

CASE COMMENTARIES

ANTITRUST

Pricing a product above cost provides no safety net for manufacturers who engage in exclusionary conduct in violation of the Sherman Act. *LePage's Inc. v. 3M*, 324 F.3d 141 (3rd Cir. 2003).

By Kerry L. Masters

Applying the Sherman Act, the Third Circuit of the United States Court of Appeals held that bundled rebates and exclusive dealing contracts constituted exclusionary conducted anticompetitive monopolization under Section 2 of the Sherman Act, even when the product is priced above cost.

The defendant in *LePage's Inc.*, Minnesota Mining and Manufacturing Company ("3M"), dominated the Scotch tape manufacturing market until the early 1990's. The plaintiff, LePage's, began selling second brand and private label transparent tape in 1980, and, by 1992, held 88% of the United States private label tape sales market. Subsequently, major retailers such as Wal-Mart, Kmart, Staples, and Office Depot began selling primarily private label tape with their brand names rather than the manufacturer's name. Demand among retailers slowly shifted from manufacturer branded tape to private label tape.

To meet market demands, 3M entered the private label business in the early 1990's and began offering bundled rebate programs to certain customers conditioned on their purchasing from six of 3M's product lines. Further, 3M encouraged exclusive contracts with retailers by conditioning discounts on exclusivity, and encouraged large retailers to cancel or refrain from renewing already existing contracts with rival tape manufacturers, including LePage's. LePage's brought an antitrust action against 3M claiming that, in response to the increased demand for private label tape, 3M engaged in several anticompetitive acts. LePage's claimed that 3M maintained a monopoly by stifling the growth of the private label tape industry by unfairly marketing to large distributors, thus keeping retail prices for their own Scotch brand high.

The Court of Appeals affirmed the District Court, holding that 3M's exclusionary conduct violated the monopolization and anti-competitive provisions of the Sherman Act, even though the product was never priced below its cost.

Section 2 of the Sherman Act states that a person cannot monopolize or attempt to monopolize any part of trade or commerce. In interpreting this Section, the Court of Appeals looked to *U.S. v. Grinnell*, 384 U.S. 563 (1966), which stated that the two elements of a monopolization claim under the Sherman Act are (1) the possession of monopoly power in the relevant market, and (2) the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident. The Court found that 3M possessed a monopoly power in the transparent tape market that it used to an anti-competitive effect. The Court noted that 3M's actions might be justifiable if its questionable conduct was for a "valid business reasons," such as the improvement of consumer welfare, and not to maintain a monopoly or discourage others from entering the market. The Court determined that 3M acted in furtherance of its economic interests and did not elicit a valid business reason as a defense to the monopolization claim under Section 2 of the Sherman Act.

Where a product manufacturer possesses monopoly power in an industry, that manufacturer should refrain from anticompetitive conduct, even if the product is priced above cost. Unless the manufacturer has a valid business reason as justification, anticompetitive conduct is strictly prohibited.

Real estate service agreement's price-fixing policy violated the Sherman Act through its detrimental effect on the ultimate consumer. *Freeman v. San Diego Ass'n of Realtors*, 322 F.3d 1133 (9th Cir. 2003).

By Michael J. Stanuszek

A real estate listing service's price-fixing policy violated Section 1 of the Sherman Act because its fee was set at a supracompetitive level and its costs were attributed to the ultimate consumer, the real estate agents.

Eleven real estate associations in San Diego County combined their separate real estate databases to form a single database that listed all available properties for sale in the area. To this end, the associations created a corporation, Sandicor, to maintain the single database and issue service agreements to the real estate associations wishing to utilize Sandicore's listing services. Because real estate agents in San Diego County were required to belong to an Association of Realtors, the eleven associations thought it was important that the individual associations that subscribed to Sandicore continue to provide their real estate agents or subscribers with their own support services. These support services included things like billing

and collecting payments, and ensuring that advertisements complied with certain regulatory guidelines.

To encourage associations to participate in the database, Sandicor paid each association \$25 per subscriber each month for the support services that the association provided to subscribers of the database. Because of their size, larger associations could provide support services to their subscribers at a cost below \$25 per member, whereas smaller associations, who could not provide support services for \$25 per member, were operating at a loss. The plaintiffs, three San Diego real estate agents, argued that the larger associations necessarily made a profit from the service fees because their operating costs for the support services were less than \$25. Thus, plaintiffs alleged that they paid an inflated fee for access to Sandicor's database because the support price was fixed at a "supracompetitive level" in violation of Section 1 of the Sherman Act.

The Ninth Circuit held that the defendants violated Section 1 of the Sherman Act because they admitted to fixing the support services fees. The Court found that Sandicor had priced its fees close to the actual cost of running the system. Therefore, the inflated fees that Sandicor paid to the larger associations for support services were passed onto consumers like the plaintiffs.

Although Defendants argued that they were immune from the Sherman Act because they were a single entity and therefore could not have conspired with one another, the Court found that the associations, in reality, do not act as a single entity. The associations are owned by their respective members and do not share profits with one another. They have different ownership, goals, and market strategies. Furthermore, the associations are actual competitors bidding to sign subscribers to Sandicor's database.

Freeman demonstrates that when a corporation enters into a price-fixing agreement that acts to the detriment of the ultimate consumer, it is not an appropriate defense to claim that its intent was to aid competition. Thus, if a service agreement benefits both consumers and joint venturers, the court will often find it legal under the Sherman Act. However, if the same service agreement has fixed support fees that act to the detriment of the ultimate consumer, the court will likely find it illegal.

BANKRUPTCY

Bankruptcy courts are not authorized to allow Chapter 11 debtors to make pre-plan payments for prepetition unsecured claims, including payments to “critical vendors.” *Capital Factors, Inc. v. Kmart Corp.*, 291 B.R. 818 (N.D. Ill. 2003).

By Mike Baisley

Reversing the bankruptcy court presiding over the largest retail Chapter 11 case in history, the United States District Court for the Northern District of Illinois held that bankruptcy courts are not authorized under the Bankruptcy Code or the equitable “doctrine of necessity” to allow debtors to make pre-plan payments for prepetition unsecured claims, including payments to “critical vendors” and “foreign vendors.”

In *Capital Factors, Inc. v. Kmart Corp.*, Kmart filed a petition for reorganization under Chapter 11 of the Bankruptcy Code. Kmart sought permission to make pre-plan payments owed to certain “critical vendors” and “foreign vendors.” Kmart argued that these payments were necessary to continue doing business with those suppliers essential to Kmart’s continued operation and successful reorganization.

Capital Factors, which held unsecured claims against Kmart for approximately \$20 million, objected to Kmart’s motions on the basis that the bankruptcy court was not authorized to allow pre-plan payments for prepetition claims. Kmart argued to the contrary, invoking both the “doctrine of necessity,” the notion that bankruptcy courts can issue orders that are otherwise not provided for when “necessary” to the reorganization, and 11 U.S.C. § 105(a), the Bankruptcy Code’s “all writs” provision – to support its position. The bankruptcy court granted Kmart’s motions and allowed Kmart to pay certain liquor vendors and issuers of prepetition letters of credit. On appeal, the District Court reversed.

Where certain suppliers are designated as “critical vendors” because their continued service is necessary for the debtor’s successful reorganization, bankruptcy courts often allow the debtor to make payments on the prepetition claims of such vendors. The courts rely upon section 105(a) of the Bankruptcy Code and the equitable “doctrine of necessity” as grounds for their authority to make such allowances. Section 105(a) provides that a bankruptcy court “may issue any order, process or judgment that is necessary or appropriate to carry out the provisions of [Title 11].” Until recently, the courts have generally held that section 105(a) authorizes a bankruptcy court to exercise its equitable powers by invoking the

“doctrine of necessity,” thus allowing debtors to pay the prepetition claims of its critical vendors, if such payments are necessary to keep the debtor in operation.

On the other hand, some courts have recently held that section 105(a) does *not* empower the bankruptcy courts to alter the payment priority established in the Bankruptcy Code. By allowing pre-plan payments of prepetition claims, a bankruptcy court essentially elevates the claims of select unsecured creditors above those of even *secured* creditors. Prior to the decision in *Capital Factors*, the Seventh Circuit held that section 105(a) allowed bankruptcy courts to use their equitable powers “only as necessary to enforce the provisions of the [Bankruptcy] Code, not to add on to the Code as they see fit.” Based on this rationale, the district court in *Capital Factors* rejected Kmart’s argument that section 105(a) empowered the bankruptcy court below to grant Kmart’s critical vendors motions. Accordingly, in *K-Mart*, the district court reversed the bankruptcy court, holding that neither the Bankruptcy Code nor Congress allowed pre-plan payment of prepetition claims.

The district court’s decision is likely to have far-reaching consequences in the way both debtors and vendors approach Chapter 11 bankruptcy and to, perhaps, reduce the appeal of Illinois as a Chapter 11 venue. First, parties to a bankruptcy in the Seventh Circuit and certainly in the Northern District of Illinois will no longer have the option of pursuing pre-plan payments for prepetition claims. This decision forces bankruptcy debtors in the Seventh Circuit (and potentially other circuits) to appease their vendors without a motion to designate them as “critical vendors.” In turn, vendors will be forced to decide the value of the debtor’s business relationship, and what additional consideration the vendor will require to offset the new risk of non-payment. Secondly, the market may assume a more significant role in determining how many entities successfully reorganize and survive Chapter 11 bankruptcy. Because it is likely that some vendors will continue to demand critical vendor treatment and others may cease to supply the same quality or quantity of goods and services, the balance of supply and demand may drive market prices up and increase the overall costs of doing business. Ultimately, the Supreme Court will likely have to decide whether bankruptcy courts are authorized to allow pre-plan payments of prepetition claims under section 105(a) and the “doctrine of necessity.”

Remedies under the Securities Investor Protection Act are available only to an insolvent broker's "customers." *In re First Interregional Equity Corp.*, 290 B.R. 265 (Bankr. D.N.J. 2003).

By Edward W. Collins

Analyzing the Securities Investor Protection Act of 1970 ("SIPA"), the federal bankruptcy court determined that loans defaulted on by brokerage houses do not qualify as "customer claims" under the act. Thus, SIPA affords no protection to these types of creditors.

Congress enacted SIPA in order to calm investors' nerves in the wake of several brokerage house insolvencies during the 1960s. SIPA operates in much the same way as FDIC insurance – in cases where the liquidation of an insolvent brokerage house does not cover the amount due to its customers, the Securities Investor Protection Corporation ("SIPC") insures investor claims for up to \$500,000 (\$100,000 of which may be cash). The protection afforded by SIPA, however, is only available to "customers" as defined by the act; creditors of insolvent brokers must recover their debts out of the general estate of the debtor. Thus, SIPA bestows preferential standing upon "customers."

Liquidation of the First Interregional Equity Corporation ("FIEC") commenced in 1997 after FIEC had allegedly engaged in a fraudulent "Ponzi" scheme.¹ The courts appointed a trustee to discharge FIEC's customer obligations pursuant to SIPA. Central to the case at hand were securities that Ms. Bonnie Josephs allowed FIEC to hold in exchange for interest payments above the securities' coupon rates. The trustee found that these "loans" did not qualify as "customer claims" as defined by SIPA and filed a Motion to Affirm the Trustee's Claim Determination.

In order to qualify as a "customer" under SIPA, the following three conditions must be satisfied: (1) a claimant must have a claim for securities or cash held by the broker in the ordinary course of its business; (2) the securities or cash must have been held from, or for, the claimant's securities account; and (3) the securities or cash must have been held by the broker for the purpose of investing in the securities market or for safekeeping. The fact that a claimant may qualify as a

¹ "Ponzi scheme" is defined as an "[i]nvestment swindle in which money from new investors is used to pay off earlier ones. Such schemes require an ever-expanding group of participants and collapse when new players cannot be found." GARY SMITH, FINANCIAL ASSETS, MARKETS, AND INSTITUTIONS app. 1, at 47 (1993).

“customer” in regard to some fiduciary relations with the broker does not automatically qualify the claimant as a “customer” with respect to all dealings with the broker. Additionally, all claims must be made within six months of the notification of the liquidation proceedings.²

In addition to some financial dealings that did qualify under SIPA, Ms. Josephs loaned several securities to FIEC in exchange for interest payments of four percent (4%) above the respective coupon rates. Ms. Josephs claimed that she did not “loan” the securities (despite referring to the transactions as “loans” in earlier correspondence with FIEC), but rather gave them to FIEC for the sake of safekeeping. Ms. Josephs’ argument failed to persuade the court. The court doubted that a business entity would pay interest in excess of the coupon rate if its only purpose was to safeguard the securities.

Furthermore, the court stated that these securities held by FIEC were not connected in any way to Ms. Josephs’ participation in the securities market since they were not listed on any account maintained for Ms. Josephs. The court found that the relationship between Ms. Josephs and FIEC in regard to these particular securities was one of creditor-debtor, not customer-broker. Ms. Josephs had invested in FIEC; the four per cent (4%) premium represented the risk Ms. Josephs assumed in allowing FIEC to maintain the securities for its own financial leverage use. Therefore, since the securities were neither listed on any account maintained for Ms. Josephs nor held for the purpose of investing in the securities market or for safekeeping, the court granted the trustee’s motion.

This case emphasizes that SIPA does not provide protection to all victims of brokerage insolvencies; the protection extends only to “customers” as defined by the act. As a result, creditors should not be lulled into a false sense of security that the debts owed by such entities are insured under SIPA. Such creditors will be relegated to recovering their losses, if at all, out of the broker’s general estate, which, if SIPA protection is required for “customers,” will most likely provide little recovery.

² The bankruptcy court held Ms. Josephs’ late filed “customer claim[s]” time barred and did not allow her to amend her original claim to include them.

Reasonableness of indemnification agreements between Chapter 11 debtors and their financial advisors will be assessed using the principles of the business judgment rule. *In re Baltimore Emergency Servs. II, LLC*, 291 B.R. 382 (Bankr. D. Md. Mar. 6, 2003).

By James B. Johnson

Following the lead of the Third Circuit, the Bankruptcy Court of Maryland held that the indemnification of a financial advisor to a Chapter 11 debtor is not a *per se* unreasonable term of employment under 11 U.S.C. § 328(a). The court further held that the reasonableness of an indemnification agreement between Chapter 11 debtors and their financial advisors will be assessed using the principles of the business judgment rule.

ECS Holdings, Inc. (ECS) retained Evercore as its financial advisor in its Chapter 11 case. The application filed out by ECS contained an indemnification provision in which ECS agreed to hold Evercore harmless from and against any losses, claims, damages, expenses, and liabilities. However, Evercore would be liable for those losses, claims, damages, expenses, and liabilities that a court of competent jurisdiction determined to have resulted from its own bad faith, gross negligence, or willful misconduct.

The issue before the court was whether the indemnification agreement of the parties was reasonable. In *In re United Artists Theater Co.*, 315 F.3d 217 (3d. Cir. 2003), the Third Circuit became the first circuit court to address the issue. In *United Artists*, the court affirmed a Chapter 11 debtor's retention of its financial advisor under terms that indemnified the financial advisor from its own negligence, but the court applied business judgment principles to place limits on the reasonableness of such indemnification provisions.

These principles provided several safeguards. First, the financial advisor would be liable for a breach of its duty of loyalty. Second, the advisor would be liable for a breach of the duty of care in the process by which it rendered its advice to the debtor. Third, an indemnification agreement would not cover contract disputes with the debtor, including disputes over the services that the financial advisor has agreed to render. Finally, "limiting words" (words that would expand the debtor's indemnification obligations) would be outside the bounds of acceptable public policy.

The *Baltimore Emergency Services* court realized that financial advice free from artificial constraints would be beneficial to debtors. In an attempt to advance that notion, the court followed the lead of *United Artists* and applied business judgment principles to the case. In doing so, the court held that (1) claims for simple negligence may be indemnified, but indemnifying claims for gross negligence would be outside the bounds of acceptable public policy, (2) agreements that eliminate the exclusion for bad faith would result in an unacceptable expansion of the debtor's indemnification obligation, (3) contractual disputes need to be expressly excluded from the scope of the indemnification agreement, and (4) the duties of loyalty and care are not dischargeable and should be expressly excluded from the scope of an indemnification agreement.

This decision illustrates the importance of financial advising services to Chapter 11 Debtors. Applying business judgment principles to assess the reasonableness of an indemnification agreement between a Chapter 11 debtor and a financial advisor clarifies the responsibilities of such a relationship.

BUSINESS ORGANIZATIONS

Non-lawyer minority shareholder prohibited from representing corporation *pro se*. *Pelts v. Int'l Med. Servs Corp.*, No. W2002-00388-COA-R3-CV, 2003 Tenn. App. LEXIS 620, 2003 WL 22071462 (Tenn. Ct. App. 2003).

By Nicholas J. Chase

Tennessee recognizes a corporation as an “artificial entity,” separate from its shareholders and officers. Consequently, the Tennessee Court of Appeals held that Tennessee Supreme Court Rule 7³ prohibits a non-lawyer minority shareholder from representing his or her corporation *pro se*.

In 1994, Hugh A. Hines, Jr. (“Hines”), Bernard Tibbets (“Tibbets”), and Carlton Smith, Jr. (“Smith”), formed International Medical Services Corporation (“IMS”). Hines, the majority shareholder with sixty percent of the shares, became the Chairman of the Board. Tibbets and Smith each held twenty percent of the

³ “No person shall engage in the ‘practice of law’ or the ‘law business’ in Tennessee, except pursuant to the authority of this Court, as evidenced by a license issued in accordance with this Rule, or in accordance with the provisions of the Rule governing special or limited practice.” TENN. SUP. CT. R. 7.

shares and assumed the positions of President and Secretary/Treasurer, respectively. The primary assets of IMS, and the cause of disagreement in the subsequent litigation, were contiguous parcels of land measuring 1.04 and 13.92 acres. In 1996, Hines notified both Tibbets and Smith of a special IMS shareholder meeting, which neither Tibbets nor Smith attended. During that meeting in which Hines's attorney assumed the role of acting Secretary, the "board" elected Hines President and Hines's wife Secretary. This "new board" (comprised of Hines as both Chairman and President and Hines's wife as Secretary) authorized Hines to sell the 13.92 acre tract. Hines waited approximately one month before notifying Tibbets and Smith of these events.

In 1999, Smith and a partner formed the Remote Internet Corporation ("RIC") and purchased the mortgage on IMS's 13.92 acre parcel. When Hines missed a payment, RIC sent a foreclosure notice to IMS. In 2000, Hines contracted to sell both parcels of land to Robert Pelts ("Pelts"). As proof of his authority to sell the land, Hines presented Pelts the minutes from the 1996 IMS "board" meeting in which the "new board" authorized Hines to sell the land. Three weeks later, Smith and Tibbets notified Pelts that Hines did not have the authority to sell the land. Pelts then sued IMS for specific performance and filed a motion for summary judgment. Smith, on behalf of both IMS and RIC, and Tibbets launched a litany of counter and cross motions. The trial court granted Pelts' motion for summary judgment under the theory that Hines acted with the apparent authority of IMS when he contracted to sell the land to Pelts. Smith filed a notice of appeal, *pro se*, and on behalf of both Tibbets and IMS.

The Tennessee Court of Appeals immediately recognized that Smith was not a licensed attorney and, therefore, could represent neither Tibbets nor IMS. As a result, the court promptly dismissed the issues involving those parties as not being properly before the court. However, the court did comment on the issue of whether Hines could sell the property to Pelts. The court endorsed the trial court's granting of summary judgment for Pelts. The court reasoned that because Tibbets and Smith had never taken appropriate action to remove Hines as President of IMS, as far as Pelts was concerned, Hines possessed the apparent authority to sell the land.

Despite the fact that many of the issues were disposed of due to the fact that Smith was not a licensed attorney, the decision reinforces the importance of awareness and prompt action in the corporate setting. Tibbets and Smith were aware of Hines's questionable actions as President of IMS and of his intent to sell the IMS property. Yet, Tibbets and Smith took no action for several years and did not deal with Hines in a timely manner and in accordance with IMS's bylaws. Their inaction

exposed their individual interests and the interests of an innocent third party. Though the outcome of this case appears to hinge on the standing of the parties before the court, the Tennessee Court of Appeals offers insight into its interpretation of apparent authority in a corporate setting.

Where the criteria of a constructive trust are satisfied, courts may impress such a trust to protect any kind of legal entity. *LaFollette Med. Ctr. v. City of LaFollette*, 115 S.W.3d 500 (Tenn. Ct. App. 2003).

By Ryan Russell

A constructive trust may be used to protect any kind of legal entity against those “who, . . . by any form of unconscionable conduct . . . obtain[] or hold[] the legal right to property which [they] ought not, in equity and good conscience, hold and enjoy.” Thus, a constructive trust can be used as a vehicle in preventing another individual or entity from diverting a legal entity’s property from its original intended use.

LaFollette Medical Center was established in 1957 to provide medical care to the local indigent community. The City of LaFollette funded the medical center’s construction through bonds, but the debt was repaid entirely by the Medical Center. Therefore, the City did not contribute any funds to the Medical Center’s construction. The Medical Center operated as a not-for-profit entity throughout its existence, and because of its corporate structure, never had to pay property taxes to the City government and was able to achieve its goal of providing medical care to anyone in need.

The LaFollette City Council, without the consent of the Medical Center’s Board of Trustees, decided in 1999 to sell the Medical Center to St. Mary’s Health Systems, a for-profit corporation. The Medical Center and its Board of Trustees then filed suit against the City of LaFollette in an attempt to stop the sale. The trial court held that the City had the authority to sell the Medical Center, but ordered all proceeds from the sale to be placed in a constructive trust for the purpose of providing healthcare to the community. The City of LaFollette appealed to the Tennessee Court of Appeals in an attempt to keep the sale proceeds out of the constructive trust.

In Tennessee, “a constructive trust arises . . . against one who, by fraud, . . . duress[,] . . . abuse of confidence, [a] commission of wrong, or by any form of unconscionable conduct . . . has obtained or holds the legal right to property which he ought not, in equity and good conscience, hold and enjoy.” The Court of Appeals then held that “if the [above] criteria [are] met . . . a constructive trust might be impressed for the benefit of . . . any . . . legal entity.”

The court noted that no City funds were used in the Medical Center’s construction and at no time in the Medical Center’s history did it receive funds from the City. The court summarized the situation by stating that “the City is attempting to reap where it has not sown.” Given these facts, the court concluded that it would be unconscionable to allow the City to use the proceeds of the sale for “any general purpose [that] [it] might choose.” The court affirmed the trial court’s decision to place the proceeds in a constructive trust “to be used for one of the original purposes for which the Hospital was built – to render indigent health care.”

The *LaFollette* court illustrated that if a party uses means that a court might consider unconscionable to obtain control over the assets of any legal entity, that party faces the real possibility that a constructive trust might be used to regain control over those assets. The court also made it clear that it was willing to impress a constructive trust for those regained assets for the benefit of any type of legal entity and for the original purposes to which that entity served.

CONTRACTS

Where contract negotiations take place in multiple states, the law of the state in which the contract binds the parties governs subsequent contract disputes. *A.I.J.J. Enters., Inc. v. Weizer*, No. W2002-00975-COA-R3-CV, 2003 Tenn. App. LEXIS 142, 2003 WL 1855102 (Tenn. Ct. App. Feb. 20, 2003).

By Joshua Flowers

The Tennessee Court of Appeals held that Tennessee’s *lex loci* rule required that where contract negotiations, formation, and performance took place in different states, the law of the state where the contract bound the parties governed the contract dispute.

AIJJ Enterprises contacted Norman Weizer regarding employment based in California with responsibilities in surrounding states. Weizer interviewed with AIJJ executives in New York and accepted an employment offer. Weizer began his

employment by attending a training session in Florida, where AIJJ asked him to sign a recruitment fee contract. The agreement obligated Weizer to pay recruitment costs incurred by AIJJ if he left his employment for any reason within two years. Weizer modified the contract by crossing out a parenthetical phrase that described “leaving” as “including but not limited to your termination of me.” Weizer signed the amended contract and faxed it to New York, where an AIJJ executive signed it. After working for ten months, Weizer submitted his resignation. AIJJ then filed suit to recover \$12,000 for Weizer’s recruitment costs pursuant to the contract under Florida law.

Applying the *lex loci* rule, the Tennessee Supreme Court found the recruitment provision in Weizer’s contract unenforceable under New York law because AIJJ terminated Weizer. In Tennessee, the general *lex loci* rule states that “the substantive law of the state in which the contract was made is applied to disputes arising from the contract.” The general rule does not apply if the parties agreed in good faith that the contract would be performed in another state and envisioned that the other state’s law would govern the contract. To determine if the exception to the *lex loci* rule applies, courts look to the terms of the contract itself and the surrounding circumstances to determine the parties’ intent.

Initially, the court considered two possible choices of law. First, Weizer argued that California law applied because AIJJ based Weizer in California during his employment. The court found that California law did not apply under the exception to the *lex loci* rule because the parties did not envision Weizer working only in California when they formed the contract. Secondly, the trial court applied Florida law because Weizer signed the contract while physically located in Florida. The Court of Appeals rejected both alternatives and concluded that New York law applied because Weizer’s amended contract constituted a counter-offer that became binding when AIJJ accepted it in New York.

Applying the New York rule that construes contracts according to the parties’ intent, the court found the contract ambiguous because the contract’s crossed-out parenthetical phrase defined the word “leave.” Thus, Weizer’s amendment eliminated his obligation to pay damages upon his termination. The court held that the contract reflected the parties’ intent that Weizer would be obligated to repay the recruitment fees if he left for any reason other than termination. Because the court did not find by a preponderance of the evidence that

Weizer resigned, it held that AIJJ failed to meet the burden of establishing all the elements of its case.

The decision emphasizes the need for careful planning during contract negotiations. In light of Tennessee's *lex loci* rule, transactional attorneys should be aware of the implications of sending offers and counter-offers to parties in other states. The *lex loci* rule emphasizes the importance of the final negotiation phase by requiring the application of the law of the state in which the contract becomes binding to any subsequent disputes.

Incorporated documents can be applicable to both signatories and non-signatories of a bank's signature card. *Jureczki v. Banc One Texas, N.A.*, 252 F. Supp. 2d 368 (S.D. Tex. 2003).

By Derrick A. Free

Applying both Federal and Texas state law, the United States District Court for the Southern District of Texas held that, although a depositor may or may not actually receive other unsigned documents that are incorporated by reference into a bank's signature card that the depositor signs, provisions included in those incorporated unsigned documents may be enforced not only as between the bank and the depositor, but also against other similarly situated non-signatory third parties.

In late 1998, the plaintiffs executed a signature card that incorporated by reference the bank's rules and regulations and authorized Banc One to conduct certain transactions on their behalf. In 2000, allegedly without the knowledge or permission of the plaintiffs, approximately \$800,000 was withdrawn from the plaintiffs' account with Banc One and used to purchase a variable annuity. The plaintiffs alleged that they ultimately lost approximately \$400,000 in the transaction and assessed a penalty when they attempted to mitigate their damages. In this action, the plaintiffs sued Banc One Texas, N.A., Banc One Securities Corp., Banc One Insurance Agency, Inc., and Bill Berry, a bank employee, individually.

The bank's rules and regulations contained a provision mandating arbitration for any claim arising from any Banc One deposit account. Banc One asserted that all the claims in the present action arose from the alleged unauthorized movement of funds from the plaintiffs' deposit account and moved the court to compel arbitration. The plaintiffs claimed that they never agreed to arbitrate claims arising

from their deposit account with Banc One and that three of the defendants were never parties to the signature card governing the deposit account.

The district court held the arbitration agreement within the bank's rules and regulations was enforceable, dismissed the plaintiffs' action without prejudice, and ordered the parties to proceed to arbitration. Using "liberal federal policy [that] favor[s] arbitration agreements," as stated in the Federal Arbitration Act (FAA), 9 U.S.C. §§ 1 *et. seq.*, coupled with Texas state law which holds that "an unsigned paper may be incorporated by reference into a paper signed by the person sought to be charged," the district court held that the arbitration agreement was applicable to the plaintiffs in their action against all of the defendants, regardless of whether they were signatories to the card arrangement. The district court characterized this particular arbitration agreement as "broad," which through the *Grigson* test applied by the court, brought the non-parties to the signature card within the scope of the arbitration agreement. Although the arbitration agreement was heavily slanted in favor of the bank, the District Court noted there is nothing per se unconscionable about arbitration agreements. Additionally, the Fifth Circuit previously rejected the argument that the inability to negotiate terms of an arbitration agreement was substantively unconscionable.

As *Jurecki* illustrates, transactional attorneys representing financial institutions have a powerful tool to compel arbitration for claims arising from account disputes. Not only does the *Jurecki* decision confirm the enforceability of arbitration agreements between parties, it also supports compelled arbitration for non-signatories who face claims arising out of the same action that fall within the *Grigson* parameters. Individual depositors should be advised about the probable inevitability of such clauses attaching to their accounts and the rights and requirements that go along with them.

COPYRIGHT

The 1998 Copyright Term Extension Act is constitutional. *Eldred v. Ashcroft*, 537 U.S. 186 (2003).

By Zachariah N. Stansell

In *Eldred v. Ashcroft*, the Supreme Court held that the Sonny Bono Copyright Term Extension Act (“CTEA”) did not violate the “limited term” requirement of the Copyright Clause or the First Amendment guarantee of free speech. In its decision, the court faced the question of whether the largest expansion on the copyright term in United States history was Constitutional.

In 1998, Congress passed the CTEA to extend the term of federal copyrights from fifty to seventy years after the death of the author of the copyrighted work or 95 years from the date of publication for any work published before 1978, making CTEA the largest expansion of the term of copyright in United States history. In *Eldred v. Ashcroft*, the petitioners were businesses and individuals whose services and products were built on copyrighted works that had gone into the public domain, but the copyright protections were resurrected for another twenty years by CTEA. The petitioners sought a determination that the CTEA fails both under the Copyright Clause and the guarantee of free speech granted by the First Amendment. The CTEA brought the baseline United States copyright term in line with the European Union term adopted in 1993. The CTEA’s new terms apply to any work published after January 1, 1978.

The Supreme Court affirmed both the District Court for the District of Columbia and the Court of Appeals, holding that the CTEA did not violate the constitutional requirement of a “limited time” for copyrights and that it did not violate the First Amendment’s guarantee of free speech. A copyright should be the engine of free expression by supplying an economic incentive to create and disseminate ideas. The extension of copyright terms would not violate free speech because copyright does not prevent the fair use of an idea and does not grant a monopoly on any fact or idea; rather, it only protects the specific form of expression that the author uses.

The Court also affirmed that the Copyright Clause allows Congress to amplify the terms of an existing copyright and noted that the Court has historically deferred to Congress’ judgment regarding copyright protection. Copyright is a quid pro quo arrangement in that the author benefits by retaining control over his or her

work in exchange for advancing the store of knowledge, while society benefits from the author's ideas in exchange for that idea becoming part of the public domain after a limited time. The Court reasoned that authors of work would reasonably understand that the protection under the Copyright Act is not only for the place in time when it is gained, but for any renewal or extension legislated during that time. The Court found no basis for the petitioners' proposition that a copyright term is not for a "limited time" if it may be extended for another "limited time." The Court disagreed with the unconstitutional argument too, especially since Congress had already expanded copyright terms in 1831, 1909, and 1978.

Transactional lawyers should advise their clients that the CTEA will reactivate copyrights that had entered into the public domain since 1978. Though future copyrights will not be greatly affected, royalties will now be due for works that have been in the public domain for over two decades. While giving a measure of long-term security to the authors of works, the Act may create a strain on businesses and researchers who will now have to pay royalties for materials previously in the public domain.

CORPORATE

In no situation are target corporations allowed to use defensive devices in such a manner as to create an absolute lockup for a merger. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003)

By Matthew J. Ledwith

Applying Delaware corporate law, a 3-2 divided Delaware Supreme Court held that although the use of defensive devices is allowed, the directors of a target corporation are not allowed to execute a merger agreement that combines these devices to create an absolute lockup. Instead, the directors are required to uphold their fiduciary duties by contracting for the inclusion of a "fiduciary out" clause, even though doing so may cause the merger to fail. A "fiduciary-out" clause in a merger agreement permits the board to terminate the signed agreement if it decides that termination is necessary to uphold the directors' fiduciary obligations.

NCS, the Delaware target corporation in this case, was a leading independent provider of pharmacy services to long-term health care institutions prior to the market decline in the health care industry in late 1999. As the market began to

decline, NCS became a financially troubled publicly traded company. Because of its financial troubles, NCS searched for companies that might be interested in a merger for over two years.

Omnicare (“Omni”), a rival in the pharmaceutical business, offered to purchase the assets of NCS out of bankruptcy, but declined any interest in the possibility of a merger. NCS rejected this initial offer because it most likely would not have provided any recovery for the NCS stockholders. NCS had no more contact with Omni between November 2001 and January 2002. Another rival, Genesis Health Ventures, Inc., expressed interest in a merger but was wary of entering into negotiations because it had previously lost a bidding war to Omni. Genesis demanded that if NCS was interested in merging with it, its deal must include the following three defensive devices: first, that NCS must present the deal to the stockholders regardless of whether the board later withdraws its recommendation; second, that NCS must omit any “fiduciary out” clause; and finally, that NCS must approve the voting agreement between Genesis and the two majority stockholders that were required to vote their shares in favor of the Genesis merger. These devices, working together, locked up the Genesis merger with NCS regardless of any superior offers that could come along later.

Omni then reentered negotiations with NCS on a conditional basis that caused Genesis to increase its offer contingent on its agreement with NCS being signed within twenty-four hours. The board of NCS met with its legal and financial counsel and, after weighing the loss of the Genesis deal against the conditional Omni deal, decided to approve both the voting agreement and the merger with Genesis. Hours after the Genesis and NCS deal was signed, Omni faxed a draft merger agreement which was still conditioned on a due diligence review. Two months later, Omni dropped the due diligence condition and irrevocably committed itself to a deal superior to Genesis’. However, the defensive devices employed by Genesis locked up its deal with NCS and prevented NCS’ board from accepting Omni’s deal.

The Delaware Supreme Court reasoned that when a board uses defensive devices, this decision is subject to the *Unocal* standard of enhanced judicial scrutiny. Therefore, to be allowed, the devices must not be preclusive or coercive and they must be within the range of reasonable responses. The majority determined that in this case the defensive devices were both coercive and preclusive and were outside of this range of reasonableness. The court held that the devices were coercive because the minority stockholders were not forced to vote for the deal but their votes were stripped of any effectiveness. The devices were preclusive in that they barred any future offers from being entertained. The defensive devices were also held to be

unenforceable because they prevented the board from carrying out its fiduciary duties. The minority stockholders were in a powerless position because the deal would be accepted regardless of how they voted and were forced to rely on NCS' board to protect their interests. The court stated that, in such a circumstance, the board must not submit to a company's demand to "lock up" a deal, but rather is obligated to demand the inclusion of a "fiduciary out" clause. This holds true regardless of whether the insistence on such a clause will cause one bidder to withdraw its offer and leave the company with a bid from a company that has continually expressed its desire for an asset sale and maintains due diligence as a condition to any merger deal.

This decision effectively removes a target company's ability to offer assurances to a bidder that the agreement reached will be approved and that competing offers will not be considered accepted. Although it appears that the majority adopted this rule to ensure stockholders receive the highest value, the rule may actually reduce the value these stockholders receive if no initial bidder can be found due to the inability to lock up the transaction. As a result of the increased risk of either losing the deal to a newcomer's subsequent superior bid, an initial bidder's first offer may also be lower to allow for the possibility that bidding may ensue.

PROPERTY

Easements do not automatically revert to the servient property when an easement holder fails to meet a condition subsequent. *Rector v. Halliburton*, No. M1999-02802-COA-R3-CV, 2003 Tenn. App. LEXIS 149, 2003 WL 535924 (Tenn. Ct. App. Feb. 26, 2003).

By Eddie L. Broomfield

Often, the destruction of an easement is more complicated than the original creation of that easement. Current land owners may experience more problems than benefits with easements that run with the land. However, owners should be cautious when they attempt to terminate existing easements upon their property; otherwise, owners may find themselves ensnared in difficulties like those considered by the Tennessee Court of Appeals in *Rector v. Halliburton*.

Elizabeth Halliburton purchased a Nashville home in 1953. In 1969, the state exercised its power of eminent domain over a portion of the property in order

to further a highway construction project. This acquisition left the remainder of the property inaccessible.

In 1973, Halliburton purchased an express easement from her neighbor, Bessie Brown. This easement allowed for a strip of land to provide driveway access to the Halliburton property. Halliburton acquired an expressly perpetual easement conditioned upon proper hard surface maintenance of the driveway.

Paul Rector purchased the Brown property in 1988. Over the next several years, Rector continuously attempted to acquire the Halliburton property. Rector consistently disturbed Halliburton by keeping her from laying new gravel on the driveway, trying to convince Nashville Electric Service (“NES”) to cut power to the Halliburton house, twice attempting to construct a fence across the Halliburton driveway, and attempting to block access to the Halliburton property by parking a vehicle across the driveway.

Rector filed suit for trespass in 1998, naming Halliburton and NES as defendants, as a result of Halliburton’s continued use of the driveway easement and NES’ repositioning of power lines over Rector’s property. Rector admitted that he had no valid claim against NES, for the power lines originally stood for more than twenty years and their uncontested use of the land resulted in a prescriptive easement. Yet, Rector claimed that Halliburton’s failure to gravel the driveway prior to 1994 resulted in a reverter and that Halliburton’s continued use of the driveway since 1994 constituted a trespass. Halliburton filed several counterclaims, including trespass. The trial court dismissed all of Rector’s claims and sustained Halliburton’s counterclaims.

On appeal, the court agreed with the trial court and further considered three key issues raised by Rector. The first issue is whether NES abandoned its prescriptive easement over Rector’s land by moving the power lines. In Tennessee, an easement owner cannot substantially increase or add to the burden placed upon the subservient estate. The power lines took up much less of Rector’s land after they were moved in 1995, resulting in a decrease of the burden upon Rector’s land.

The second issue considered whether Halliburton’s express easement expired when she failed to maintain a hard surface along the driveway. The agreement between Brown and Halliburton stated that the driveway should be maintained at the holder’s expense as “either rock, gravel, or paved.” The court viewed this as a condition subsequent not resulting in an automatic reverter to Rector. The court

further determined that the easement continued because Rector did not affirmatively attempt to establish control of the disputed land prior to 1994.

Finally, the court considered whether Rector had committed a trespass by interfering with Halliburton's interest in the driveway. The law clearly states that an easement holder has a right to the full enjoyment and use of the easement. Thus, the court found interference in Rector's attempts to fence off and otherwise block the driveway.

Rector v. Halliburton illustrates the difficulty of destroying easements upon property. Transactional attorneys should advise their clients not to interfere with easements upon their land, but to watch carefully for any abuse of that easement. If an abuse occurs, the owner of the subservient estate should act with haste in order to revert the easement. Transactional attorneys should note that easements do not automatically revert to the servient property when an easement holder fails to meet a condition subsequent, and that courts will find actionable any interference with the easement holder's full enjoyment and use of the easement.

County's decision to freeze homestead property values on date of acquisition for purpose of *ad valorem* tax assessment violates neither the Federal nor the Georgia Constitutions. *Columbus-Muscogee County Consol. Gov't v. CM Tax Equalization, Inc.*, 579 S.E.2d 200 (Ga. Mar. 24, 2003).

By Nathaniel A. Earle

Applying state and federal constitutional law, the Supreme Court of Georgia upheld the constitutionality of a local constitutional amendment authorizing a county to freeze the value of homestead property for *ad valorem* tax purposes at the property's fair market value during the year acquired. The Court determined that the Homestead Freeze did not conflict with the uniformity in taxation clause of Georgia's Constitution, did not violate the equal protection clauses of the state and Federal Constitutions, and did not unreasonably interfere with the right to travel guaranteed under the Federal Constitution. Therefore, the County's decision to utilize an acquisition-value system for assessing homestead property taxes constituted a legitimate exercise of the government's policy-making function.

In 1981, the General Assembly of Georgia approved a local constitutional amendment permitting Columbus-Muscogee County (the “County”) to assess homestead property for *ad valorem* tax purposes at the property’s value on the date of acquisition, instead of the usual method of reassessing the value of the property periodically.

The Court found that the Homestead Freeze did not conflict with the state constitution’s uniformity in taxation clause. The Court noted that the Homestead Freeze reflected the express intent of the legislature to modify the uniformity clause, and that the amendment expressed the prevailing sovereign will of the people.

Under equal protection analysis, when a classification does not impact a fundamental right or operate to the disadvantage of a suspect class, the disparate treatment caused by the classification must satisfy only the rational relationship test. A classification will survive rational relationship review if it is based on rational distinctions and bears a direct relationship to the purpose of the legislation. Using equal protection analysis, the Court found that the goals of the Homestead Freeze included neighborhood preservation, continuity and stability, and the protection of reliance interests of existing homeowners, and that the acquisition-value system bore a rational relationship to those purposes.

The Court further observed that the Homestead Freeze applied to all homeowners regardless of income. The state based the Homestead Freeze solely on the acquisition date, irrespective of a buyer’s income or ability to pay. Moreover, the Court determined that the Homestead Freeze benefited all homeowners, including those belonging to minority groups and lower income brackets, for the Homestead Freeze shielded homeowners from the adverse effects of gentrification in their neighborhoods.

The Court concluded that the state may legitimately choose to protect the reliance interests of existing homeowners, even at the expense of new purchasers. In theory, existing owners have vested expectations in their homes which are relatively more deserving of protection than the anticipatory expectations of prospective buyers.

Finally, the Court noted that the Homestead Freeze applied to all persons seeking to purchase homestead property in the County, both new arrivals and long-term county residents alike. The Freeze, therefore, did not constitute an impermissible burden on the right to travel.

Because acquisition-value taxation will not necessarily benefit all purchasers of homestead property, clients should be advised to consider the probable duration of their investments. While the long-term investor stands to gain predictable tax liability and protection against inflation and gentrification in an acquisition-value system, the best advice for the transient homeowner is *caveat emptor*, buyer beware.

TAX

In Tennessee, when a taxpayer pays taxes to another state on an item used to produce tangible personal property, the taxpayer is allowed a credit equivalent to that amount of taxes previously paid. *Bellsouth Adver. and Publ'g Co. v. Johnson*, 100 S.W.3d 202 (Tenn. 2003).

By Joseph W. Ballard

In Tennessee, a taxpayer paying taxes to another state on an item used to produce tangible personal property is allowed a Tennessee tax credit in that same amount. Moreover, this credit can be used to offset the applicable Tennessee use tax if the taxpayer distributes the tangible personal property. Regardless of whether the distributed property actually contains the item used in production, the credit can be applied. This is the situation the Tennessee Supreme Court addressed in *Bellsouth Advertising and Publishing Co. v. Johnson*.

The defendant, the Tennessee Department of Revenue, audited the plaintiff, a producer and distributor of telephone directories. During the audit, the plaintiff realized it neglected to claim credit for \$165,000 in sales tax previously paid in another state in connection with a purchase of photocompositions. Photocompositions are properly formatted pages of a telephone directory that transfer to printing plates. The printing plates then produce the actual pages of the telephone directories. Upon completion of the printing process, the photocompositions are destroyed.

During the audit, the plaintiff asked the auditor to apply an appropriate reduction for the tax credit it neglected to claim on the sales tax paid on the photocompositions. The auditor declined to do so. Following the audit, the auditor issued an assessment for sales and use tax liability against the plaintiff in the amount of \$125,179.87. If allowed, the proposed credit for the photocompositions would have more than completely offset the auditor's tax assessment.

The plaintiff filed a claim asking for a refund from the Department of Revenue. The Department denied the plaintiff's claim, and the plaintiff proceeded to file a claim in Chancery Court challenging the auditor's sales and use tax assessment. This claim was consolidated with the plaintiff's second claim, which demanded a refund for the amount of sales tax paid on the photocompositions. The Special Chancellor granted the Department's motion for summary judgment on both claims. The Tennessee Court of Appeals upheld the trial court's decision, and the plaintiff timely filed an appeal to the Tennessee Supreme Court, which reversed the courts below.

In Tennessee, a use tax is levied on the cost price of each item of tangible personal property distributed rather than sold. However, the use tax will not duplicate the taxes if the distributor of tangible personal property has previously paid *like* taxes in another state. The cost price of tangible personal property includes materials used, labor or service costs, transportation charges, or any expenses whatsoever. The plaintiff's cost price included the cost of the photocompositions, printing, and other expenses.

The trial court and the Tennessee Court of Appeals found the sales tax the plaintiff paid on the photocompositions to be dissimilar to the use tax assessed on the distribution of the directories. As the auditor's assessment of a delinquent use tax failed to duplicate a like tax previously paid by the plaintiff, the courts had held the auditor's denial of a tax credit was appropriate.

On appeal to the Tennessee Supreme Court, the plaintiff argued that Tennessee allows items used in producing tangible personal property to be calculated in the total cost price of the tangible personal property. Therefore, the portion of the cost price that includes the photocompositions had already been assessed a like tax in another state.

In determining the merits of this case, the Tennessee Supreme Court reviewed the underlying purposes originally intended for the use tax. Initially, the Court found that the use tax is a compliment – not a supplement or addition – to the sales tax. The Court noted that the use tax was designed to create parity between resident and nonresident merchants doing business in Tennessee. The use tax is not designed to hinder out-of-state merchants; instead, the tax attempts to prevent foreign merchants from obtaining unfair advantages over local merchants. The Court found the legislature never intended multiple taxes to apply to the same goods and services.

Interpreting the definition of cost price, the Court found that taxes paid on items used to produce the final product and taxes paid on the final product were indistinguishable. Accordingly, the sales tax and the use tax complement one another and should not be simultaneously applied to the same product. The Court, therefore, reversed the judgment of the lower courts and granted summary judgment in favor of the plaintiff.

As *Bellsouth* indicates, Tennessee provides a tax credit to alleviate a taxpayer from paying duplicate taxes. Transactional attorneys need to instruct taxpayers to claim a use tax credit on taxes paid out-of-state for the completed product when the product is distributed. Additionally, a taxpayer is entitled to a use tax credit on taxes assessed on items used in the production of the completed product. Taxpayers should account for any taxes paid in a foreign state from the start of the project until the distribution of the completed project.

Oral license agreements involving equipment on ocean vessels are subject to Florida's state use tax; taxes involving ocean vessels engaged in interstate or foreign commerce are entitled to a prorated tax rate. *Dream Boat, Inc. v. Dep't of Revenue*, No. 1D02-1253, 2003 WL 1560175, 2003 Fla. App. LEXIS 4097 (Fla. Ct. App. Mar. 27, 2003)

By Anna Burck

The Florida Court of Appeals held that oral license agreements involving gambling equipment on gambling ocean vessels were subject to Florida's state use tax. Further, appellant was not entitled to have taxes involving his ocean vessels prorated because appellant's ocean vessels were not engaged in interstate or foreign commerce.

The appellant owned several ocean vessels equipped with gambling equipment. Companies would charter appellant's vessels and take passengers on cruises for the purpose of gambling. Gambling only took place when the vessels had traveled outside of the three mile Florida state boundary limit. The companies chartering these vessels entered into oral license agreements with Appellant for the use of the gambling equipment.

The court first considered whether the oral license agreements involving the gambling equipment were subject to Florida's state use tax. Florida Statute section 212.05 (1999) imposes a tax on sales, use, and other activities of Florida businesses. Florida Statute section 212.02(20) (1999) defines "use" as "includ[ing] the exercise of any right or power over tangible personal property incident to the ownership thereof, or interest therein" Appellant "exercise[d] his right or power over" his slot machines in Florida when he entered into the oral license agreements; therefore, the court concluded that the oral license agreements were subject to Florida's use tax.

Second, the Court considered whether taxes resulting from Appellant's operation of his ocean vessels should be prorated pursuant to Florida Statute section 212.08 (1999). The statute provides a prorated tax rate to businesses engaged in transporting people or property in interstate or foreign commerce. Following the United State Supreme Court's decision in *Lords v. Steamship*, 102 U.S. 541 (1880), the Florida Court of Appeals reasoned that the purpose of the prorated tax rate was to prevent companies, which engaged in interstate or foreign commerce, from being over burdened by many sets of laws. Appellant conceded that his vessels never left the United States. Following an analysis of *Steamship*, this Court found that though appellant's vessels left the state of Florida, the vessels never left the United States. Appellant was not engaged in interstate or foreign commerce, and therefore, appellant was not entitled to a prorated tax rate pursuant to Florida Statute section 212.08 (1999).

This decision clarifies an existing tax law so that it would apply to businesses that fall in between those that conduct operations solely inside the state and those that engage in interstate or foreign commerce. Not only did the Florida Court of Appeals clarify the tax law as it applied to gambling ocean vessels, but through its reasoning, it enables transactional attorneys to counsel their clients about whether a particular business would be subject to certain taxes or entitled to certain exemptions under these tax laws.

Absent any significant differences, a state taxing scheme that burdens one group more than another would be in violation of the intergovernmental tax immunity doctrine. *Kerr v. Killian*, 65 P.3d 434 (Ariz. Ct. App. 2001).

By Aaron B. Flinn

The Arizona Court of Appeals held that, when deciding if a state tax procedure violates the intergovernmental tax immunity doctrine, the court should

focus on whether the imposition of a heavier tax burden on one group is justified by and directly related to significant differences between the two groups. In doing so, the court held that the Arizona statutes violated the intergovernmental tax immunity doctrine.

Under 4 U.S.C. § 111, the United States consents to the taxation of its employees by individual states, so long as the state taxing authority does not discriminate against federal governmental employees based on their source of compensation. Federal, state, and local employees are all required to make mandatory contributions to their respective retirement plans; however, under 26 U.S.C. § 414(h), Congress authorizes state and local employers to “pick up” these contributions. An employer “picks up” contributions when the portion of an employee’s salary designated for mandatory contributions is no longer considered compensation paid to the employee, which excludes this amount from that employee’s federal gross income. However, Congress elected not to “pick up” federal governmental employees contributions, thereby forcing federal employees to include these contributions in their federal gross income. Consequently, when a state uses an individual’s federal gross income as the starting point for determining one’s state income tax, a federal employee’s mandatory contribution is subject to taxation, while the corresponding contribution of a state or local governmental employee whose employer “picks up” this contribution is not.

A federal employee brought suit claiming that the Arizona taxing procedure violated the intergovernmental tax immunity doctrine. Beginning in 1985, the Arizona legislature decided to permit state and local governmental employers to “pick up” the mandatory contributions of their employees. This subjected the mandatory contributions of federal employees to taxation, while exempting the same contributions of state and local governmental employees. In 1989, Kerr brought suit claiming that Arizona statutory sections 43-1001(2) and 43-1022(2) violated the intergovernmental tax immunity doctrine. The court held that both statutes violated the doctrine. (*Kerr I*; vacated on other grounds by *Kerr II*). The lower court held that the Arizona law did not violate the doctrine since the statute did not discriminate against the plaintiff “because of the *source* of [their] pay or compensation.” (emphasis added). The issue for the Arizona Court of Appeals is whether or not Arizona’s taxing scheme, via section 43-1001(2), violates the intergovernmental tax immunity doctrine, as codified at 4 U.S.C. § 111.

The United States Supreme Court invalidated a similar Michigan tax scheme in *Davis v. Michigan Department of Treasury*, 489 U.S. 803 (1989). The Court stated that the intergovernmental tax immunity doctrine is not violated so long as the inconsistent tax treatment is directly related to, and justified by, “significant differences between the two classes.” Therefore, the relevant inquiry is whether the inconsistent treatment is based on and justified by some significant differences between the two groups. Holding that Arizona’s section 43-1001(2) did not violate the intergovernmental tax immunity doctrine because it did not discriminate against Kerr based on his source of pay, the appellate court in *Kerr I* erroneously focused on the literal language of 4 U.S.C. § 111, instead of following the holding in *Davis*. On reconsideration, however, the appellate court realized its mistake and stated that, “[u]nder *Davis* and its progeny, the only pertinent question is whether significant differences between [the] two classes exist that are directly related to and justify this differential treatment.”

After examining the differences between the group of federal employees and state and local employees, the court concluded that no such significant differences existed since both are required to make mandatory contributions to their respective retirement plans. Since there were no significant differences between the two groups which could justify the differential treatment, the court concluded that Arizona’s 43-1001(2) violated the intergovernmental tax immunity doctrine.

Lawyers need to be aware that the proper inquiry, when deciding if a state’s taxing procedure violates the intergovernmental tax immunity doctrine, should be whether significant differences exist between the two groups of employees. These significant differences must be directly related to and capable of justifying any unequal tax burden. Absent any significant differences, a state taxing scheme that burdens one group more than another would be in violation of the intergovernmental tax immunity doctrine as codified in 4 U.S.C. § 111.

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