stay. *Ditto v. Delaware Sav. Bank*, No. E2006-01439-COA-R3-CV, 2007 WL 471146 (Tenn. Ct. App. Feb. 14, 2007).

By Whitney L. Frazier

Section 362 of the United States Bankruptcy Code prohibits the liquidation of property of a bankruptcy estate without prior authorization of the bankruptcy court while the petition is pending. This automatic stay protects both the debtor and creditors who have an interest in the debtor's property and continues until the property is no longer part of the bankruptcy estate. As a general rule, actions taken in violation of the automatic stay are void or voidable, regardless of whether the parties have knowledge of the filed bankruptcy petition. At issue here was whether a tax sale held in violation of, but without notice of, the debtor property owner's bankruptcy or the automatic stay was void or voidable. The Tennessee Court of Appeals held that, on the facts before it, the sale was void.

In *Ditto v. Delaware Savings Bank*, Samevelyn Rock ("Ms. Rock") purchased real property in Hamilton County, Tennessee, in 1983 and executed a deed of trust in 1997 in favor of Delaware Savings Bank (the "Bank") to secure repayment of a loan. In 1998, Ms. Rock filed a petition for relief under Chapter 13 of the United States Bankruptcy Code. However, at that time, Ms. Rock had failed to pay her property taxes. Pursuant to a court order, Ms. Rock's property was sold at a tax sale to Carlton J. Ditto ("Mr. Ditto") on June 7, 2001, while her bankruptcy petition was pending. Neither the county clerk nor Mr. Ditto had notice of the pending bankruptcy action at the time of the tax sale. The Chancery Court entered a decree confirming the sale to Mr. Ditto on June 15, 2001.

Controversy soon arose, and in October of 2003, Mr. Ditto sought to quiet title to the property he purchased at the tax sale. The Bank answered Mr. Ditto's state court complaint by citing the validity of its mortgage lien and claiming that the tax sale to Mr. Ditto was void *ab initio* because it violated the automatic stay in § 362 of the United States Bankruptcy Code. Both parties filed motions for summary judgment.

The trial court held that: (1) Ms. Rock was discharged from bankruptcy on September 26, 2002; (2) the automatic stay does not automatically invalidate a tax sale; and (3) only a debtor or her trustee has standing to file an action to set aside the back tax sale. On appeal, however, both parties agreed that the tax sale violated the automatic stay. In *Ditto*, the Tennessee Court of Appeals addressed two issues: (1)

whether the Bank had standing to challenge the tax sale of the property to Mr. Ditto and (2) whether the sale to Mr. Ditto should be voided.

A party challenging an automatic stay violation must show that it has both constitutional and prudential standing. A plaintiff can prove constitutional standing by showing that it "has suffered a personal injury as the result of the allegedly illegal conduct and that the injury suffered is likely to be remedied by the relief requested." Neither party in *Ditto* challenged the Bank's constitutional standing.

A party may prove prudential standing by showing that it is a "proper party" to seek resolution in the dispute at hand. To determine whether a party has prudential standing, a court must ask: "(1) whether the complaint raises abstract questions or a generalized grievance more properly addressed by the legislative branch; (2) whether the plaintiff is asserting his or her own legal rights and interests rather than the legal rights and interests of third parties; and (3) whether a plaintiff's grievance arguably falls within the zone of interests protected by the statutory provision invoked in the suit."

Mr. Ditto argued that because the Bank neither owned the property during the sale nor served as the bankruptcy trustee, the Bank did not meet the third prong of the test and did not have prudential standing. The Bank responded by citing § 362 of the Bankruptcy Code, and asserting that the automatic stay protects the interests of both creditors and debtors. This section gives the debtor a "breathing spell," permitting the debtor "to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy." The automatic stay also provides protection to creditors as parties with a "pecuniary interest adversely affected by a post-petition transfer of property."

Rather than perpetuating a chaotic race to the courthouse, "[b]ankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally." If the automatic stay did not protect their interests, creditors would be able to pursue their own remedies against the debtor's property. Thus, the court held that the Bank did have constitutional and prudential standing to challenge the tax sale.

Next, the Tennessee Court of Appeals addressed whether the tax sale to Mr. Ditto should be declared void or voidable. "Void" denotes that the transaction "is nugatory and ineffectual so that nothing can cure it," or as having "no legal force or effect and so incapable of confirmation or ratification." "Voidable" means "not void in itself," but "capable of being adjudged void, invalid, and of no force." While the court has recognized some equitable exceptions to the automatic stay, it nonetheless has held actions taken in violation of the stay completely void, absent

some equitable circumstance that would render them are voidable. The court previously suggested in *Easley v. Pettibone Michigan Corp.*, 990 F.2d 905 (6th Cir. 1993), "that only where the debtor unreasonably withholds notice of the stay and the creditor would be prejudiced if the debtor is able to raise the stay as a defense, or where the debtor is attempting to use the stay unfairly as a shield to avoid an unfavorable result will the protection of the automatic stay be unavailable to the debtor." Since no such equitable circumstance existed in the present case, the court declared the sale to Mr. Ditto *void* for violating the automatic stay. Thus, the tax sale had no effect, and the property interests of the parties remained the same as they were prior to the sale.

The decision in *Ditto v. Delaware Savings Bank* illustrates that § 362 of the Bankruptcy Code protects more than just the interests of the party who files the petition. Rather, both creditors and debtors with valid interests have standing to challenge transfers of property of the bankruptcy estate made in violation of the automatic stay. Transactional lawyers should advise their clients that any entity with an interest in such property might challenge such a transaction, even if the sale was pursuant to court order. Attorneys should also discourage clients from purchasing property without conducting diligent research to determine if a bankruptcy petition has been filed by one holding property rights in the property, as notice of the bankruptcy petition is not necessary for the automatic stay to take effect.

Good Faith Required to Preserve Debtor's Right to Conversion. *Marrama v. Citizens Bank*, 127 S. Ct. 1105 (2007).

By Stephen D. Hargraves

Although federal courts virtually unanimously agree that prepetition bad-faith conduct may cause a forfeiture of any right to proceed at the outset of a Chapter 13 bankruptcy case, some courts have held that a bad-faith debtor has an absolute right to convert at least one Chapter 7 case to a Chapter 13 case. In *Marrama v. Citizens Bank*, the United States Supreme Court addressed the issue of whether the United States Bankruptcy Code ("the Code") requires such a conversion even though the case may subsequently be dismissed or immediately returned to Chapter 7.

Robert Marrama ("Marrama") initially filed a voluntary bankruptcy petition under Chapter 7 of the Code. In verified schedules attached to his petition, Marrama asserted numerous misleading or inaccurate statements, including statements regarding his principal asset, a house in Maine. Marrama stated that the

revocable trust that owned the Maine property had zero value and that he had not transferred any property during the year preceding the petition's filing other than in the ordinary course of business. However, the Maine property carried substantial value, and Marrama had transferred the property into the revocable trust without consideration within the preceding year. The Chapter 7 estate trustee subsequently confirmed that Marrama's transfer of the Maine property was an effort to protect the property from Marrama's creditors. In addition, Marrama claimed a homestead exemption for property in Gloucester, Massachusetts, even though Marrama did not reside at the property but received rental income from it.

After discovering the misleading and inaccurate statements, Marrama's Chapter 7 estate trustee conveyed to Marrama the trustee's intention to recover the Maine property as an asset of the estate. Upon learning of the trustee's intention, Marrama filed a motion to convert the Chapter 7 petition to a Chapter 13 petition. Thereafter, the bankruptcy judge determined that Marrama acted in "bad faith" and denied the request for conversion.

On appeal, the Bankruptcy Appellate Panel ("BAP") interpreted Section 706(a) of the Code as creating a right to convert a case from Chapter 7 to Chapter 13 that "is absolute only in the absence of extreme circumstances." The BAP determined that Marrama's failure to disclose the transfer of the Maine property to a trust, as well as his attempt to claim an exemption on rental property, constituted such extreme circumstances. As a result, the BAP affirmed the denial of the conversion. On appeal, the Court of Appeals for the First Circuit affirmed the two previous decisions. The court noted that given its authority to dismiss a Chapter 13 petition for "bad faith" by the debtor (as implicitly authorized in Section 1307(c)), it should not treat an attempt to convert a Chapter 7 case to Chapter 13 differently than if the debtor initially filed a Chapter 13 petition.

The United States Supreme Court noted that subsections (a) and (d) of Section 706 of the Code are the most relevant in determining whether a debtor has an absolute right of conversion. Subsection (a) states that "[t]he debtor may convert a case under this chapter to a case under chapter 11, 12, or 13 of this title at any time, if the case has not [already] been converted . . . . Any waiver of the right to convert a case under this subsection is unenforceable." In addition, subsection (d) states that "[n]otwithstanding any other provision of this section, a case may not be converted to a case under another chapter of this title unless the debtor may be a debtor under such chapter."

Marrama contended in his appeal that subsection (a) created an absolute right of conversion that could not be forfeited. The language in the related Senate Report that a debtor has a one-time absolute right of conversion of a liquidation case

(Chapter 7) to a reorganization or individual repayment plan case (Chapter 13) appeared to support Marrama's position. Furthermore, the Senate Report confirmed that a waiver of the right to convert a case is unenforceable. However, the Court dismissed Marrama's argument that the unenforceable waiver provision in the Code works as a shield against forfeiture. In dismissing the argument, the Court noted that the unenforceability provision merely functions as a consumer protection provision against adhesion contracts. In the instant case, the record did not show any evidence of adhesion contracts between Marrama and his creditors that required a waiver of Marrama's right to conversion. As to the one-time absolute right of conversion, the Court noted that when read in conjunction with subsection (d), the words "unless the debtor may be a debtor under such chapter" expressly conditioned Marrama's right to convert on his ability to qualify as a "debtor" under Chapter 13.

Although multiple reasons why Marrama may not qualify as a debtor under Chapter 13 exist, the Court focused its analysis on Section 1307(c) of the Code. Subsection (c) provides that a Chapter 13 proceeding may be either dismissed or converted to a Chapter 7 proceeding "for cause" and includes a nonexclusive list of ten (10) causes justifying such relief. Although none of the listed causes identifies prepetition bad-faith conduct, the majority of bankruptcy courts treat dismissal or conversion of Chapter 13 cases for prepetition bad-faith conduct as implicitly authorized by the words "for cause." Therefore, in the instant case, Marrama's prepetition bad-faith conduct during his earlier Chapter 7 proceeding precluded him from qualifying as a debtor under Chapter 13. As a result, Marrama was not deemed a member of the class of "honest but unfortunate debtors" that the Code intended to protect. The Court found that the conditional language in Section 706(d) provided authority for the denial of Marrama's motion to convert. Consequently, the Court affirmed the lower court's decision.

Although the federal courts have nearly unanimously held that prepetition bad-faith conduct may cause a forfeiture of any right to proceed at the outset of a Chapter 13 bankruptcy case, the Court's holding in *Marrama* resolved that a debtor does not have an absolute right to convert his bankruptcy case from Chapter 7 to Chapter 13. A transactional lawyer should advise his clients to diligently provide all necessary disclosures so that the lawyer may accurately prepare the schedules accompanying the client's Chapter 7 bankruptcy petition. Failure to accurately portray the client's financial position may be viewed as prepetition bad-faith, and, consistent with the holding in *Marrama*, result in the client's removal from the class of "honest but unfortunate debtors" who enjoy the right to convert their cases from Chapter 7 to Chapter 13. A loss of this right would mean that the client would lose the opportunity to repay his debts while retaining possession of his assets.

BUSINESS ASSOCIATIONS

Duty of Good Faith Strictly Enforced When Expelling Members from an LLC. *Anderson v. Wilder*, No. E2006-02647-COA-R3-CV, 2007 Tenn. App. LEXIS 582 (Tenn. Ct. App. June 19, 2007) (*Anderson II)*.

By Burke Keaty

Recently, the Tennessee Court of Appeals upheld a jury's decision to award damages to former minority members of a Tennessee member-managed limited liability company who sued majority members alleging that the majority members violated their fiduciary duties and obligation of good faith in voting to expel the minority members from the firm. Although there was an operating agreement that authorized the expulsion of the minority members, *Anderson v. Wilder* makes it clear that the majority's actions must be taken in a manner consistent with their fiduciary duties and obligation of good faith. Contractual language in an operating agreement does not shield the majority from breaches of fiduciary and good faith responsibilities.

The court's opinion includes a procedural history of the case and a lengthy review of the testimony and evidence offered at trial before addressing the issues raised on appeal. After the Plaintiffs filed suit, the "Defendants moved for summary judgment arguing that their actions were expressly permitted under the operating agreement, and that they acted in good faith in expelling the Plaintiffs." The operating agreement provided that "the Company may expel a Member, with or without cause, from the Company upon a vote or written consent of the Members who hold a majority of Units." The trial court initially agreed with the Defendants and granted their motion for summary judgment; however, the appellate court did not and vacated the trial court's order. In *Anderson I*, decided in 2003, the appellate court held that a "majority shareholder of an LLC stands in a fiduciary relationship to the minority . . . [and] [s]uch a holding does not conflict with the statute, and is in keeping with the statutory requirement that each LLC member discharge all of his or her duties in good faith." The court held that a genuine issue of material fact existed as to:

> [W]hether the defendants' actions in expelling the minority Plaintiffs were taken in good faith, as required by the LLC Act, or whether they expelled Plaintiffs solely in order to force the acquisition of their membership units at a price of $150.00 in order to sell them at $250.00 per unit, in violation of their fiduciary duty.

Upon its decision, the appellate court remanded the case for trial. However, at trial the jury was unable to reach a unanimous verdict and the trial court declared a mistrial. The case proceeded to trial a second time, and the jury found in favor of the plaintiffs, awarding damages and pre-judgment interest totaling $98,895.36. The Defendants appealed the result of the second trial in *Anderson II*.

Plaintiffs were current and former members of FuturePoint Administrative Services, LLC ("FuturePoint"), a Tennessee member-managed limited liability company in the business of administering third-party medical claims. Upon creation of the firm, the members executed an operating agreement dividing equity interests in the firm into "ownership units" and providing for a management committee to oversee and manage the firm's business operations. Specifically, the management committee was responsible for controlling the funds in the firm's operating account. There were a total of eleven members, and each member paid $150.00 per ownership unit, with the exception of defendant Brett Wilder and his wife, who were allocated a 20% ownership interest in the company without contributing any money capital. The operating agreement provided that the firm could expel any member, with or without cause, upon a vote or written consent of the members who held a majority of units. In such cases, the remaining members were obligated to purchase the expelled member's ownership units at $150 per unit.

The dispute giving rise to this case began at a FuturePoint members' meeting that took place on September 10, 2001. The members discussed offers from outside investors interested in purchasing ownership units for $250 per unit. The members were divided as to whether they should accept any offer, primarily because they disagreed about what would happen to the money in the company's operating account if an offer were accepted. Some members argued that those who decided to sell their shares should be entitled to their share of the firm's profits. These members reasoned, using law and the terms of the operating agreement, that the profits should be distributed prior to a new investor entering the company. Other members contended that the company should not distribute its profit because the price per unit offered by the outside investors would decrease.

The company had accumulated $63,000 in its operating account as profit, and it was the management committee's responsibility to determine whether to make distributions. In concluding the September 10th meeting, the members decided not to accept any offer and instead to wait until the upcoming management committee meeting when they would know whether the $63,000 would be distributed. The management committee meeting was scheduled to take place the following day; however, due to the September 11 attacks, the meeting was rescheduled for September 14, 2001.

The management committee consisted of Plaintiffs Michael Atkins, Charles Quade, and Bill Thompson and Defendants Lamarr Stout and Brett Wilder. According to the testimony at trial, the three Plaintiffs on the committee favored distributing the money in the operating account, while the two Defendants disagreed. Knowing they were outnumbered three to two, the Defendants acted before the meeting could take place. Defendant Wilder contacted his accountant, who put Wilder in touch with a lawyer, Lewis Howard, Jr. Wilder testified that he was told that he and the other members who felt the money in the operating account should not be distributed should disband the operating agreement and expel the members who disagreed. Howard testified that he reviewed the operating agreement, specifically the provision dealing with the expulsion of members, and determined that a majority vote of the members can expel members from the company. Furthermore, he testified that "Mr. Wilder's group constituted a majority of the membership interest of the company, and therefore under the operating agreement, they had the ability to vote to expel members, and I advised them that they could do that under this agreement."

The Plaintiffs alleged that Wilder led a majority of shareholders to act against those who wanted to disburse the $63,000 by taking advantage of the operating agreement's provision regarding the expulsion of members. According to a document entitled "Actions taken by written consent of the members of FuturePoint Administrative Services, LLC," the Defendants, holding a majority of units: (1) expelled the Plaintiffs; (2) deleted the article in the operating agreement creating the management committee and reassigned its functions to defendant Wilder; and (3) replaced plaintiff Quade with defendant Stout as secretary of the firm. The remaining members of the firm purchased the expelled members' ownership units at $150 per unit as provided in the operating agreement.

Less than one month later, the Defendants sold a total of 499 membership units to an investor for $250 per unit. The Plaintiffs, consisting of six expelled members who held a 47% ownership interest in the firm before their expulsion, filed suit against the Defendants, Wilder and four others who collectively held the remaining 53% ownership interest before the expulsion. The suit alleged that the Defendants violated their fiduciary duties and obligations of good faith and fair dealing as members in exercising the authority granted in the expulsion provision of the operating agreement. At trial, the jury agreed and found that the Defendants violated their fiduciary duties and their obligation of good faith by not allowing the Plaintiffs the opportunity to sell their shares at a profit.

On appeal, the Defendants argued that they were entitled to a new trial because the trial court erred in (1) denying their motions for a directed verdict, (2) awarding pre-judgment interest, and (3) charging the jury. First, the appellate court

found that the jury was presented with sufficient material evidence to support its verdict; thus, the trial court did not error in denying the Defendants' motions for a directed verdict. The appellate court stated that the "Defendants' arguments in regard to this issue are, in essence, a reflection of Defendants' continuing belief that our opinion in *Anderson I* was wrong . . . [and] no fiduciary duty is owed between members of a member-managed LLC." The appellate court held that because the Defendants did not appeal *Anderson I,* it was "the law of the case," and therefore, a majority member of a member-managed LLC has a fiduciary duty to a minority member. The appellate court affirmed the jury's decision holding the defendants liable for breaching their fiduciary duties.

Second, the appellate court noted that "an award of prejudgment interest is within the sound discretion of the trial court and the decision will not be disturbed by an appellate court unless the record reveals a manifest and palpable abuse of discretion." Finding no abuse of discretion, the trial court's decision to award prejudgment interest was affirmed.

Third, the Defendants argued that the trial court erred in charging the jury in two respects. First, the Defendants argued that the court read too much of a statute to the jury as part of its charging. However, the appellate court found no error in the trial court's decision. Second, the Defendants argued that the trial court erred by refusing to give their proposed jury instruction to the jury. However, the appellate court found that the proposed jury instruction was "simply an attempt to circumvent [the appellate court's] clear ruling in *Anderson I*." Thus, the trial court's refusal to give the proposed jury instruction was proper.

Anderson v. Wilder serves as a serious warning to attorneys who give advice to members of Tennessee member-managed limited liability companies. Even though the authority to expel members was properly granted and clearly stated in FuturePoint's operating agreement, the court found that the members who acted under such authority violated their fiduciary duties to the other members of the firm. In reaching its decision, the appellate court relied on *Anderson I*, which held that "a majority shareholder of an LLC owes a fiduciary obligation to a minority shareholder" and "each LLC member is required to discharge his or her duties in good faith." Thus, there currently is a conflict between authority granted in an operating agreement and mandatory fiduciary duties. Until the court either resolves this conflict or clarifies the boundaries of its holding in *Anderson II*, transactional attorneys should practice with the knowledge that the Tennessee Court of Appeals adamantly enforces mandatory fiduciary duties. Transactional attorneys should advise their clients that actions taken in accordance with the provisions of an operating agreement must be consistent with the actor's fiduciary duties and obligations of good faith and fair dealing. Further, actions taken in accordance with

the provisions of the operating agreement must be consistent with the actor's fiduciary duties and obligations of good faith and fair dealing.

COMMERCIAL LAW

Active and Personal Involvement: The Fiduciary Shield Doctrine and Personal Jurisdiction. *Innovative Eng'g & Consulting Corp. v. Hurley & Assoc., Inc.*, No. 1:05CV0764, 2006 U.S. Dist. LEXIS 70502 (N.D. Ohio Sept. 28, 2006).

By Aaron J. Kandel

An officer of a corporation who is actively and personally involved in the corporation's transactions in another state may be liable in their individual capacity, not just as an agent of the corporation. Although the fiduciary shield doctrine prevents the forum state from exercising personal jurisdiction over an officer whose contacts with the state were made in his official capacity, the Sixth Circuit recently overruled, or at least severely limited, the doctrine's application. This is especially relevant when the officer has conducted multiple transactions in the forum state and has claimed to have an interest in intellectual property that was designed and manufactured in that state. Such was the situation presented to the District Court for the Northern District of Ohio in *Innovative Engineering & Consulting Corp. v. Hurley & Assoc., Inc.*

Innovative Engineering & Consulting Corp. ("IEC"), an Ohio corporation with its principal place of business in Cleveland, Ohio, and Hurley & Associates, Inc. ("H&A"), a Maryland corporation with its principal place of business in Mt. Airy, Maryland, had a preexisting business relationship. IEC designed and manufactured the custom components for use in H&A's surveillance systems. In early 2004 and late 2005 the parties entered into another series of contracts for the purchase of custom components. IEC performed all of its obligations under the contracts by manufacturing the requested components and preparing them for delivery. However, in early 2005, H&A refused to accept delivery of, or pay for the components.

IEC filed suit asserting multiple claims against H&A and against Thomas Hurley ("Hurley"), the owner and officer of H&A. Specifically, IEC asserted the following claims against Hurley: (1) false designation of origin, 15 U.S.C. § 1125(a)(1)(A); (2) false advertising, 15 U.S.C. § 1125(a)(1)(B); (3) unfair competition; and (4) sought declaratory judgment as to whether Hurley is a co-

inventor under patent law. Subsequently, Hurley filed a motion to dismiss the counts asserting that he entered into the IEC contracts in his capacity as an officer of H&A and thus the fiduciary shield doctrine prevents the court from exercising personal jurisdiction over him.

Because IEC's declaratory judgment action arose under federal patent law, the court applied the law of the Federal Circuit to determine whether the court may exercise personal jurisdiction over Hurley. Under federal circuit law, a court must first determine whether a provision of the state's long-arm statute makes the defendant amenable to process. Second, the court must ensure that maintenance of the suit does not offend traditional notions of fair play and substantial justice under federal due process.

The Ohio long-arm statute confers jurisdiction if the defendant regularly does or solicits business in Ohio, engages in any other persistent course of conduct, or derives substantial revenue from goods used or consumed in the state. Conversely, the fiduciary shield doctrine prevents a court from exercising personal jurisdiction over a defendant whose contacts with the state were made solely in his official capacity as an officer of a corporation. However, the Sixth Circuit recently held that the fiduciary shield doctrine does not prevent a court from exercising personal jurisdiction where an out-of-state officer was actively and personally involved in the conduct that gave rise to the claim. In those situations, traditional notions of fair play and substantial justice govern the exercise of personal jurisdiction.

Thus, the court's inquiry focused on the specifics and nature of Hurley's contacts with the forum state. The court found that (1) Hurley conducted approximately 625 transactions with IEC that resulted in over 2.3 million dollars of business; (2) Hurley had provided $20,000 in software development funds to IEC; (3) Hurley claimed to have an interest in intellectual property that was designed, developed, and manufactured in Ohio; and (4) Hurley made numerous phone calls and sent several written demands into Ohio. Based on those findings, the court concluded that Hurley was actively and personally involved in "all aspects of the business relationship" with IEC.

Next, the court applied the standard three-part inquiry under federal due process to determine whether specific personal jurisdiction existed. First, the court found that Hurley had purposefully directed his business activities at residents of Ohio. Second, the court found that IEC's claims "arise out of and relate to" its contacts with Hurley. Third, the court found that the exercise of jurisdiction over Hurley was fair and reasonable. Therefore, the court concluded that it could exercise personal jurisdiction over Hurley and denied his Rule 12(b)(2) motion to dismiss.

As *Innovative Engineering & Consulting Corp. v. Hurley & Assoc., Inc.* illustrates, the fiduciary shield doctrine has been severely limited in some jurisdictions. However, even in those jurisdictions, a court cannot exercise personal jurisdiction in a manner that offends due process. Thus, a transactional attorney in a limited application jurisdiction should advise his clients that their actions as an officer of a corporation may subject them to personal liability. The risks of personal liability, however, cannot be quantifiable.

CONTRACT LAW

An Aggrieved Purchaser May Not Seek Revocation of Acceptance Against the Distributor or Manufacturer of a Product. *Watts v. Mercedes-Benz USA, LLC*, No. E2007-00311-COA-R3-CV (Tenn. Ct. App. 2007).

By Whitney L. Quarles

Most automobile purchasers expect to retain a right to revoke acceptance if he or she discovers that the newly-purchased automobile is a "lemon." However, such rights of revocation are limited. In *Watts v. Mercedes-Benz USA, LLC*, the Tennessee Court of Appeals addressed the issue of whether the purchaser of a new automobile may seek revocation of acceptance against the automobile distributor. The court held that "the remedy of revocation of acceptance . . . is only available against the seller, not the distributor, of the product."

In 2001, Robert L. Watts purchased a new 2002 model Mercedes-Benz automobile from a dealer in Knoxville, Tennessee. The automobile was supplied to the dealership by Mercedes-Benz USA, LLC ("MBUSA"). MBUSA provided a limited written warranty agreeing to cover repair costs or replacement caused by defects in materials or workmanship for a period of 4 years or 50,000 miles.

Three years later, while the automobile was still covered by MBUSA's warranty, Mr. Watts brought suit against MBUSA. His suit cited the automobile's inoperability for 54 days and alleged breaches of express warranty and the implied warranties of merchantability and fitness for a particular purpose. He further alleged a violation of the Magnuson-Moss Warranty Act ("the Act"). The trial court granted MBUSA's motion for summary judgment as to each claim except the breach of express written warranty. After trial, Mr. Watts dismissed his request for monetary damages, leaving only his request for revocation of acceptance under Tenn. Code Ann. § 47-2-608 and the Act.

The Tennessee Court of Appeals began its opinion by noting that "the UCC remedy of revocation of acceptance, 'for all practical effect replaces the old equitable doctrine of rescission.'" The court then explained that both Tennessee statutes and "common-sense" dictate that an aggrieved purchaser has no right of revocation of acceptance against the distributor of a product. The court used a textualist approach to reach its conclusion; it stated that Tenn. Code Ann. § 47-2-608, which provides for revocation of acceptance, "exclusively uses the terms 'buyer' and 'seller.'" This language suggested to the court that "a buyer-seller relationship is required for revocation of acceptable to be available." Thus, because "sale" is defined under Tenn. Code Ann. § 47-2-103(1)(d) as "the passing of title from the seller to the buyer for a price[,]" the remedy of revocation of acceptance is unavailable in a buyer-distributor relationship when title has not passed and privity does not exist. This reasoning applies equally to bar revocation of acceptance against a manufacturer. Instead, privity of contract between a buyer and seller is required to allow a revocation of acceptance.

The court rejected Watts' argument that the distributor's warranty, which was part of the consideration for the purchase price, created privity between the seller and the distributor. The court acknowledged that an aggrieved buyer is not without a remedy against a distributor who breaches an express warranty; however that remedy is limited to monetary damages. The court found no merit in a claim for revocation against a distributor because the buyer accepted the product from and paid the purchase price to the seller.

Furthermore, the court rejected Watts' claim under the Act, which provides that "a consumer who is damaged by the failure of a supplier, warrantor, or service contractor to comply with . . . a written warranty, implied warranty, or service contract, may bring suit for damages and other legal and equitable relief." The court stated that, according to the Act's language, state law determines the available remedies. In *Long v. Monaco Coach Corp.*, No. 3:04-CV-203, 2006 U.S. Dist. LEXIS 62808 (E.D. Tenn. Aug. 31, 2006), the United States District Court for the Eastern District of Tennessee, applying Tennessee law, "found that revocation of acceptance was not available under the Magnuson-Moss Act."

Although the *Watts* Court denied a revocation of acceptance against the distributor, it noted that Mr. Watts may pursue other remedies. He may potentially seek monetary damages from the distributor or a revocation of acceptance against the seller.

Watts v. Mercedes-Benz USA, LLC represents a decision favorable to distributors and manufacturers. Because purchasers are not in privity with distributors or manufacturers as to constitute a "buyer-seller" relationship, a court

may not award a revocation of acceptance to an aggrieved purchaser against them. In dispensing with this remedy, the court enumerated a "purchaser's only" remedy against a distributor or a manufacturer – the ability to seek monetary damages. Although distributors and manufacturers are not relieved from all liability for a breach of express warranty, a monetary damage award is likely to be far less than the purchase price of a new automobile. Thus, the court's holding effectively limits the liability of a distributor and a manufacturer to money damages for breach of warranty.

You Say Mobile; I Say Modular. When the Restrictive Covenant for a Tennessee Subdivision Does Not Expressly Prohibit "Modular Homes," the Covenant's Specific Prohibitions Against "Mobile Homes" and "Trailers" Cannot Be Expanded to Include This Distinct Type of Housing. *Williams v. Fox*, 219 S.W.3d 319 (Tenn. 2007).

By Bradley J. Hearne

In *Williams v. Fox*, the Supreme Court of Tennessee considered the issue of whether a subdivision's restrictive covenant that specifically prohibits "mobile homes" and "trailers" includes a restriction on "modular homes." The court held that modular homes are distinct types of structures from mobile homes and trailers and when the restrictive covenant at issue does not expressly prohibit modular homes, the plain language of the covenant cannot be expanded to prohibit them.

The plaintiffs and defendant each owned lots in a residential subdivision. The restrictive covenants for this development specifically prohibited the construction or placement of "temporary buildings of any kind including mobile homes . . . or trailers" on any lot. The covenant, however, was silent as to modular homes and did not provide a definition of mobile homes or trailers. After the defendant had a modular home delivered to his lot and began to assemble it, the plaintiffs, citing the subdivision's restriction against mobile homes, obtained a permanent injunction ordering the defendant to remove the partially constructed structure from his property.

Under the Tennessee Motor Vehicle and Title Registration Law ("TMVTRL"), mobile homes and house trailers are given the same definition. In part, mobile homes and house trailers are defined as "any vehicle or conveyance, not self-propelled, designed for use as a residence." The definition also includes any "manufactured home," which is described, in part, by the TMVTRL as being "built on a permanent chassis." Finally, under the TMVTRL, mobile homes and house

trailers are required to be titled as motor vehicles. In *Williams*, the Tennessee Supreme Court noted that these provisions "illustrate the temporary and mobile nature of these structures."

In 1985, Tennessee enacted the Tennessee Modular Building Act ("TMBA"), which defined modular homes as something distinct from mobile homes or trailers and recognized the need to establish new inspection procedures to encourage the construction of affordable housing. Notably, the Act describes "modular building units" as "not designed for ready removal to another site." In *Williams*, the trial court found, and the parties did not dispute, that the structure delivered to the defendant's lot was a modular home.

The court relied on these statutory distinctions and concluded that modular homes are distinct structures from mobile homes and trailers. Mobile homes and trailers are built on permanent chassis and are, by nature, temporary and mobile. On the other hand, modular homes are not built on permanent chassis and are not easily moved to another location after installation. Additionally, whereas mobile homes and house trailers are required to be titled as motor vehicles, modular homes are not.

As further evidence of a recognized distinction, the court noted that other subdivision covenants in the area already recognized and addressed the distinction between modular homes, mobile homes, and trailers by specifically referring to each by name in the text of the restrictions. Each of the nearby covenants to which the court referred were recorded prior to the covenant at issue but after the enactment of the TMBA. The covenant at issue was recorded in 1995, some 10 years after the TMBA defined and regulated modular homes as something distinct from mobile homes and trailers.

The court also resolved the discrepancy between some established rules of construction and the prior interpretation of restrictive covenants by Tennessee courts. "As a general rule, restrictive covenants are not favored in Tennessee because they are in derogation of the right of free use and enjoyment of property." As a result, these covenants are typically strictly construed and ambiguities are resolved "in a manner which advances the unrestricted use of the property." However, in prior cases, Tennessee courts have tended to broadly construe restrictions against mobile homes and trailers, reasoning that such construction is in line "with the desire of developers to prevent property owners from placing residential units that were constructed off-site onto subdivision lots." The court resolved this discrepancy by noting that *Williams* was the first case in which the structure at issue was a modular home. In each of these prior cases, the structure at issue was a mobile home "built on permanent chassis and titled and registered pursuant to the [TMVTRL]." Based on the distinct characteristics of modular homes recognized by the legislature and

the drafters of restrictive covenants for nearby subdivisions and because the covenant at issue did not expressly prohibit modular homes, the court held that the plain wording of the covenant could not be expanded to prohibit the defendant's modular home.

The significance of the *Williams* decision to practicing attorneys is clear. If a client wants a restrictive covenant to prohibit modular homes, the drafter of the restrictions must specifically refer to modular homes and not just mobile homes and/or trailers. It may be wise to define exactly what constitutes the prohibited structure in the restrictions as well to avoid the risk of courts looking outside the document to statutory definitions and other covenants to determine the meaning of such terms. *Williams* reinforces the rule of strict construction of restrictive covenants, which promotes the free use and enjoyment of property. At the same time, it provides sufficient flexibility for drafters of restrictive covenants to retain mastery over their terms. Advocates of clearly defined property rights should rejoice!

Contract Modification Requires Mutual Assent Supported by Consideration; Waiver and Estoppel Acknowledge a Party's Legal Right, But Assert That Some Conduct by the Party Precludes It from Exercising Its Right. *E & A Ne. Ltd. P'ship v. Music City Record Distrib., Inc.* No. M2005-01207-COA-R3-CV, 2007 Tenn. App. LEXIS 145 (Tenn. Ct. App. Mar. 21, 2007).

By Rachel E. Levinson

Before a contract can be modified, it is said that the party seeking to modify the contract and the responding party must have a "meeting of the minds." If no meeting of the minds occurs, then the responding party is entitled to the benefit of the bargain it originally reached. The bottom line is that there must be bargained for consideration on both sides of the modified claim for it to be legally enforceable. The Tennessee Court of Appeals addressed this type of situation in *E&A Northeast Ltd. P'ship v. Music City Record Distributors, Inc.*

Music City Record Distributors ("Music City") and E&A Northeast Partnership ("E&A") entered into a written agreement, entitled "License Agreement for the Use of Vacant Space" on March 1, 2001 (the "Agreement"). This Agreement, provided that Music City would pay a monthly rent of $4,445 for retail store space. Condition ten of the Agreement allowed either party to terminate the agreement by giving 60 days written notice to the other party.

In the summer of 2002, Music City requested a reduction in the rental rate. E&A showed no inclination that it would agree to this request. Music City then sent a letter to E&A regarding E&A's failure to respond and stated that Music City would begin paying a reduced rental amount on May 1, 2003. The letter further stated that no response from E&A would indicate E&A's agreement to the reduction. If, however, E&A did not agree to the reduction, the letter provided that E&A should send notice for Music City to vacate by June 30, 2003.

E&A did not send any written communication to Music City regarding this request. Subsequently, Music City began paying the reduced rate. During the next several months, correspondence between the parties included E&A's request for the full amount of rent and Music City's refusal to pay it. On November 7, 2003, E&A's counsel sent a letter to Music City indicating that Music City had materially breached the contract by failing to pay $11,145 in back rent. Music City did not remit the requested funds. Instead, Music City sent a letter of termination pursuant to condition ten of the agreement, indicating it would vacate the premises and terminate the agreement on January 15, 2004. E&A accepted this lease termination and sent a certified letter to Music City requesting immediate payment of the full amount due under their rental agreement, now over $14,000. Music City did not pay.

On February 18, 2004, E&A filed suit in the Chancery Court of Davidson County for the unpaid rent. Music City denied owing any money and argued that E&A had waived enforcement of the original agreement and that E&A's actions estopped Music City from denying that it had accepted the new agreement. Both parties moved for summary judgment. The court ruled that the parties had not modified their agreement because no "meeting of minds" occurred. Further, even if E&A's actions could be deemed an implied consent to a rental reduction, Music City's defenses still failed for lack of consideration. The chancery court awarded the full amount of the rent deficiency to E&A.

On appeal, Music City raised several issues. First, Music City questioned whether the trial court erred in ruling that the Agreement had not been modified. Music City requested E&A to either modify the existing agreement or send a notice to vacate; however, E&A chose to reject either alternative. According to the precedent set in *Thompson v. Creswell Indus. Supply, Inc.,* the burden rests on the defendant to demonstrate that an existing contract has been modified by mutual assent. While Music City attempted to construe inaction by E&A as acceptance of the contract modification, Tennessee contract law does not give Music City that power. A party has no duty to respond to an unsolicited offer; only an overt action can result in acceptance of an offer. The court of appeals held that E&A's acceptance of the rental checks for the reduced amount did not satisfy this burden. The court also addressed the requirement that a contract modification be supported

by consideration. The trial court ruled that merely sending a letter that provided no benefit for E&A's bargain did not constitute consideration. Music City contended that it proffered some consideration by not terminating the lease, which it had discretion to do. The appellate court held that because E&A never agreed, either explicitly or impliedly, to such a reduction, Music City was barred from prevailing.

Additionally, Music City also argued that waiver and estoppel prevented E&A from collecting the unpaid rent. Waiver is an intentional relinquishment of a known right. Music City argued that E&A's failure to promptly respond to its request and its subsequent acceptance of checks for a reduced amount represented E&A's intention to waive its right to receive the full rental amount. However, the court of appeals held that E&A was under no legal duty to respond to the letter. Moreover, since E&A consistently expressed its intention to hold Music City to the original terms of the contract, it did not voluntarily relinquish its right to accept full payment by merely accepting the partial payments.

On the other hand, estoppel recognizes that a party could be stripped of its legal right by *any* conduct that the other party relied on to its detriment. In this regard, Music City argued that because it relied on E&A's failure to respond to their request in a timely manner in determining not to terminate the lease, E&A should be estopped from asserting its right to the original rental amount. The court of appeals disagreed; it was not reasonable for Music City to rely on a failure of E&A to respond in a timely manner when Music City was the party who determined the timeframe upon which the failure to act was based. Thus, the court of appeals affirmed the trial court's decision to award E&A the full rental amount.

As *E&A* illustrates, contract modification requires mutual assent and be supported by consideration on the part of each party. A meeting of the minds must occur to enact any amendments to key terms of a contract. E&A did not agree to the modification that Music City proposed. Moreover, there was no evidence of consideration on the part of Music City. If Music City had attempted to renegotiate the terms of the Agreement by offering some benefit to E&A to reduce the rate, Music City's case would have been much stronger. In addition, this case illustrates that reasonableness is necessary in post-contract negotiations. Music City would have been wise to terminate the agreement once it became evident that E&A would not recognize partial payment as meeting the terms of the Agreement. In attempting to modify a contract, a transactional lawyer should advise clients to never treat silence as acceptance, especially if the client is setting out the terms. If it is evident that the opposing party had no intention of accepting the modification, the client should leverage the benefits of its bargain to renegotiate the terms. The client may end the lease if the owner is unwilling to renegotiate, provided such a right is included in the terms of the original lease.

The Importance of a Having a Detailed Record for Contract Disputes, Ending Disputes Quickly to Reduce Prejudgment Interest, and Precise Language in Contracting for Attorneys' Fees. *ABC Painting Co. v. White Oaks Apartments of Hermitage*, No. M2006-00280-COA-R3-CV, 2007 Tenn. App. LEXIS 2 (Tenn. Ct. App. Jan. 2, 2007).

By Patrick W. Norton

In a contract for services between an apartment complex and a contractor, the relationship and expectations of the parties play a critical role. A contract will govern the duties of the parties, but the court will consider more than just the contract when making its ruling. In *ABC Painting Co. v. White Oaks Apartments of Hermitage*, one party did not keep detailed records to mitigate its damages in a breach of contract claim. The parties disputed the claim over an extended period of time causing the court to award prejudgment interest. The contract, however, was too ambiguous to allow recovery of all attorneys' fees.

ABC Painting Co. ("ABC") entered into a contract with White Oaks Apartments of Hermitage ("White Oaks") for the interior painting of certain apartments. The contract stated that ABC would complete work on a pre-determined "cost schedule." The contract also stated that the work should be done in a workmanlike manner and that White Oaks would pay "reasonable costs and expenses associated with a collection effort."

From May of 2003 to October of 2003, ABC painted 110 apartments and submitted invoices totaling $21,255. White Oaks refused to pay, claiming that the work was not completed in a workmanlike manner. As a result, White Oaks hired Hagan Painting and Drywall ("Hagan") to correct the problems. Hagan estimated that White Oaks paid between $8,000 and $10,000 to correct ABC's mistakes. ABC brought suit against White Oaks for payment, and White Oaks counter-claimed arguing that ABC had not completed the work in a workmanlike manner. At trial, the judge, sitting without a jury, ruled that ABC should recover $13,500 for unpaid work and $3,500 for attorneys' fees.

On appeal, ABC raised three issues. First, ABC alleged that the trial court erred in failing to award ABC payment of all unpaid invoices. Second, ABC argued that it deserved prejudgment interest as a part of its recovery. Lastly, ABC asserted that the trial court erred by not awarding all attorneys' fees. The Tennessee Court of Appeals reviewed the record de novo with no presumption of correctness.

On the first issue, the court determined that the trial court erred when it failed to award the full amount requested by ABC for the unpaid invoices. Based on

the record, the court noted that the preponderance of the evidence weighed in favor of ABC. The court concluded that ABC completed work valued at $21,255 in a workmanlike manner. The court relied on White Oak's inability to prove that the work from Hagan was done to mitigate ABC's mistakes and noted that none of the testimony for mitigation was supported by documentary evidence. The court stated, "White Oaks could have easily reviewed the apartments which ABC painted and documented which apartments they found unacceptable." Without this documentation, White Oaks did not prove with reasonable certainty that the damages awarded to ABC should be offset by mitigation costs. Thus, the court of appeals awarded the full amount to ABC.

On the second issue, the court held that the trial court erred when it did not award pre-judgment interest with ABC's damages. The court stated that the award of pre-judgment interest is based on "the principles of equity" and "the purpose of awarding the interest is to fully compensate a plaintiff for the loss of the use of funds to which he or she was legally entitled, not to penalize a defendant for wrongdoing." The court held that pre-judgment interest should be awarded because ABC waited over three years to receive its remedy.

On the last issue, the court held that the trial court did not err in the amount it awarded for attorneys' fees. ABC requested that all attorneys' fees be paid. Tennessee has adopted the "American Rule" where litigants pay their own fees unless the parties contract otherwise. In the present case, the contract stated that:

> In the event that payment is not made in a timely manner and it becomes necessary for ABC Painting to enforce payment, customer agrees to pay all costs and expenses of any legal action or collection efforts . . . including but not limited to, reasonable attorneys fees incurred as a result of such breach.

The court stated that "[t]he determination of reasonable attorneys' fees and costs is necessarily a discretionary inquiry to the [t]rial [c]ourt, to which the appellate courts will defer, absent an abuse of discretion." Following that precedent, the court upheld the trial court's determination of fees.

ABC Painting teaches the transactional attorney several lessons. First, in order to substantiate a claim of a breach of the condition for workmanlike quality, a complete record detailing the breach must be kept. That record should include the exact nature of the breach and the costs it took to correct it. Second, the court established that time is a factor in the determination of pre-judgment interests; thus the transactional attorney should seek to end disputes quickly rather than allowing them to continue over several years. Finally, it is very difficult to contract for full

payment of attorneys' fees if a dispute arises. Transactional attorneys should ensure that the language in the provision asking for attorneys' fees does not give the trial court enough interpretive leeway to award reasonable fees rather than all fees, although such awards are largely within the discretion of the trial court and a rule of reasonableness will undoubtedly apply.

EMPLOYMENT LAW

Last-Day-Worked Rule Determines when One-Year Statute of Limitations Begins to Run in Workers' Compensation Cases Involving Gradually Occurring Injuries. *Bldg Materials Corp. v. Britt*, 211 S.W.3d 706 (Tenn. 2007).

By Jessica H. Shafer

In Tennessee, the last-day-worked rule determines when the statute of limitations for workers' compensation claims begins to run in cases involving a gradually occurring injury. In *Building Materials Corp. v. Britt*, the Tennessee Supreme Court ruled that the one-year statute of limitations will begin to run on the first day of work the employee misses due to the work-related injury.

Mr. Britt was an employee of Building Materials Corporation d/b/a GAF Materials Corporation ("GAF"). Mr. Britt began experiencing back pain in 1996 and reported that he sustained a work-related back injury to GAF in 1997. At that time, GAF approved medical treatment for Mr. Britt's back pain and Mr. Britt did not miss any work. In August 2001, Mr. Britt reported to his supervisor and the personnel manager at GAF that his back pain was worsening.

Believing that any workers' compensation claim by Mr. Britt would be barred by the one-year statute of limitations, GAF filed suit seeking a declaratory judgment in the Davidson County Chancery Court in November 2001. Mr. Britt filed an answer and a counterclaim seeking partial disability benefits due to an alleged gradually occurring back injury. At the time of this filing, Mr. Britt had not missed any work due to his back injury. Finally, on March 31, 2004, Mr. Britt underwent surgery and missed his first day of work related to his injury.

Although the trial court ruled that Mr. Britt's claim was time-barred, the appeals panel reversed that holding. On further appeal, the Tennessee Supreme Court affirmed, holding that Mr. Britt's workers' compensation claim was not time-barred and that the last-day-worked rule should be used to identify the date from which the statute of limitations runs. Under the last-day-worked rule, the statute of

limitations begins running on the first day of work missed due to the injury. The court noted that this rule was consistent with the spirit of workers' compensation law. In addition, the court stated that any other rule might create a "trap" forcing employees with gradually occurring injuries to choose between bringing a claim before their disability has actually developed or waiting for the injury to gradually occur and then finding themselves time-barred from bringing a claim.

The court noted that the "first notice" rule had been applied in a few recent gradually occurring injury cases. This rule provided that the statute of limitations begins running when the employee first gives notice of the injury to his or her employer. In *Building Materials Corp.*, however, the court specifically overruled these cases and rejected this test.

Because the last-day-worked rule now applies to all workers' compensation claims for gradually occurring injuries, transactional attorneys should encourage their clients to keep detailed records not only of reports of work-related injuries, but also of any time missed due to such injuries. This missed time could trigger the one-year statute of limitations for a workers' compensation claim and thus provide a possible defense to the claim.

INSURANCE LAW

The Phrase "In Transit" in Cargo Insurance Policies Construed to Include Temporary Stops Incidental to Transportation. *Cargo Master, Inc. v. ACE USA Ins. Co.*, No. W2005-02798-COA-R3-CV, 2007 Tenn. App. LEXIS 28 (Tenn. Ct. App. Jan. 19, 2007).

By John J. Radacsy IV

The language in an insurance policy determines the scope of the coverage purchased. When a party seeks to recover under a policy, the meaning of particular words often becomes the subject of litigation. This was the situation presented in *Cargo Master, Inc. v. ACE USA Insurance Co.*, where the Tennessee Court of Appeals analyzed the meaning of the phrase "in transit" in a cargo insurance policy.

In March 2000, Cargo Master, Inc. ("Cargo Master") into a carrier agreement with S&A Trucking, an independent trucking company. S&A Trucking, which was to transport certain goods for Cargo Master, promised to assume liability if the goods become lost or damaged while in S&A Trucking's possession or control. Consequently, S&A Trucking obtained a motor truck cargo insurance policy from

ACE USA Insurance Company ("ACE Insurance"). The policy stated, in pertinent part:

> We will pay for loss to Covered Property for any one of the Covered Causes of Loss.
>
> 1. Covered Property
>
> Covered property means lawful goods and merchandise of others that you have accepted for transportation under a bill of lading, tariff, shipping receipt or contract of carriage as a common or contract motor carrier or when you trip lease to another motor carrier. Such property is covered *while in due course of transit* while either in your care, custody or control or in the custody of a connecting carrier. (emphasis added.)

Subsequently, S&A Trucking undertook transportation of a shipment of tires for Cargo Master. The tires belonged to a third party, Continental Tire, Inc. ("Continental"). On November 26, 2001, during the course of shipment, S&A Trucking's driver parked the trailer containing the tires behind a shopping mall in Memphis, Tennessee and departed with the tractor, leaving the trailer unattended for the night. When the driver returned the next morning, he noticed the tires had been stolen.

S&A Trucking filed a claim with ACE Insurance for the loss of the tires. ACE Insurance denied the claim, asserting that the policy had expired for failure to pay the required premiums. Ultimately, Cargo Master paid Continental $35,700.61 for the loss of the tires and filed a breach of contract suit against S&A Trucking and ACE Insurance. In its answer, ACE Insurance asserted that the policy was in default for nonpayment of premiums. Alternatively, it argued that the insurance policy did not cover the loss because the unattended trailer was not "in the course of transit," as required by the policy, when the theft occurred.

After discovery, the parties filed cross-motions for summary judgment. The trial judge ruled that there was no coverage under the insurance policy because the tires were not "in transit" at the time they were stolen. Reasoning that "in transit" as meant "in [the] course of passing from point to point," the trial court stated, "the expectation is not that a load of cargo in a trailer is going to be left in a public parking lot." Thus, the trial judge granted ACE Insurance's motion for summary judgment and did not address the question of whether the policy was in default for

failure to pay the required premiums.

The sole issue presented on appeal was whether the trial court erred in granting ACE Insurance's motion for summary judgment on the basis that, at the time of the theft, the shipment of tires was not "in the course of transit" as contemplated by the cargo insurance policy. The court of appeals noted that the rules of construction pertaining to contracts in general are also applied when specific language in an insurance policy is being construed. The ultimate goal is to give effect to express language where possible, thereby honoring the presumed intentions of the contracting parties. Accordingly, the precise language used in an insurance policy is given its plain and ordinary meaning, and ambiguous terms are construed against the insurer. The court also stated that questions concerning the scope of an insurance policy are matters of law rather than fact and may be resolved by summary judgment where the factual circumstances related to the transaction are not in dispute.

Although the policy issued by ACE Insurance did not define the phrase "in due course of transit," the court observed that it had previously construed this phrase in *Williams v. Berube & Associates*, 26 S.W.3d 640 (Tenn. Ct. App. 2006). In *Williams*, the plaintiff's trailer was left unattended for more than one week before its contents were stolen. The *Williams* Court held that the phrase "in transit" contemplates only "the time that cargo is actually in route from one place to the next." Thus, the *Williams* Court affirmed the lower court's holding that the shipment was not "in transit" at the time the merchandise was stolen.

In *Cargo Master*, the court distinguished the facts in *Williams*. *Williams* involved cargo "left on a lot, where it was not discovered missing for more than a week." Thus, the cargo was "clearly not 'in the process of being shipped, and it was not parked overnight in the course of delivery.'" The *Cargo Master* case, however, involved "a shipment of tires [that] was parked behind a shopping center overnight and discovered missing the next day." Further, the cargo may have been parked overnight due to mechanical problems with the trailer. Presented with these substantially different facts, the court determined that a more comprehensive definition of the phrase "in transit" was necessary.

The court examined decisions from other jurisdictions that discussed this phrase in the context of determining insurance coverage. These cases generally held that reasonable delays and temporary stops, provided they are related to the transportation of the goods in question, are within the scope of the definition of "in transit." Adopting the rulings of these cases, the Tennessee Court of Appeals held that the "common and ordinary meaning of the terms 'in transit' and 'in due course of transit,' while limited to cargo that is actually en route from one place to the next, contemplates temporary stops which are incidental to the course of transportation."

The court added that "[w]hether an interruption in the actual movement of the cargo is incidental to the course of transportation depends upon the purpose and extent of the stop."

Because the limited facts in the record did not reveal the reason why S&A Trucking's driver parked his trailer behind a Memphis mall on the night of the theft, the court reversed the grant of summary judgment and remanded the case to determine whether the overnight stop was incidental to the process of shipping the cargo. The court stated that "the issue of whether cargo remains 'in transit' during temporary cessations in actual movement must be decided on a case-by-case basis, considering the particular circumstances presented."

In *Cargo Master*, the Tennessee Court of Appeals both clarified and expanded the scope of its definition of the phrase "in transit" as it is applied in cargo insurance policies. Although this decision applies narrowly to only those insurance contracts that would cover cargo that is in transit, it is significant because it broadens the liability of those types of insurers. This outcome, however, is not surprising; the expansion of the phrase "in transit" to include stops or delays that are incidental to the course of shipping is consistent with the maxim of construing language contained in insurance policies against the insurer.

PROPERTY LAW

Deficiency Judgments Owed to Creditors: May They Be Reduced if the Creditor Purchases the Property Below the Market Value and Sells the Property at Market Value? *Lost Mountain Dev. Co. v. King*, No. M2004-02663-COA-R3-CV, 2006 Tenn. App. LEXIS 810 (Tenn. Ct. App. Dec. 19, 2006).

By Joshua Mullen

When a mortgage default occurs, secured creditors may seek a foreclosure sale to force the sale of the mortgaged property to satisfy outstanding debts. If the foreclosure sale proceeds are insufficient to discharge the debt, the creditor can seek a deficiency judgment, requiring the debtor to personally satisfy the difference. When the foreclosed property sells at a price significantly below the fair market value, the creditor is entitled to a larger deficiency judgment than if the property were sold at the true market value. If the creditor is also the entity who buys the foreclosed property at a price considerably less than the fair market value, the creditor is in a position to earn a windfall by both selling the foreclosed property at a large profit and by receiving the deficiency judgment.

In *Lost Mountain Development Co. v. King*, the Tennessee Court of Appeals determined whether a court could either deny or reduce a deficiency judgment owed to a creditor when the same creditor bought the foreclosed property for a price significantly below the fair market value and subsequently sold the property for its full market value. The court provided a list of relevant factors and ultimately concluded that a deficiency judgment may be reduced or denied if it would otherwise provide a windfall to the creditor.

Mr. King sold 4,650 acres of mountaintop land in Franklin County, Tennessee, to the Lost Mountain Development Co. ("Lost Mountain") for a purchase price of $4,600,000. Lost Mountain, a Tennessee general partnership consisting of investors from Florida, intended to develop the property into a private gated community. The partnership members executed personal guaranties on the loan. After Lost Mountain failed to make five consecutive mortgage payments, Mr. King instituted foreclosure proceedings. The parties renegotiated the terms of the loan, Mr. King was immediately paid $800,000, and a new payment schedule was established. Mr. King cancelled his foreclosure proceedings and Lost Mountain made the monthly payments, but failed to make an agreed upon final balloon payment of $3.8 million.

On October 31, 2001, Lost Mountain made a "preemptive strike" by filing a complaint against Mr. King, alleging fraud, misrepresentation, and breach of contract, and moved to enjoin foreclosure. Mr. King answered and also filed a counter-complaint against Lost Mountain and its associate investors. Lost Mountain filed for Chapter 11 Bankruptcy protection and Mr. King filed a motion for partial summary judgment against the four primary Lost Mountain investors who personally guaranteed the loan and against eight other signatories on the basis of third party liability. Eventually, the bankruptcy court dismissed Lost Mountain's Chapter 11 proceeding and dismissed with prejudice all the claims against Mr. King.

On May 30, 2003, the 4,650 acres were sold in a foreclosure sale and Mr. King was the only bidder. Mr. King purchased the property for $1.1 million and then filed a motion for summary judgment, requesting a deficiency judgment of $4.0 million. Later, Mr. King sold a large portion of property for $3.0 million and assigned the purchaser, Mr. Manfull, his rights to the deficiency judgment. Mr. Manfull settled with all of the Lost Mountain partners except Bemis Smith. Citing *Holt v. Citizens Central Bank*, the trial court held that Mr. Smith did not present evidence of "'irregularity, misconduct, fraud, or unfairness on the part of the mortgagee"' to overcome the presumption that the market value of the property at the time of foreclosure was equal to the sales price. As a result, the trial court granted summary judgment against Mr. Smith for $4.4 million. Mr. Smith appealed.

On appeal, Mr. Smith argued that the court should deny or reduce a deficiency judgment in situations where such a judgment would result in a windfall for the lender and be highly unfair to the borrower. Mr. Manfull argued that the trial court ruled correctly because there was not evidence of "'irregularity, misconduct, fraud, or unfairness . . . that caused or contributed to an inadequate price for a court of equity to set aside the sale.'"

Disagreeing with the trial court, the Tennessee Court of Appeals first determined that *Holt v. Citizens Central Bank* was not controlling to the case at bar because *Holt* dealt with the issue of whether a foreclosure sale should be set aside. The issue in *Lost Mountain Development Co.* was not whether a foreclosure sale should be set aside, but whether a deficiency judgment should be denied or reduced when the creditor was already made whole by purchasing the foreclosed property at a price well below the actual market value.

After providing a detailed discussion of the law related to deficiency judgments in Tennessee, the court of appeals ultimately decided that the value of the property sold could be examined in a deficiency judgment case if there is a charge of fraud or if the foreclosure sales price was grossly inadequate. Further, the court ruled that in the absence of an allegation of irregularity, the presumption that the foreclosure sales price is the fair market value of the property prevails. Finally, when a debtor claims that the price was grossly inadequate, the debtor has the burden of overcoming that presumption.

The Tennessee Court of Appeals explained that the trial court's grant of summary judgment to Mr. Manfull was inappropriate because Mr. Smith alleged that "(1) the foreclosure sales price was grossly inadequate and (2) that the creditor unfairly bid that low price, acquired the land, and sought a deficiency judgment that would inequitably provide him a windfall." The Tennessee Court of Appeals ruled that Mr. Smith provided enough information to raise a sufficient dispute of fact. Thus, the court reversed and remanded the case for further proceedings.

The overriding lesson from *Lost Mountain Development Co.* is that creditors entitled to a deficiency judgment should not expect to earn a windfall by both purchasing the foreclosed property at a price considerably below market value and obtaining a large deficiency judgment. Tennessee courts may examine the creditor's purchase price of the foreclosed property to potentially reduce or deny a deficiency judgment to avoid a grossly unfair result. An attorney advising a creditor placed in this situation should set expectations so the client fully appreciates the impact of choosing to purchase, or not to purchase, the foreclosed-upon property. Should the creditor still decide to purchase the foreclosed property, he or she should at least know that the purchase could potentially reduce or deny their deficiency judgment.

An Ordinance that Rezones Property Provides a Sufficient Legal Basis to Hold Both Original and Subsequent Developers Liable to Fulfill Any Requirements on Which the Zoning Change Was Conditioned. *Metro. Gov't of Nashville & Davidson County v. Barry Constr. Co.*, No. M2005-01749-COA-R3-CV, 2007 Tenn. App. LEXIS 93 (Tenn. Ct. App. Feb. 21, 2007).

By Lindsey M. Vaughan

When a local governmental agency adopts an ordinance rezoning property based on a developer's preliminary master plan, the developer incurs a legal obligation to ensure that any conditions of that ordinance are met and that obligation does not terminate if the property is later sold. In *Metropolitan Government of Nashville & Davidson County v. Barry Construction Co.*, the Tennessee Court of Appeals held that the conditions and requirements set forth in a preliminary master plan are binding not only on the original developer, but also on subsequent developers that purchase the restricted property.

JCH Development Co., Inc. ("JCH") induced the City of Nashville ("City") to rezone property and approve a planned unit development ("PUD") overlay to accommodate its project. The preliminary master plan called for the construction of a road across the property to be paid for by the developer. This road was a major factor in the City's decision to rezone the property. The Metropolitan Planning Commission ("Planning Commission") approved the preliminary master plan, and the Metropolitan Council ("Council") amended the comprehensive zoning ordinance to rezone the property and apply the PUD district overlay.

Subsequently, JCH sold Phase I, sections 1 and 2 of the project to Barry Construction Co. ("Barry"). Barry agreed to bear the cost of all development, including construction of the road. Because of the project's configuration, Phase I, section 1 included only the north and south ends of the road, while the middle section was part of Phase I, section 2. Barry built out Phase I, section 1, including the north and south ends of the road. Before beginning construction on Phase 1, section 2, Barry hired another company to draw up new subdivision plats dividing the section into two new parts—Phase I, sections 2 and 3. Neither of these new subdivision plats included the middle section of road. Oblivious to the omission, the Planning Commission approved Barry's subdivision plats for sections 2 and 3. When the Planning Commission realized that neither developer intended to finish the road, the City sued both developers.

The Tennessee Court of Appeals held that there was sufficient basis to require both developers to complete the road. With respect to JCH, the ordinance and attached preliminary master plan showed definitively that JCH agreed to build

and pave the entire length of parkway in return for the Council's rezoning of the property and application of the PUD district overlay. When the Council accepted JCH's offer, JCH incurred a legally enforceable obligation to ensure that the road was built and paved during the course of the development of the project. JCH's transfer of Phase I to Barry did not terminate its legal obligation to ensure the implementation of the plan.

The court held Barry similarly liable. First, the zoning ordinance expressly required subsequent developers to complete their part of the project in strict conformance with the adopted final master development plan. Second, Tennessee case law recognizes that a PUD district overlay is a type of zoning, and the preliminary master plan that forms the basis for the approval of a PUD constitutes a set of legally enforceable development restrictions. Because they are the equivalent of zoning restrictions, the court agreed with the weight of authority in other jurisdictions that the conditions and requirements of the preliminary master plan are binding not only on the original developer, but also on subsequent developers and owners of property within the PUD. Third, Barry's assertion that any obligation it had was extinguished by the Planning Commission's approval of the final subdivision plats for Phase I, sections 2 and 3 failed. Planning commission approval of a subdivision plat is insufficient to alter zoning or create an estoppel against the enforcement of zoning restrictions. The Planning Commission did not have the authority to allow this modification of the PUD plan without the approval of the Council. Therefore, the ordinance requirements, including construction of the road, continued to apply.

The Tennessee Court of Appeals' decision to hold both JCH and Barry responsible for completion of the road serves as a warning to developers who seek to circumvent what the local governmental agency has explicitly provided for in granting a PUD district overlay. A developer cannot hope to "contract away" its legal obligation by transferring property that was the subject of the council's approval of the PUD district overlay. Nor can a subsequent developer sidestep the conditions and requirements of the master plan by seeking the council's approval for successive projects or through creative surveying that simply omits the part of the property subject to the council's conditions.

TAX LAW

Executor/Beneficiary of an Estate Has a Duty of Consistency in Reporting Valuation of Property on Estate Tax Return as Executor and Own Individual Income Tax Return as Beneficiary. *Janis v. Comm'r*, 461 F.3d 1080 (9th Cir. 2006).

By Ryan C. Edens

An executor who is also a beneficiary of the estate has a duty of consistency in reporting the valuation of property on his individual income tax return where the IRS and the co-executors have previously agreed to the value of the property for estate tax purposes. Some types of property, such as collections of art, are especially open to interpretations of their value. The duty of consistency rule prevents a taxpayer from changing his or her position as to the value of such property from year to year in ways meant to benefit the taxpayer. Such was the situation presented in *Janis v. Commissioner*.

Conrad and Carroll Janis were the co-executors and the only beneficiaries of their father's estate, as well as co-trustees and beneficiaries of a trust established by their father for their benefit. The corpus of the trust included almost five hundred works of art from their father's art gallery, some by well-known artists. The estate had the art collection appraised, then calculated a "blockage discount" meant to account for the effects of placing all of the pieces on the market at the same time. The blockage discount provided for the number of pieces in the collection, the nature of the works, and other similar factors. The estate then filed fiduciary income tax returns for each year between 1990 and 1992 with the value of the collection reported at a blockage discounted value of $12,403,207. This enabled the gallery to report a net operating loss each year from 1990 to 1992.

After the 1991 tax return was filed, the IRS examined the valuation of the collection and concluded that a blockage discount was appropriate. However, the IRS determined that the actual undiscounted value of the collection was $36,636,630, and the appropriate blockage discounted value was $14,500,000. Although the limitation period for assessment against the 1991 estate tax return had previously expired, meaning the IRS could not impose tax liability on the difference in valuations, Conrad and Carroll consented to the IRS's valuation of the collection in January 1994.

Beginning in February 1994 and continuing through 1997, Conrad and Carroll claimed the undiscounted value of the collection, $36,636,630, on all fiduciary and individual income tax returns, including the amended returns for 1990-92. The tax returns used the undiscounted value rather than the discounted value of

$14,500,000. The IRS eventually reviewed the trust tax returns for 1995-97 and the individual tax returns of Conrad Janis and his wife Maria Janis (the "Janises") for the same years and discovered the inconsistent claims. Under the IRS's valuation, the Janises owed more taxes because they were unable to claim the same net operating losses on their returns. The IRS filed a notice of deficiency for the Janises' 1995-1997 individual tax returns. The Janises contested the issue in tax court; however, the trial court upheld the deficiencies.

On appeal, the Janises raised two issues: (1) whether the tax court clearly erred in its valuation of the art collection; and (2) whether the tax court erred in holding that the Janises violated a duty of consistency in reporting the value of the art collection in their tax returns from year to year. Regarding the first issue, the Ninth Circuit follows the rule that the valuation of property is a finding of fact to be reversed only for clear error. Thus, the Janises had to prove that the tax court clearly erred in determining that application of the blockage discount was appropriate in determining the value of the art collection. Un-swayed by the Janises argument, the Ninth Circuit disagreed with the Janises and held that the tax court did not clearly err in its valuation of the art collection. Because the Janises agreed with the IRS on the $14,500,000 valuation for estate tax purposes, this valuation should have also been reflected on the Janises individual income tax returns. The tax court held that the value of the art collection should have been lower than the Janises reported on their income tax returns and because the tax court's property valuation is a finding of fact, the district court upheld the valuation for lack of clear error.

Next, the Ninth Circuit addressed whether the tax court erred in holding that the Janises violated a duty of consistency. The duty of consistency, as invoked by the Ninth Circuit and the tax court, requires "(1) a representation or report by the taxpayer; (2) on which the Commission[er] has relied; and (3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm the Commissioner."

The tax court ruled that under the duty of consistency, the Janises were "bound to use the collection's discounted value as their basis for purposes of calculating the gallery's [cost of goods sold] for 1990 through 1997." Consequently, the Ninth Circuit determined that the Janises' individual tax returns for 1995 through 1997 contained deficiencies.

The Ninth Circuit upheld the tax court's ruling on all three elements of the duty of consistency. Conrad and Carroll's agreement as executors of the estate that the fair market value of the collection was $14,500,000 satisfied the first element – representation by the taxpayer. Although the Janises argued that the agreement for

estate tax purposes did not bind them for income tax purposes, the Ninth Circuit held that Conrad's interests as beneficiary and co-executor of the estate overlapped. Further, the Ninth Circuit opined that allowing inconsistent positions on the estate tax returns and the income tax returns would violate the duty of consistency by allowing Conrad to reduce the value of the taxable estate as a co-executor while simultaneously benefiting as an heir. The second element, reliance by the Commissioner, was also satisfied because the IRS relied on the co-executors' agreement regarding the discounted value. The IRS's allowance of the statute of limitations to run on further assessment of the 1991 estate tax return satisfied the third element–a change in position by the taxpayer that is harmful to the Commissioner.

Janis demonstrates the significance of valuation agreements with the IRS, as well as the tax consequences that executory or fiduciary duties might have on an individual. Beneficiaries of an estate must keep in mind the consequences of agreeing to serve as an executor of an estate. Co-executors are bound by a duty of consistency to report the valuation of property in their own income tax returns equivalent to its value in the estate tax return. Executors must be careful in determining the value of property in an estate for not only the benefit of the estate itself, but also for any interests they may take as beneficiaries.

WILLS AND ESTATES

Tennessee Anti-Lapse Statute Does Not Save Gifts to Devisee's Issue when the Language in the Will Allows a Contrary Inference. *In re Estate of Snapp*, No. E2006-00933-COA-R3-CV, 2007 Tenn. App. LEXIS 113 (Tenn. Ct. App. Feb. 28, 2007).

By Andrew Oldham

When a will contains ambiguous language, the beneficiaries of the will often call upon the court to interpret the testator's intent. The Tennessee legislature recently adopted an anti-lapse statute, which provides that if a devisee or legatee predeceases the testatrix, then the devisee or legatee's issue shall take the devised interest upon the testatrix's death. However, the issue will only take the devisee's interest if the will does not provide or require a different disposition. The court in *In re Estate of Snapp* held that the testatrix's will did not allow for a gift to be transferred to a devisee's issue when the devisee did not survive the testatrix.

In *Snapp*, the testatrix devised to her three sisters her one-quarter interest in a farm provided that "[pursuant to Item VII of the Will] . . . if any sister should predecease [Snapp], then . . . the surviving sister(s) shall take the deceased sister's share." Item VIII of the testatrix's Will (the "Will") provided that "the rest and residue of my estate . . . I give, devise, and bequeath in equal shares unto my three sisters." The three sisters were Viola Swingle, Anne E. Fowler, and Lena Mae Hartsell. Swingle died in 1987, Fowler in 1997, and Hartsell in 2002. The testatrix, however, did not die until 2005. Only two of the sisters, Swingle and Hartsell, died with issue. Hartsell's issue ("Hartsell") and Swingle's issue ("Swingle") brought this action seeking a declaratory judgment to determine the disposition of the estate.

Hartsell interpreted the language "surviving sister(s)" to mean that the last surviving sister receives the estate at the time of the testatrix's death. Adopting this interpretation would mean Hartsell, who lived the longest, would receive the gifts devised to Swingle and Fowler. Swingle argued that "surviving sister(s)" refers to surviving the testatrix, not simply surviving the other sisters. The trial court determined that the anti-lapse statute applied to the gifts devised to Swingle and Hartsell because they died with issue, but the statute did not apply to the gift to Fowler because she died without issue. Following this line of reasoning, the court held that 50 percent of the farm went to Swingle and 50 percent to Hartsell with the remainder of the estate being split in the same manner.

On appeal, the parties raised two issues. First, the parties questioned whether the trial court correctly interpreted "the surviving sister(s)" as referring to survival of the testatrix, not survival inter sese. The cardinal rule in construing a will is that the court must attempt to ascertain the intent of the testator from the natural meaning of the language used in the will. The natural meaning of "surviving" is "[r]emaining alive. Living beyond the life of another or beyond the happening of some event so as to be entitled to a distribution of property or income." Thus, the court concluded that "the only condition guarantying entitlement to the gifts is surviving the Testatrix," a feat which none of the sisters accomplished. As a result, the court held that the gifts to the three sisters lapsed unless the anti-lapse statute saved them.

Second, the Tennessee Court of Appeals addressed whether the trial court correctly applied the anti-lapse statute to the gifts in Items VII and VIII of the Will. Essentially, the Tennessee anti-lapse statute states that if the devisee dies before the testatrix, leaving issue, the issue takes the gift "unless a different disposition thereof is made or required by the [W]ill." The anti-lapse statute is based on a presumption that the testatrix understood and intended that the devised gifts will likely descend to the beneficiary's issue. The purpose of the statute is to further this presumed intent unless the will expresses a material intent to the contrary. The court concluded that

the survivorship clauses expressed such contrary intent. The language in Item VII explicitly conditioned the sisters' gifts upon the sisters' surviving the testatrix. Furthermore, the court presumed that the testatrix was "acquainted with applicable rules of law when executing the [W]ill." Based on this reasoning, the court must presume that the testatrix knew that her sisters' predeceasing her raised the question of partial intestacy. Therefore, the court concluded that the testatrix knew that partial intestacy would result, and still chose not to alter her Will.

Following this conclusion, the court rejected Swingle's other argument that the rule against partial intestacy required application of the anti-lapse statute. The presumption that someone did not intend to die intestate as to any part of his or her property is only applicable when a contrary intent does not exist, and such presumption does not apply in situations where the testatrix has simply failed to make a complete disposition of the estate. The court also rejected Swingle's contentions that the gift should be implied and that *In re Estate of Harper*, an analogous Tennessee Court of Appeals case, does not apply. Courts must construe what the testatrix has written or published and will only imply a gift where it is absolutely necessary to take such action. Additionally, the court found *Harper* very persuasive on account of the similarity between the testamentary language found in that case and the language in Snapp's Will. In addition, numerous cases from other jurisdictions support the holding in *Harper*. Based on these findings, the court ultimately held that the anti-lapse statute did not apply to the gifts in Items VII and VIII and that the entire residuary estate would therefore pass by intestate succession. The case was remanded to the trial court for further proceedings in accordance with these holdings.

As *Snapp* illustrates, the foundation of proper estate planning is still the proper drafting of testamentary language. All of the rules of interpretation aside, the most important factor for determining the intent of a testatrix is the language of her will. Although the purpose of the anti-lapse statute and the rule against partial intestacy is to further a presumed intent that the testatrix's meant for the gifts to pass on to the issue, these rules will not save gifts in the face of contrary language in the will. When such contrary language exists, the anti-lapse statute cannot apply, and the state's intestacy statute must govern the disposition of the incomplete gifts. A transactional attorney should advise his client to avoid ambiguous language and should fully explain all possible scenarios or results stemming from the language chosen for the client's will.

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