CASE COMMENTARIES

AGENCY

In proving the existence of an agency relationship, the burden of proof lies with the party asserting the validity of the relationship and such party cannot rely solely on the statement of the purported agent to prove its claim. *Barclay v. Kindred Healthcare Operating, Inc.*, No. W2008-02828-COA-R3-CV, 2009 Tenn. App. LEXIS 590, 2009 WL 2615821 (Tenn. Ct. App. Aug. 26, 2009).

By Sabrina Carlson

Although a non-specific statement may form the basis for an express oral authority to act on a person's behalf, it may not replace an explicit written agreement to act as a person's attorney-in-fact, as a matter of law. In *Barclay v. Kindred Healthcare Operating, Inc.*, the Tennessee Court of Appeals held that the burden of proof lies with the party asserting the validity of an agency relationship. Further, the party must rely on more than the statement of the purported agent to prove its claim.

In *Barclay*, Ernest Napier ("Napier") lived with his uncle, Odis Barclay ("Barclay"). During Napier's teenage years and throughout his adulthood, Napier and Barclay remained in close contact. As Barclay aged, he entrusted Napier to deposit his social security check and pay his bills from a joint checking account that they both shared. Barclay did not, however, expressly grant Napier his power of attorney.

Upon admission to the Cordova Rehabilitation and Nursing Center ("Cordova") in February 2005, Barclay signed and executed his own "Admissions Agreement" and "Consent to Admission and Treatment." A week later, Napier signed an optional arbitration agreement on Barclay's behalf. The agreement was signed without Barclay's knowledge and was revocable up to 30 days after its execution.

In March 2007, Casey Barclay, Barclay's son, filed an action in the circuit court for Shelby County, Tennessee against Kindred Healthcare Operating, Inc., d/b/a Cordova Rehabilitation and Nursing Center, for the wrongful death of his father. Casey Barclay argued against the validity of the arbitration agreement because Barclay had neither appointed Napier to be his legal representative nor executed a power of attorney in favor of Napier. Cordova responded by filing a

motion to stay the litigation and compel arbitration under the arbitration agreement.

In May 2008, the trial court found that Napier was authorized to handle Barclay's financial affairs and to make medical decisions on his behalf. The court held that Napier had express oral authority to bind Barclay to the optional arbitration agreement with Cordova and that the arbitration agreement signed by Napier was enforceable and not unconscionable. The court denied Casey Barclay's plea for an interlocutory appeal, and in November 2008, the court entered both a final judgment and an order to dismiss the case.

On appeal, the court of appeals examined two issues: (1) whether non-specific statements by an uncle to a nephew to "take care of" him gives the nephew express oral authority to act as the uncle's agent as a matter of law, thus binding the competent uncle to an optional arbitration agreement at the time of his nursing home admission; and (2) whether the trial court erred in finding that the arbitration agreement was not unconscionable. Although the court of appeals declined to address the issue of unconscionability, the court reversed the trial court's dismissal and remanded the case for further proceedings. The court held that in proving the existence of an agency relationship, the burden of proof lies with the party asserting the validity of the relationship and that such party cannot rely solely on the statement of the purported agent to prove its claim.

The court of appeals resolved that Barclay did not expressly give Napier the oral authority to act as his agent as a matter of law. The court explained that Barclay had ample time to appoint Napier as his power of attorney and that Napier's belief that he possessed that power was not "sufficient to establish authority as a matter of law." Additionally, the court cited *Mitchell v. Kindred Healthcare Operating Inc.*, No. W2008-01643-COA-R3-CV, 2009 WL 1684647 (Tenn. Ct. App. June 17, 2009) in determining that Cordova was "not entitled . . . to simply rely upon someone who comes in and says, 'I'm the power of attorney. Let me sign the documents.'" The documents explicitly required the signature of the patient's legal representative or agent, and Cordova was aware that Napier had not signed the admission agreement in this capacity.

Barclay v. Kindred Healthcare Operating, Inc. serves as a reminder that in the absence of an explicit written agreement to act as a person's attorney-in-fact, the testimony of the purported agent may not be sufficient to establish the existence of an agency relationship. This is especially important with regard to end of life care, where all too often only the testimonies of the purported agent and the healthcare

facility remain. If healthcare facilities allow purported agents to act on behalf of a patient without the patient's explicit written consent, healthcare facilities could find themselves embroiled in litigation, as arbitration agreements could be found invalid.

To strengthen both agency relationships and arbitration agreements, practitioners must advise clients to put all such relationships in writing. These writings should be explicit and list all of the agent's responsibilities, including whether or not an agent may enter into an arbitration agreement on behalf of a client. Practitioners should also review existing agreements to ensure that such agreements meet this standard.

Furthermore, the holding in *Barclay* is important for practitioners because the court of appeals invites the Tennessee Supreme Court and the Tennessee General Assembly to reconcile Tennessee's statutory provisions with the Tennessee Rules of Appellate Procedure. While the general rule is that arbitration issues are decided in favor of arbitration, the court of appeals noted that questions regarding the formation of arbitration agreements are contractual questions that must be decided by a court of law. After a court determines if the agreement was valid, the court is then free to decide whether the agreement was unconscionable. Tennessee Rule of Civil Procedure 54.02 permits the trial court to stay the matter in order to hear an interlocutory appeal of its judgment on the validity of the agreement. The court of appeals explained that the trial court's use of Tennessee Rule of Appellate Procedure 3 to dismiss "the matter, making the trial court's judgment appealable as a final judgment . . . amounts to an end run around the statute."

BANKRUPTCY

Bankruptcy courts may refuse to allow a creditor's previous filings to qualify as an informal proof of claim where the creditor had ample notice of the filing requirement and failed to provide an explanation for not filing. *In re Nowak*, 586 F.3d 450 (6th Cir. 2009).

By Lindy Degnan Harris

In *In re Nowak*, the Sixth Circuit Court of Appeals considered whether the bankruptcy court abused its discretion in refusing to allow a creditor's previous filings with the bankruptcy court to collectively qualify as an informal proof of claim. The Nowaks ("Debtors") executed a mortgage on their residence in favor of PCFS Financial ("Creditor"). Three years later, Debtor filed for Chapter 7

bankruptcy relief. The trustee successfully voided Creditor's lien based on a technical error in the execution of the mortgage instrument, and Creditor lost its secured status. Creditor failed to file the required proof of claim, and the trustee's final report proposed no distribution to Creditor. Creditor objected and moved the court to allow an informal proof of claim based on its prior filings as a secured creditor. The court of appeals found that the bankruptcy court had not abused its discretion by finding for the trustee.

In *Nowak*, Debtors executed a mortgage on their residence in March 1998 for $470,900 in favor of Creditor. Three years later, Debtors jointly filed for Chapter 7 bankruptcy relief. The trustee issued notices to the estate's creditors to file proofs of claim. At that time, Creditor was secured and was not required to file a proof of claim pursuant to the Federal Rules of Bankruptcy Procedure, Rule 3002(a). Debtors received a bankruptcy discharge in 2001. The trustee obtained an attorney pursuant to § 544 of the United States Bankruptcy Code ("Code") and commenced an adversary proceeding for the purpose of voiding Creditor's lien. The basis for voiding the lien was that it was invalid under Ohio law because two people had not witnessed the execution of the mortgage.

Meanwhile, the trustee filed a notice of intent to sell the residence on the basis that it was the subject of a bona fide dispute. Creditor filed an objection to the sale, claiming it was not the subject of a bona fide dispute and that the sale price would be insufficient to satisfy the lien and would create a deficiency. Creditor also filed a motion for relief from the automatic stay and for the estate to abandon the residence to it.

The bankruptcy court overruled Creditor's objection to the sale, and Creditor withdrew its motion for relief from the automatic stay. Subsequently, the court ruled that the mortgage was not executed with the proper formalities and entered an order voiding Creditor's lien on Debtors' residence, causing Creditor to be unsecured. Creditor appealed the court's decision to the Bankruptcy Appellate Panel ("BAP"). While the appeal was pending, the trustee filed an amended intent to sell the residence, to which Creditor filed no objection. The residence later sold for $300,000, and the BAP affirmed the bankruptcy court's decision to void Creditor's lien.

In January 2007, the trustee filed a final report and accounting, recommending a distribution of funds to all unsecured creditors that filed proofs of claim. This final report did not include Creditor, because it had made no proof of

claim. Creditor objected and moved the court to allow an informal proof of claim based on its previous filings collectively, including the motion for relief from stay, documents that had been previously filed, and Debtor's testimony during the adversary proceeding. The trustee argued that Creditor's claim should not be allowed because it had opportunity to file a formal proof of claim but failed to do so. The bankruptcy court held in favor of the trustee, finding that Creditor's previous filings did not constitute an informal proof of claim because they did not contain a demand on the estate and did not express intent to hold Debtors liable for the debt. As such, the court found that the equitable result was to disallow Creditor's informal proof of claim.

The bankruptcy court reasoned that Creditor failed to file any of the documentation prior to the deadline, that Creditor had not explained its failure to file a formal proof of claim, and that if it allowed Creditor's claim, the other creditors' recovery would be reduced from 100% to 29%. Thus, the court overruled Creditor's objection and denied its motion to allow an informal proof of claim.

Creditor appealed the bankruptcy court's decision to the BAP. The BAP held that Creditor's filings in the bankruptcy court did meet the requirements of an informal proof of claim, but that the bankruptcy court did not abuse its discretion by disallowing the proof of the claim as inequitable. Creditor then appealed the decision of the BAP.

The Sixth Circuit reviewed the equitable decision under an abuse of discretion standard, determining whether a reasonable person could agree with the bankruptcy court's decision. Generally, an unsecured creditor must file a proof of claim in order to partake in the distribution of the estate's assets.[1] A timely filed proof of claim is prima facie evidence of the existence and amount of a claim. If a proof of claim, however, is not filed prior to the deadline (known as the claims-bar date), exceptions are allowed in some cases to prevent an elevation of form over substance where a creditor has failed to follow the strict formalities of the Code, but has put all parties on sufficient notice of its claim. The court may allow a creditor to use its pre-bar date filings as an informal proof of claim and to amend those filings, post-bar date, to conform to Rule 3001's requirements.

The bankruptcy court used the five-factor Sixth Circuit test set forth in *In re*

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[1] Fed. R. Bankr. P. 3002(a).

N.J. Waterman & Associates, Inc., 227 F.3d 604 (6th Cir. 2000). According to this test, such filings must meet the following four elements to be considered an informal proof of claim:

> (1) The proof of claim must be in writing; (2) [t]he writing must contain a demand by the creditor on the debtor's estate; (3) [t]he writing must express an intent to hold the debtor liable for the debt; and (4) [t]he proof of claim must be filed with the bankruptcy court. If those four elements are present, the court may examine a fifth factor – whether it would be equitable to allow the amendment of the informal proof.

The fifth factor is an equitable determination within the discretion of the bankruptcy court. This standard is designed to protect the debtor and the other creditors who timely file their proofs of claim and could be negatively affected by another creditor's failure to timely file, while not punishing those who filed improperly based on a technicality.

A secured creditor is generally not required to file a proof of claim.[2] Where a creditor's lien on the collateral exceeds the value of the property, however, that claim is partially unsecured and that creditor must file a proof of claim in order to receive any distribution from the estate.[3] In addition, where a creditor's lien is successfully voided, as it was here, the creditor loses its secured status and therefore must file a proof of claim.

In Creditor's appeal to the BAP, the sole issue presented was whether the bankruptcy court had abused its discretion by not allowing Creditor's proof of claim. In denying the informal proof of claim, the court relied on three factors. The first factor was the length of Creditor's delay in pursuing an unsecured claim, despite having clear notice that it might lose its secured status. Further, even if Creditor had won the adversary proceeding and not lost its secured status, the sale of the home created an unsecured deficiency, for which a proof of claim was necessary. The second factor was the lack of any explanation from Creditor for the failure to file any formal proof of claim or for the delay in filing a motion for an informal proof

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[2] Fed. R. Bankr. P. 3002.

[3] *See* 11 U.S.C. § 506(a)(1); Fed. R. Bankr. P. 3002(a).

of claim. The court determined that Creditor was a "sophisticated lender that [had] been represented by counsel throughout the proceedings," and that its failure to file a timely claim was a "self-inflicted wound." The third factor was the significant reduction in the distribution amount that would be available to the other creditors if Creditor's claim were allowed.

The BAP held that the bankruptcy court's determination was not unreasonable, and therefore was not an abuse of discretion. The opinion distinguished between a creditor that complied with the substance of the bankruptcy rules but unwittingly failed to file the proper form, and the Creditor in the present case, who was a sophisticated lender with plenty of notice that voluntarily failed to comply with the rules. The BAP determined that reasonable minds could differ as to the balancing of equities in this case, so no abuse of discretion occurred.

The BAP's decision should indicate to practitioners that an informal proof of claim may be allowed, but only for its designated purpose: to avoid elevating form over substance where a filing is late or improper based on the intricacies of the Code. It is not designed to allow a creditor to supersede or navigate around the rules where the creditor easily could have complied with them. Practitioners should note, however, that the BAP's decision was limited to review of the lower court's weighing of the equities under an abuse of discretion standard, and it held that *reasonable minds could differ* on the subject. Therefore, practitioners should not attempt to expand the scope of this opinion by applying the precedent to all situations with similar facts.

BUSINESS ASSOCIATIONS

In alleging breach of fiduciary duty in a merger transaction, a plaintiff must demonstrate that the directors failed to attempt to obtain the highest sale price where the directors are otherwise exculpated from liability relating to the duty of care. *Wayne County Employees' Ret. Sys. v. Corti*, No. 3435-CC, 2009 Del. Ch. LEXIS 126, 2009 WL 2219260 (Del. Ch. July24, 2009).

By K. Chris Collins

Courts applying the business judgment rule presume that a corporation's directors are making informed decisions in good faith and in the best interests of the corporation. This standard is applied within the context of the business decision being made. Therefore, in the context of a merger, the courts will assume that the board is performing its fiduciary duties to achieve the maximum sale price for the

corporation's stock. In *Wayne County Employees' Retirement System v. Corti*, the Delaware Chancery Court granted a motion to dismiss, holding, in pertinent part, that the defendants in the case did not breach their duty of loyalty.

In *Corti*, Activision, Inc. ("Activision"), a leading developer of video games, entered into negotiations in late 2006 with Vivendi S.A. ("Vivendi"), the manufacturer of the popular game *World of Warcraft*, regarding a possible merger. Prior to negotiations, Activision evaluated 17 other possible corporate matches. On April 30, 2007, Activision's Board of Directors ("Board") was informed of the negotiations. The Board was comprised of eight directors, and of the eight, only Robert Kotick ("Kotick"), Co-Chairman of the Board and Activision's CEO, and Brian Kelly ("Kelly"), also Co-Chairman of the Board, acted as primary negotiators throughout the negotiations.

On December 1, 2007, Activision announced that a combination agreement with Vivendi had been reached. Pursuant to that agreement, Vivendi would (1) contribute its subsidiary, Vivendi Games, to the combined corporation; (2) purchase newly issued shares of Activision at a price of $27.50 per share; and (3) possess an executable option to purchase up to 50% of any remaining Activision shares at a price of $27.50 per share. Upon completion of the merger, Vivendi owned 52% of Activision.

The dispute in this case arose out of the role Kotick and Kelly played in negotiations. The plaintiff, a former shareholder of Activision, Inc., alleged that Kotick and Kelly breached their duty of loyalty by favoring their own interests in obtaining optimum employment benefits over the best interests of the corporation's stockholders. Plaintiff also alleged that the remaining Board members breached their duty of loyalty by permitting Kotick and Kelly to dominate negotiations.

Because the Board was exculpated from any liability arising from breach of the duty of care, the issue before the court was whether the members of the Board had violated their duty of loyalty, or otherwise acted in bad faith. The court held that (1) the Board did not violate its duty of loyalty, because both Kotick and Kelly were sufficiently disinterested in the negotiations; and (2) the Plaintiff did not plead facts sufficient to overcome the presumption that the Board did not fail to attempt to achieve the highest price for the corporation's shares.

As the court states, there is no monetary liability for failing to conduct the perfect merger. As such, a plaintiff must allege facts sufficient to overcome the presumption of the business judgment rule. The court found that Kotick and Kelly

were disinterested parties because their future with the company had already been determined, and there was nothing further for the two to gain. Further, Kotick's and Kelly's employment extensions were signed by Activision, not Vivendi. Therefore, the plaintiff could only survive dismissal by demonstrating that the Board failed to attempt to obtain the highest sale price for the corporation's stock.

The business judgment rule is a "contextually based" rule. It is applied in the specific context of whichever business decision is being made. That being the case, the court determined that the business judgment rule was to be applied in the context of the potential merger.

Activision's role in the merger was to give up the controlling share of its stock. Activision's only interest was to achieve a sufficient price level for its stock to support the feasibility of the merger. The business judgment rule was applied in the context of that interest. Therefore, the plaintiff's claims would fail unless he demonstrated that the Board "*knowingly and completely*" failed to *attempt* to obtain that price level. The court found that Activision's Nominating and Corporate Governance Committee, as well as its financial advisor, met routinely throughout the negotiations and considered several facts and analyses prior to agreeing to the merger. Therefore, the presumption of the business judgment rule could not be overcome by the plaintiff.

This case is a demonstration of the force of the business judgment rule. Because courts apply the rule in the context of the specific decision in interest, a plaintiff is forced to plead facts that are both highly specific and material to that specific decision in interest in order to survive a motion to dismiss. The business judgment rule, if utilized properly, can serve as a strong shield for defendants in these types of cases. Attorneys representing the directors and decision makers of corporations need to consistently reinforce the application of the business judgment rule in all transactions entered into by their clients on behalf of their respective corporations. On the other hand, attorneys representing possible plaintiffs in these types of cases need to impress upon their clients the high demand courts place on plaintiffs in demonstrating that the business judgment rule has been violated. Not only do the plaintiffs need to plead facts that are material, but those facts must also be specifically tailored to the exact business decision being attacked. If they do not, they will likely not survive a motion to dismiss.

Creditors of an insolvent or near-insolvent corporation may assert a claim for

breach of fiduciary duty against officers or directors who are also creditors of the corporation in cases involving self-dealing or preferential treatment. *Sanford v. Waugh & Co.*, No. M2007-02528-COA-R3-CV, 2009 Tenn. App. LEXIS 402, 2009 WL 1910957 (Tenn. Ct. App. June 30, 2009).

By S. Ryan Hoffman

It is well settled that directors of a corporation owe fiduciary duties to the corporation and its shareholders. Less clear are the duties, if any, owed by a director or officer to the creditors of a corporation. Certain jurisdictions hold that directors or officers owe no duties to a corporation's creditors, while others hold that fiduciary duties expand to the corporation's creditors only in limited circumstances. In *Sanford v. Waugh & Co.*, the Tennessee Court of Appeals held that fiduciary duties exist between corporate officers or directors and the corporation's creditors where the officers or directors are also creditors of the insolvent (or near-insolvent) corporation and a preferential transfer or other self-dealing transaction is involved.

In *Sanford*, a creditor of the corporation, Michael Sanford, sued SecureOne, Inc. ("SecureOne") and its former directors and officers, claiming that he was owed $1,300,000. In 1995, Sanford and Bruce Prow formed SecureOne, a close corporation that sold and serviced security systems as an authorized dealer for ADT Security Services, Inc. ("ADT"). Both individuals owned a 50% interest in SecureOne. After a disagreement, Sanford agreed to sell his shares of SecureOne to Prow and his wife for $3,000,000. In this transaction, Sanford received $1,000,000 in cash, a secured promissory note for $2,000,000 (the "Sanford Note"), and a security agreement granting Sanford a security interest in all SecureOne assets.

Prior to the stock sale, Prow borrowed money from his in-laws, Troy and Carol Waugh, to purchase the shares. Without Sanford's knowledge, the Waughs purchased 25% of SecureOne's stock for $100,000 and loaned SecureOne an additional $900,000. In return, the Waughs received two promissory notes from SecureOne. The first note was issued to the Waughs for $425,000, and the second was issued to Waugh & Co. for $475,000. In addition to the notes, SecureOne executed a loan and security agreement, which listed the Prows as guarantors of the $900,000 loan.

After the transaction was completed, Troy Waugh called a meeting of SecureOne's board of directors. During this meeting, Bruce Prow was elected President and CEO, Leslie Prow was elected Treasurer and Vice President of Finance, Carol Waugh was elected Secretary, and Troy Waugh was elected Chairman

of the Board. SecureOne made payments on the Sanford notes from February 2003 until December 2003. At the same time, SecureOne was experiencing financial difficulties. After sales declined in 2003, the Waughs extended a loan of $70,000 to SecureOne. In October 2003, after SecureOne defaulted, the Waughs foreclosed on the Prows' shares and became the outright owners of SecureOne. In December 2003, the Waughs loaned SecureOne an additional $120,000 and received a security interest in SecureOne's house accounts. After Sanford did not receive January or February 2004 payments, he met with the Waughs and learned that SecureOne was not able to pay him the $1,300,000 he was owed.

Later that year, the Prows started a new company, Security Networks, which was a direct competitor of SecureOne. The Prows ran Security Networks and SecureOne out of the same room in their home. Bruce Prow purchased four vehicles from SecureOne, stored SecureOne equipment and furniture at the house, and transferred SecureOne's phone number to Security Networks. Before its winding down, SecureOne received $1,173,213 from ADT pursuant to a franchise agreement. In 2004, SecureOne paid Troy Waugh $75,000 and Carol Waugh $30,000 for consulting fees. Between 2003 and 2004, Waugh & Co. received $48,883 and the Waughs received $55,991 in interest payments from SecureOne.

In February 2003, Sanford filed suit to enforce the Sanford Note against Leslie Prow and SecureOne. SecureOne and Leslie Prow counterclaimed that Sanford had intentionally or negligently misrepresented SecureOne's financial condition at the time of the stock sale. Troy Waugh, Carol Waugh, and Waugh & Co. filed an action against Sanford in April 2004, also alleging that Sanford fraudulently misrepresented SecureOne's financial condition. In March 2005, the Waughs voluntarily dismissed their complaint against Sanford. In April 2006, Sanford was awarded a judgment of $1,560,000 against Leslie Prow and SecureOne (the "SecureOne Judgment").

On April 13, 2005, after the Waughs dismissed their complaint and before the SecureOne Judgment, Sanford filed a complaint against Waugh & Co., and Troy and Carol Waugh individually. In the complaint in which he sought compensatory and punitive damages, Sanford alleged causes of action for abuse of process, malicious prosecution, breach of fiduciary duty, fraudulent conveyance, conspiracy, and conversion. The essence of Sanford's claim was that the Waughs and the Prows "engaged in a course of conduct they knew would prevent SecureOne from paying Sanford and acted for their own benefit." Sanford listed seven instances of alleged fraudulent conveyances, including: (1) payments by SecureOne to Security Networks;

(2) rent payments by SecureOne to Leslie Prow for property that she did not own; (3) payments by SecureOne to the Waughs for "consulting" services that were not performed; (4) interest payments by SecureOne to the Waughs; (5) payments by SecureOne for the Prows' legal and accounting bills; (6) sale of SecureOne assets to Security Networks; and (7) the sale of SecureOne assets over Sanford's perfected liens. Sanford claimed that the Waughs had no basis for the fraudulent misrepresentation claim and that they only brought the claim to delay the payment of money owed under the Sanford Note.

The most important aspect of the *Sanford* decision is the treatment of Sanford's claim of breach of fiduciary duties. The lower court found that Sanford could not bring a direct action against the officers and directors of an insolvent corporation because he was only a creditor of the corporation. Further, the trial court determined that Sanford would only have standing if he was to file a derivative action on behalf of all SecureOne creditors. The court of appeals reversed, finding that a creditor may directly pursue such a course of action in limited circumstances.

The court began by recognizing the general rule that, as agents of the corporation, officers and directors are liable only to the corporation; therefore, they usually do not have a fiduciary relationship with the corporation's creditors. The court recognized, however, that a "majority of the jurisdictions have held that an officer or a director may owe a fiduciary duty to corporate creditors, especially when the corporation becomes insolvent and the insider has a personal pecuniary interest in the corporation."

The court pointed to *Intertherm, Inc. v. Olympic Homes Systems, Inc.*, 569 S.W.2d 467 (Tenn. Ct. App. 1978), which "recognized that officers and directors have a duty not to act to the unfair detriment of certain interested third parties lacking the power of a fiduciary." The court read *Intertherm* to allow minority shareholders and creditors to "challenge the good faith and fairness of transactions between majority shareholders, officers, or directors of the corporation." Because Sanford raised legitimate questions about whether the Waughs intended to prefer the debts of other creditors as a direct target against him, Sanford was allowed to file an action individually, rather than derivatively on behalf of all SecureOne creditors. Reviewing the law of other jurisdictions, the court noted that the majority rule does not allow an insolvent corporation to prefer its own directors or officers over other creditors. The reason for this rule is that corporate officers and directors cannot use their inside knowledge to benefit themselves at the expense of non-insider creditors. Specifically, when a corporation becomes insolvent, directors and officers have a

fiduciary relationship with and a corporate duty to corporate creditors because of their position and control over corporate assets. Therefore, the directors or officers cannot secure any preference or advantage that gives them priority over other creditors by using the powers that result from their position.

Adopting the majority rule, the court held that:

> [A] creditor to an insolvent corporation or a corporation on the verge of insolvency may assert an action for breach of fiduciary duty against officers or directors who are also creditors of the corporation when they have been given preference in their preexisting debt or have engaged in self-dealing conduct.

The court reasoned that the limitation of the creditor's right to bring such an action to cases involving self-dealing and preference avoids any conflict between the director's duty to "maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors." Finding that genuine issues of material fact existed as to whether the Waughs were given insider preferential treatment, the court reversed the trial court's dismissal of Sanford's breach of fiduciary duty claim and remanded the issue to allow Sanford to present evidence related to a self-dealing transaction to a jury.

By recognizing the individual creditor's right to sue for breach of fiduciary duties, the Tennessee Court of Appeals in *Sanford* expanded the non-bankruptcy remedies for corporate creditors. This presents a new concern for corporate clients facing insolvency. In addition to bankruptcy remedies, which would allow a corporate creditor to set aside a preferential transfer, *Sanford* affords the corporate creditor a right to sue the corporation directly and recover compensatory damages for economic harm suffered as a result of this transfer.

Tennessee transactional attorneys should advise their insolvent or near-insolvent corporate clients of this increased risk associated with preferential transfers in order to prevent liability on a creditor's suit for breach of fiduciary duty. Therefore, if a client is contemplating bankruptcy and has made a transfer on account of a debt owed to a corporate insider within the last year, attorneys should advise their clients not to file a petition. Tennessee's adoption of a new fiduciary duty raises the stakes much higher than having the transfer set aside. Now, the directors and officers of corporate clients may find themselves in a much worse position by being held liable for damages resulting from a breach of their fiduciary

duty to the corporation's creditors.

Where one business owner personally pays more shared business debt than a co-business owner, the right-of-contribution doctrine permits recovery from the lesser contributing owner in the amount paid exceeding the owners' contractual obligations under the company ownership agreement. Thompson *v. Davis*, No. W2008-00380-COA-R3-CV, 2009 Tenn. App. LEXIS 613, 2009 WL 2868820 (Tenn. Ct. App. Sept. 8, 2009).

By Steven J. Stuart

Although successful business ventures can produce immense opportunity and wealth, poorly managed business ventures involve great risk and can have long-lasting consequences for the business and its partners. Misunderstandings among business partners, stress, tarnished reputations, and damaged relationships may all stem from a mismanaged business venture. This is especially true when a business venture requires sizable personal capital contributions. Differing amounts of capital contributions among business partners may affect the business venture's success and impair the business partners' understanding of the venture's financial health.

In *Thompson v. Davis*, the Tennessee Court of Appeals addressed whether two business partners could succeed in a right-of-contribution action against a third, lesser contributing business partner. The court held that because each partner was equally liable for business debts, the two business partners could recover the payments that exceeded their financial obligations under the ownership agreement from the lesser contributing partner.

In *Thompson*, Jon Thompson, Ed Gatlin (collectively, "Plaintiffs"), and J.T. Davis, M.D. ("Defendant") formed and operated a Tennessee corporation, Memphis Arena Football, Inc. Soon after its 1995 formation, the corporation bought an Arena Football League ("AFL") franchise. In 1996, the corporation was converted to a limited liability company ("Company") in which Plaintiffs and Defendant maintained equal ownership. From 1996-2002, the Company operated the AFL franchise in three states with an overall financial loss. In 2002, Plaintiffs and Defendant sold the franchise back to the AFL for $5.8 million.

Throughout their business venture, Plaintiffs and Defendant held informal meetings at a café to discuss company financials. Initially, the parties equally infused cash into the Company as needed. However, in more recent years, Defendant

stopped contributing, while Plaintiffs continued to make contributions with the understanding that repayment would come from the Company or directly from Defendant. Thus, Plaintiffs each contributed their share of the Company's cash requirements, plus half of Defendant's share. In sum, Plaintiffs contributed close to $1 million more to the Company than Defendant. Repeatedly, Defendant turned down Plaintiff's buyout offers and increasingly distanced himself from the Company's finances, admitting, "[i]t got so depressing for me, I never kept up with it." From 2001-03, Plaintiff Gatlin received $229,418 in disbursements, Plaintiff Thompson received $166,845, and Defendant received $25,466. Plaintiffs maintained that their disbursements were repayments from their loans to the Company.

Two loans were central to the case. In December 2001, all three partners jointly took out a $300,000 personal loan from Trustmark National Bank of Bartlett ("Trustmark"). Executing a promissory note in favor of Trustmark (the "Trustmark Note"), the parties loaned the proceeds to the Company. At the time the parties sold their franchise back to the AFL, the Company had $18,474 remaining on the note. Subsequently, Plaintiffs collectively paid $17,800 to the Company, and the Company paid Trustmark the balance due. Defendant did not contribute to the $17,800 payment.

In September 2002, all three individuals took out a second loan of $2.5 million from First Bank of Lexington ("First Bank"). Executing a promissory note in favor of First Bank (the "First Bank Note"), the parties loaned the proceeds to the Company. At the time they sold the franchise back to the AFL, the Company had $392,122 remaining on this note. In December 2003, after they filed this lawsuit, Plaintiffs personally bought the First Bank Note and executed another note in favor of First Bank. By doing so, Plaintiffs and the Company avoided $45,000 in late fees. Again, Defendant abstained from this transaction.

Plaintiffs filed this lawsuit in October 2003. Thereafter, the circuit court denied Plaintiffs' November 2004 motion for summary judgment as to Defendant's liability for contribution under a partnership theory of recovery. In their subsequent June 12, 2006 amended complaint, Plaintiffs alleged Defendant was liable pursuant to § 47-3-116 of the Tennessee Code for his pro-rata contribution of debts owed by all parties, but paid for by Plaintiffs. In November 2006, Defendant filed an answer denying complete liability to Plaintiffs. Defendant claimed to be entitled to offset his liability to the extent of any improper company distributions. Further, Defendant maintained that because the Company, not Plaintiffs, discharged the Trustmark Note

debt, Plaintiffs were not entitled to Defendant's contribution from that debt's discharge. The trial court found, however, that because Plaintiffs directly funded the Company's Trustmark Note debt payment, Plaintiffs were entitled to contribution from Defendant. Ultimately, Defendant was held liable to Plaintiffs for one-third of the Trustmark and First Bank Notes. The trial court also ordered Defendant to pay Plaintiffs' attorney fees.

On appeal, Defendant contested his liability for his pro-rata share of the First Bank and Trustmark Note balances. Tennessee case law describes the right of contribution as being couched in principles of equity and natural justice. Section 47-3-116(a) of the Tennessee Code "authorizes an action for contribution when one party having joint and several liability on a note pays the entire instrument." The right of contribution arises once another contract debtor pays more than his fair share of the joint obligation.

Regarding the First Bank Note, Defendant argued that Plaintiffs received improper LLC distributions of capital of $345,332 related to the First Bank Note payoff. Plaintiffs argued that the distributions were loan repayments, from the Company to Plaintiffs, for the First Bank Note. The trial court held that the distributions were loan repayments to Plaintiffs. Finding that the evidence did not preponderate against the trial court's holding, the Tennessee Court of Appeals affirmed.

Regarding the Trustmark Note, the Tennessee Court of Appeals affirmed the trial court's holding that Plaintiffs personally discharged the Trustmark Note debt. With an analysis similar to the trial court's, the court of appeals found that Plaintiffs' payments to the Company were intended for and actually used for the Company's Trustmark Note payoff. Therefore, the court held that Plaintiffs' payments to the Company served as Plaintiffs' personal discharge of debt of the Company, and affirmed the trial court's doctrine of contribution application. Since Plaintiffs paid more than their fair share of the joint obligations, the court held that Plaintiffs could recover against Defendant for his pro-rata share of the First Bank and Trustmark Notes.

As *Thompson v. Davis* illustrates, business ventures should always be managed vigilantly. Although most people do not relish discussing unsuccessful financial ventures, thorough documentation and understanding among business partners can manage spiraling financial losses and partners' expectations. When subsequent cash infusions are required to maintain a business venture's operations, business partners

should strive for complete transparency and understanding of those financial sources.

In situations such as that in *Thompson v. Davis*, Tennessee attorneys should inform their clients that stated business ownership percentages are crucially important. Equal ownership means each business partner has equal financial responsibilities. Clients should be advised to regularly update and document ownership percentages, capital contributions, and distributions. Further, Tennessee attorneys, advising both business owners and business suppliers, should advise their clients of the consequences inherent to the right of contribution. A closer look at the actual sources of a business's financing and cash flows may clarify whether there will be enough cash to adequately meet the business's financial requirements after all due owners take their cut.

CIVIL PROCEDURE

Tennessee's new, more stringent summary judgment standard makes it more difficult to get summary judgment against claims of fraudulent or negligent misrepresentation in contract disputes. *Biancheri v. Johnson,* 2009 Tenn. App. LEXIS 274, 2009 WL 723540 (Tenn. Ct. App. Mar. 18, 2009).

By Christopher M. Smith

In *Biancheri v. Johnson*, the Tennessee Court of Appeals considered whether a contract dispute involving alleged fraudulent or negligent misrepresentations was appropriate for summary judgment. The parties disagreed on what material representations were made during negotiations and whether a party would be justified in relying on such statements if they were made. Because these questions involved disputed issues of fact, the court of appeals applied Tennessee's new, higher summary judgment standard and reversed the trial court's summary judgment.

In the 2008 case of *Hannan v. Alltel Publishing Co.*, the Tennessee Supreme Court raised the standard that a party must meet to prevail on summary judgment in Tennessee courts. In addition to showing "that there are no genuine issues of material fact and that the moving party is entitled to judgment as a matter of law," Tennessee courts require one of two steps: the moving party must present evidence either "(1) affirmatively negating an essential element of the nonmoving party's claim; or (2) showing that the nonmoving party cannot prove an essential element of the claim at trial." A mere "assertion that the nonmoving party has no evidence" is

not enough to win on summary judgment in Tennessee courts.

In *Biancheri*, Theresa Biancheri ("Biancheri"), trustee of the Mercer Family Trust, attempted to sell the Mercer family house through real estate agent Ida Louis Cromwell ("Cromwell") to Charles and Vikki Johnson (the "Johnsons"). Both parties entered into a sales contract and moved toward closing the deal. The Johnsons claimed that Cromwell made two representations during negotiations that induced the Johnsons to purchase the house: first that the late Mr. Mercer died in an ambulance outside the house; and second, that the integrated television system in the downstairs living room would stay with the house.

As it turned out, the Mr. Mercer had actually been shot to death inside the house and the only piece of audio-visual equipment left in the downstairs living room was an inoperable television monitor. When the Johnsons discovered these two facts, they refused to attend the closing to complete the purchase of the house.

Biancheri sued the Johnsons for breach of contract for failing to complete the purchase. The Johnsons brought a counterclaim, alleging that (1) Cromwell breached the contract by removing the television equipment after saying "all this is included;" and (2) the contract was void because of Cromwell's misrepresentation regarding Mr. Mercer's death inside the house. Cromwell denied making both statements. The Johnsons also filed a separate action against Cromwell, "alleging fraudulent misrepresentation, fraud, promissory fraud, fraud in the inducement, negligent misrepresentation, and violations of the Tennessee Consumer Protection Act."

In sum, all of the claims involved either fraudulent or negligent misrepresentation. To prevail on a *fraudulent* misrepresentation claim, the Johnsons would have to prove that Cromwell knowingly or recklessly made a false representation to them regarding a material fact, and that they "reasonably relied on the misrepresented material fact" and "suffered damages as a result." To prevail on a *negligent* misrepresentation claim, the Johnsons would have to prove that Cromwell supplied false information to the Johnsons after failing "to exercise reasonable care in obtaining or communicating the information," and that the Johnsons "justifiably relied on the information" when they entered the sales contract.

Under either of the two theories, the main points of dispute were (1) what material misrepresentations, if any, did Cromwell make to the Johnsons; and (2) whether the Johnsons "justifiably relied on" any such misrepresentations in entering the contract.

Biancheri and Cromwell filed for summary judgment, arguing that "the Johnsons could not establish justifiable reliance, which is an essential element for both negligent misrepresentation and fraudulent misrepresentation." Despite Tennessee's new rule that a mere "assertion that the nonmoving party has no evidence" is insufficient to get summary judgment, the trial court granted the motion for summary judgment against the Johnsons, dismissed all of the Johnsons' claims, and awarded Biancheri liquidated damages of $20,000 in earnest money that the Johnsons had paid toward the purchase. The Johnsons appealed the summary judgment and the dismissal of their claims. Biancheri and Cromwell appealed the limited award of liquidated damages.

On appeal, the Tennessee Court of Appeals reversed the trial court's summary judgment and the award of $20,000 to Biancheri and Cromwell. The court applied Tennessee's new summary judgment standard to find that the defendants could not establish the undisputed facts necessary to either "affirmatively negat[e] an essential element of the [Johnsons'] claim . . . or show[] that the [Johnsons] cannot prove an essential element of the claim at trial." Therefore, the defendants could not get summary judgment under the new standard.

The key to the court's reasoning was that the material facts of the case were legitimately in dispute. Biancheri and Cromwell first argued that Cromwell never made the two alleged statements about Mr. Mercer's death and the television system. They then argued that, assuming Cromwell did make those statements, the Johnsons did not reasonably rely upon the statements in making the purchase. The Johnsons, of course, disagreed on both counts. The court found that these were the types of genuine issues of material fact that cannot be decided as a matter of law. Instead, these types of material facts must be hashed out at trial, where the fact finder can evaluate witness credibility to decide which facts to believe. "Whether a plaintiff's reliance on an alleged misrepresentation is reasonable is generally a question of fact," the court explained, "and thus, is generally not appropriate for summary judgment."

Biancheri shows that Tennessee courts are serious about applying their new, higher burden of proof for summary judgment in the context of contract disputes. Specifically, this case illustrates that it will be difficult to get summary judgment against claims of fraudulent or negligent misrepresentation for two reasons. First, there will often be genuine issues of material fact. Second, a mere statement that the plaintiff cannot prove his case is insufficient to get summary judgment under the new standard. Biancheri and Cromwell learned this lesson the hard way: They lost summary judgment and the court assigned half of the appeal's costs to Biancheri's

trust and half to Cromwell and her real estate company. For a Tennessee attorney seeking summary judgment against a claim of fraudulent or negligent misrepresentation, *Biancheri* is now required reading.

CONSUMER PROTECTION

Misrepresentations made to increase confidence in a product and induce reliance are not protected against a claim for fraud or violation of the Tennessee Consumer Protection Act, even where ordinary diligence would have revealed the defect. *Bradley v. All Am. Classics of Tenn., Inc.*, No. M2008-01738-COA-R3-CV, 2009 Tenn. App. LEXIS 138, 2009 WL 1034797 (Tenn. Ct. App. April 16, 2009).

By Ashley Speth

The buyer in *Bradley v. All American Classics of Tennessee, Inc.*, relying on representations on the seller's website and claims from the seller's employees regarding the quality of the car, purchased a car from the seller without inspecting it. Because the car was not as represented, the buyer tried to return the car for a full refund, but the seller refused. As a result, the buyer brought suit against the seller based on fraud and the Tennessee Consumer Protection Act.

The Tennessee Court of Appeals reversed the trial court's decision and held that even where a plaintiff failed to exercise ordinary diligence by not inspecting the car at issue, the defendants were not entitled to a directed verdict where reasonable minds could disagree as to whether a reasonable inspection was required in light of the deceptive practices employed by a defendant. The court also held that a plaintiff is not required to perform an inspection prior to purchase, where the plaintiff detrimentally relied upon the defendant's deception.

In *Bradley*, Mark Bradley ("Bradley") bought a 1968 Dodge Charger from All American Classics of Tennessee, Inc. ("All American") without inspecting the car. Because Bradley was residing in California, he relied on representations made by employees of All American, photographs of the car, and claims made on All American's website. The car Bradley received was not in the condition All American represented. All American refused to take the car back or refund the purchase price, and Bradley brought suit for fraud and violation of the Tennessee Consumer Protection Act ("TCPA"). This case has substantial significance today, as many

purchases are now made online, as opposed to historically prevalent face-to-face transactions.

Bradley, a native of the United Kingdom, found an advertisement for a 1968 Dodge Charger on All American's website. The ad included information regarding price, engine, color, etc., as well as several claims regarding the condition of the car. The ad stated that the car was rust-free, the brakes were rebuilt and operating properly, and that the car's "numbers [were] matching." An employee of All American told Bradley that the car "needed nothing," and that the engine had been rebuilt a year ago and was "mechanically perfect." Relying upon these assertions, as well as those represented by the pictures, Bradley purchased the car for $36,000.

Upon delivery, Bradley noticed several problems with the car and took it to A & E Automotive for a full inspection. The inspector's report stated, "I found so many things wrong with this car that I could not believe someone had the nerve to sell this car for the money they were asking." The inspector noted specific problems with the underbody, brakes, engine, and transmission. According to his general overview of the car, the inspector considered the car a "worn out rust bucket that had superficial cosmetic enhancement done to make the car appear that it was in good condition." On appeal, the Tennessee Court of Appeals held that the "ordinary diligence" requirement relied upon by the trial court is moot where the defendant engaged in lies "calculated to lull the suspicions of a careful man into a complete reliance thereon."

The elements of a fraud claim are: (1) intentional misrepresentation of a material fact; (2) the representation was made knowingly or recklessly without regard to its truthfulness; (3) reasonable reliance resulting in damages; and (4) the misrepresentation relates to a fact, either current or past. While the defense focused on the third requirement of reasonable reliance, the court found that a reasonable person could find that Bradley justifiably relied on the website and photographs. The court stated that the Internet has "revolutionized commerce," and while it may be reasonable for someone nearby to inspect the merchandise, the same may not be necessary for a person farther away. A reasonable man should be able to rely upon representations made via a company's website when it would be unreasonable for him to travel to inspect the item.

The pictures sent to Bradley were taken from an angle that hid defects that would have been discovered through an inspection. Similarly, the website contained many lies and misrepresentations regarding the condition of the car. The court

stated that a company cannot fill its website with lies and misrepresentations and expect to be immune from liability simply because the customer did not inspect the item before proceeding with the transaction.

Whether Bradley justifiably relied on the representations made by All American must be viewed in light of the totality of the circumstances. The court found that in light of the misrepresentations on the website, lies told by the All American employees, and intentional acts to conceal defects with the car, it could not determine whether Bradley was unreasonable in relying on these representations. As a result, the court reversed the trial court's order of a directed verdict on the fraud claim.

Liability under the TCPA can only be found where there has been an unfair or deceptive act by the defendant; there is no requirement of reliance. An act is unfair under the TCPA if it "causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers." The court found that misrepresentations and the distance between participants in a transaction could be obstacles to the "free exercise of consumer decision-making." The court held that it could not definitively state whether Bradley could have reasonably avoided the injury and reversed the trial court's ruling of a directed verdict on the TCPA claim.

This case could have a substantial impact in the field of consumer protection law, especially with the growing number of online transactions. *Bradley* demonstrates that when a company engages in fraud and misrepresents its products, it will no longer be protected from liability simply because a customer cannot inspect the items. The Internet has increased the distance between which consumers and sellers can do business. It is no longer reasonable to require all customers to inspect a product before purchasing.

Where there is fraud or misrepresentation, transactional lawyers representing plaintiffs should be aware that their clients could have a valid claim for fraud or violation of the TCPA regardless of whether their client inspected the product. Transactional lawyers representing online sellers should advise their clients that they will no longer be able to rely on a customer's failure to inspect an item to defeat a claim for fraud or violation of the TCPA. If a company posts lies and misrepresents its products on its website, it can be found liable.

CONTRACTS

A contract must be inherently illegal to violate public policy, and affirmative defenses must be appropriately pled to avoid waiver. *Vintage Health Res., Inc. v. Guiangan*, No. W2008-01288-COA-R3-CV, 2009 Tenn. App. LEXIS 567, 2009 WL 2601327 (Tenn. Ct. App. Aug. 25, 2009).

By Kevin Hartley

In *Vintage Health Resources, Inc. v. Guiangan*, the Tennessee Court of Appeals applied Tennessee law and held that the affirmative defense of unconscionability must be pled to avoid waiver, and that a contract is not unconscionable where its terms are fair and favorable, rather than "one-sided," "unreasonably harsh," or "oppressive." Likewise, the court ruled that a contract does not violate public policy unless its terms or purpose are inherently illegal. Finally, the court determined that injunctive relief should be used sparingly and only if it is not "broader than necessary to achieve its purposes."

In *Vintage Health*, James Jose Guiangan ("Guiangan"), a nurse living in the Philippines, signed an employment agreement in March 2004 with Vintage Health Resources, Inc. ("Vintage"), a company that provides health care workers to employers in the United States and commonly recruits from the Philippines. Under the agreement, Guiangan committed to a three-year term of employment with Vintage in exchange for several benefits, including free transportation and housing until he began his new job. Vintage classified the aforementioned costs as free during Guiangan's recruitment. Despite this representation, upon Guiangan's arrival in the United States, he was informed that his transportation and housing costs would actually be deducted from a stipend he would receive each month until his employment began. Nonetheless, the stipend resulted in a net of $300 dollars a month for Guiangan.

Vintage and Guiangan maintained an amicable working relationship until September 2005. At that time, approximately one year into Guiangan's three-year term of employment, Guiangan e-mailed a letter to Vintage's Senior Vice-President, informing him that he would be resigning. Vintage responded by holding a meeting with Guiangan to discuss his future. During the meeting, Vintage management attempted to convince Guiangan to rethink his position. When Guiangan refused, the Vice President for Operations warned Guiangan that if he resigned, Vintage would report him to immigration officials for breaching his employment agreement.

Vintage reserved this right in the employment agreement.

Following the meeting, Vintage sent Guiangan a letter informing him that if he resigned, Vintage would file a lawsuit for breach of the employment contract and would seek his deportation or denial of his application for citizenship. Still defiant, Guiangan resigned in October 2005. As such, Vintage filed suit. In response, Guiangan asserted, among other things, that his employment agreement was void as contrary to public policy and counterclaimed that Vintage breached the agreement by failing to provide him with the same benefits he was promised during recruitment.

The trial court held that Guiangan's employment agreement was unenforceable because it was unconscionable and contrary to public policy. Moreover, the trial court determined that Vintage breached the agreement by providing Guiangan with benefits different from those promised during his recruitment. As a result, the court issued two injunctions: one provided that Vintage could no longer threaten to report employees to immigration officials, and the other prevented the company from continuing to use recruitment materials that differed from the actual employment agreements signed by employees.

On appeal, the Tennessee Court of Appeals held that the contract was not unconscionable because Guiangan never pled unconscionability, which is an affirmative defense. According to Tennessee Rule of Civil Procedure 8.03, affirmative defenses must be asserted in appropriate pleadings. Guiangan never actually pled unconscionability, but argued that his defense asserting the employment agreement violated public policy sufficed as an unconscionability claim. The court determined that violation of public policy and unconscionability are distinct issues; therefore, they must each be pled appropriately. Thus, the court concluded that Guiangan waived his right to assert the defense of unconscionability because he failed to plead it.

Additionally, the court held that, even if Guiangan had properly pled unconscionability, the contract was not unconscionable. A contract is unconscionable when its "provisions are so one-sided, in view of all the facts and circumstances, that the contracting party is denied any opportunity for meaningful choice." The court reasoned that the employment agreement between Guiangan and Vintage was not "one-sided," and that the evidence did not prove that Guiangan was left without a "meaningful choice." As such, the court reversed the ruling of the trial court and held that the employment agreement was not unconscionable.

Likewise, the court ruled that Guiangan's contract was not contrary to public

policy. A contract does not violate public policy unless it harms the public good or conflicts with Tennessee's constitution, laws, or judicial decisions. More specifically, courts will not hold that a contract is contrary to public policy unless the impropriety is inherent in the terms or purpose of the contract. First, the court reasoned that the purpose of Guiangan's employment agreement with Vintage was to allow him to live and work in America and allow Vintage to profit off of his work; therefore, the purpose of the contract was not inherently illegal. Second, the court determined that no terms in the contract were inherently illegal. The court reached this result despite Guiangan's half-hearted allegation that the term in his contract providing Vintage the right to report him to immigration officials was illegal. Based on these findings, the court again reversed the trial court and held that Guiangan's employment agreement did not violate public policy.

Next, the court determined whether the injunctive relief fashioned by the trial court remained appropriate. The court held that Vintage could not be enjoined from using recruitment materials listing benefits marginally different from those actually provided in its employment agreements. The court reasoned that the actual benefits received by Guiangan were greater than those promised to him during recruitment. Thus, there was no evidence of wrongdoing by Vintage or that the practice enjoined by the trial court would harm any future recruits. As a result, the court vacated the injunction that prevented Vintage from using certain recruitment material.

Finally, the court affirmed the injunction issued by the trial court, which provided that Vintage could no longer threaten to report its employees to immigration officials if they chose to seek other employment in contravention of their employment agreement.

The ruling by the Tennessee Court of Appeals in this case illustrates two important practitioner's tips for contract lawyers. First, this case unequivocally provides that affirmative defenses must be pled properly. If an attorney fails to do so, such a defense will be waived and could result in a negative outcome for a client. Second, this case shows the uphill battle an attorney must fight to prove that a contract violates public policy. Here, Guiangan's employment agreement gave Vintage the right to report him to immigration officials, even though Vintage brought him to the country for mutual benefit. While this may seem unfair, it serves as a reminder that either the purpose of a contract or the terms of a contract must be illegal and not merely unfair for a court to hold that it violates public policy.

A contract to bypass a valid stock transfer restriction is unenforceable by the seller. *Baugh v. Novak*, No. M2008-02438-COA-R3-CV, 2009 Tenn. App. LEXIS 54, 2009 WL 2474714 (Tenn. Ct. App. Aug. 13, 2009).

By Bryan C. Hathorn

Baugh v. Novak presents a case where a seller attempted to bypass a stock transfer restriction in a sale of securities. The buyer of the securities was a *bona fide* purchaser with no knowledge of the restriction. The consideration for the sale was, in part, indemnity for a guaranty on a loan the securities were pledged to satisfy. When the seller defaulted on the loan, the court held that public policy prevented the seller from enforcing a contract bypassing a valid stock transfer restriction.

In *Baugh*, Wendell and Laura Baugh ("Baughs") originally purchased Precision Service, Inc. ("Company") through an asset purchase agreement with Ronald and Gayla Miller ("Millers"). As part of the agreement, the Millers granted a loan to the Company, which was guaranteed by the Baughs. The loan agreement contained a stock transfer restriction whereby shares of stock or ownership interests in the Company could not be transferred without the Millers' prior written consent.

The Baughs subsequently desired to sell an interest in the company to Herman and Faith Novak ("Novaks"). The Millers, however, would not consent to the transfer without an additional loan guaranty from the Novaks. Nonetheless, the Baughs drafted a purchase and indemnification contract whereby the Novaks would receive a one-half ownership in the Company in exchange for a cash payment and indemnification on one half of the guaranty of the note to the Millers. The contract warranted that there were no transfer restrictions on the stock, and there was no evidence that the Novaks had any notice of the restriction. At trial, the Baughs acknowledged that the contract was designed to bypass the stock transfer restriction.

Ultimately, the business failed, the Company defaulted on the loan, and the Millers collected from the Baughs on the loan guaranty. The Baughs sued the Novaks to enforce the indemnity provision in the contract, and the lower court found the contract to be enforceable.[4]

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[4] The lower court resolved a number of other issues which were not necessary to the appellate decision. The lower court found that there was a contract, the contract was enforceable under the statute of frauds even though the original was lost in a fire, and that the terms of the contract could be established from parol evidence. Ultimately, the court of appeals affirmed these results but

On appeal, the Tennessee Court of Appeals reversed the trial court and held that the contract was unenforceable because it violated public policy. The legislature in Tennessee has set out a clear policy of allowing reasonable restrictions on stock transfers in § 48-16-207(b) of the Tennessee Code, which states that "[a] restriction on the transfer or registration of transfer of shares is valid and enforceable against the holder or transferee of the holder if the restriction is authorized by this section . . . ." Permitted purposes include "any . . . reasonable purpose."[5] The court ruled that a contract designed to undermine the statute permitting stock transfer restrictions did not present a reasonable purpose and also violated public policy.

The situation in this case creates an asymmetry between the buyer and the seller of stock subject to a stock transfer restriction. When the contract bypasses a valid stock transfer restriction, the seller of the stock cannot enforce the contract. The buyer of the stock—a *bona fide* purchaser with no knowledge of the stock transfer—can enforce the contract based on the language of § 48-16-208 of the Tennessee Code, which states that "a [stock transfer] restriction is not enforceable against a person without knowledge of the restriction." Effectively, a contract which bypasses a stock transfer agreement is one that is enforceable at the option of the buyer.

In the present case, the Millers demanded an additional guaranty from the Novaks of the note to release the transfer restriction. The requirement of the Millers could have been accomplished by having the Novaks grant the guaranty of the note and having the Baughs indemnify the Novaks for half the loan amount. The net result would be the same and the contract for sale would have been enforceable, because the Millers would consent to the transfer. Such a bargain could expose the Novaks to additional risk because the Novaks might not be able to collect on an indemnification claim against the Baughs. These additional considerations would be factors to be negotiated in the price and terms for the sale of the business.

As a practical matter, when there is a valid transfer restriction on stock, the seller must comply with all requirements to release the restriction before the transfer. In addition to all other requirements for the sale of securities, an attorney drafting a stock purchase agreement must ensure that the stock is freely transferable or that all

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reversed on other grounds.

[5] TENN. CODE ANN. § 48-16-207(c)(3).

requirements relating to the restriction on stock transfers have been met. In addition, if the buyer is to be subject to share transfer restrictions, the share transfer restrictions must satisfy all of the requirements of § 48-16-207 of the Tennessee Code, including conspicuous notation of the restriction on the shares.

INSURANCE

Commencement of foreclosure proceedings does not constitute an "increase in hazard" for notice purposes under a standard mortgage clause in an insurance policy. *U.S. Bank, N.A. v. Tenn. Farmers Mut. Ins. Co.*, 277 S.W.3d 381 (Tenn. 2009).

By Joshua H. Lee

In *U.S. Bank v. Tennessee Farmers Mutual Insurance Co.*, a case of first impression, the Tennessee Supreme Court considered whether the absence of notice from a lienholder bank to the insurer of a residence concerning the foreclosure of that residence constituted an "increase in hazard" under the standard mortgage clause of the insurance policy. If the commencement of the foreclosure proceedings was to indeed qualify as an "increase in hazard," then a bank's coverage under that policy would be void in light of the absence of the notice. The court subsequently held, however, that the commencement of foreclosure proceedings *does not* constitute an "increase in hazard" for notice purposes under a standard mortgage clause in an insurance policy, nor under Tennessee statutory law, so as to preclude a bank's right to recovery.

In *U.S. Bank*, U.S. Bank ("Bank") financed a homeowner's "purchase and was designated as the mortgagee for the purposes of insurance coverage" in February 1999. Tennessee Farmers Mutual Insurance Company ("Farmers") subsequently issued the homeowner an insurance policy covering fire loss. That policy contained a "standard mortgage clause," as opposed to a "simple/open clause," that *independently* protected the Bank's interest in the property, regardless of acts concerning the property outside the Bank's knowledge (such as a change of ownership). In consideration of such extensive protection, the Bank was required to notify Farmers of "any increase in hazard" within the Bank's knowledge. No provision of the policy, however, explicitly required the Bank to notify Farmers of a commencement of foreclose proceedings.

As might be expected, the homeowner quickly became delinquent in her

mortgage payments and the Bank subsequently initiated a foreclosure action upon the residence. The Bank properly and adequately notified the homeowner of this proceeding, but failed to notify Farmers. The homeowner subsequently filed for bankruptcy, which initiated an automatic stay upon the foreclosure process. Six months later, the residence at issue was destroyed by a fire which prompted the Bank to submit a claim to Farmers to recover their interest in the residence. Farmers refused to pay, however, claiming that the Bank voided its protection under the policy by failing to notify Farmers of the foreclosure proceedings, an "increase in hazard" according to Farmers. The Bank disagreed with such a broad interpretation of "increase in hazard" and brought suit, claiming, among other things, bad faith refusal to pay an insurance claim and "unfair or deceptive practices under the Tennessee Consumer Protection Act."

On appeal, the Tennessee Supreme Court held that the commencement of the foreclosure proceedings *did not* constitute an "increase in hazard" for notice purposes under the standard mortgage clause in the insurance policy, nor under Tennessee statutory law. In reaching this conclusion, the court analyzed the facts at issue independently under both the insurance policy and § 56-7-804 of the Tennessee Code.

First, the court noted that insurance policies are subject to the same general rules of construction as contracts and therefore "should be interpreted and enforced as written" absent fraud or mistake. Addressing the policy at issue, the court quickly noted that the parties to the policy chose to employ a "standard mortgage clause," rather than a "simple/open clause." That election provided expansive coverage for the Bank as lienholder, "regardless of the actions of the insured borrower," such as becoming delinquent in mortgage payments. In consideration of this expansive coverage, the court made special note of the Bank's explicit agreement to "notify [Farmers] of any change of ownership or occupancy or any increase in hazard of which the [Bank] has knowledge." The court, however, found no explicit duty of the Bank to notify Farmers of any commencement of foreclosure proceedings in the policy. Thus, the court next addressed Farmers' contention that the commencement of foreclosure proceedings was an "increase in hazard" under the policy.

Although no Tennessee court had yet specifically addressed whether the commencement of foreclosure proceedings could be deemed an "increase in hazard" under an insurance policy, the court found one 1901 Tennessee Supreme Court case very instructive. In that case, the court concluded that the commencement of foreclosure proceedings at issue did not require invalidation of

insurance coverage because the "initiation of foreclosure proceedings did not necessarily affect the insurer's risk."

Additionally, the court noted that other jurisdictions had reached similar conclusions on the issue. In a case dealing with extremely similar facts to *U.S. Bank*, the Supreme Court of Indiana, for example, explicitly rejected the classification of an initiation of foreclosure proceedings as an "increase in hazard." That Indiana court reasoned that if the insurance company had wished to be notified of such activity, it should have expressly stipulated for such a notice in the policy. In line with that mandate, the court cited multiple other jurisdictions that had strictly enforced insurance policy provisions *explicitly* requiring notice of foreclosure proceedings, thus evidencing widespread foresight regarding the issue.

In light of these persuasive decisions and the absence of explicit language in the Farmers policy requiring notice of the commencement of foreclosure proceedings, the court held that the Bank was not required to give such notice to Farmers. Accordingly, the court held that, under the policy, the lack of notice on behalf of the Bank did not invalidate the Bank's insurance coverage.

Given that the language of § 56-7-804 of the Tennessee Code mirrors that of a "standard mortgage clause," the court's subsequent statutory analysis was extremely similar to that under the policy itself. The court again refused to classify the commencement of foreclosure proceedings as an "increase of hazard"[6] under the statute. Rather, the court chose to employ the "plain and ordinary" meaning of the phrase—requiring physical change in the property that increases the probability that the property will be destroyed—which excludes the commencement of foreclosure proceedings in the court's opinion, and in other jurisdictions' opinions, as well.

Practitioners should thus be mindful, as always, in drafting insurance policy provisions concerning activities that will serve as an "increase in hazard" to the property. Specifically, if an insurance company desires to condition a loss payee's coverage on the notification of any commencement of foreclosure proceedings, that demand should be made explicit in the policy agreement. Moreover, if an insurance company wishes to immediately void any and all coverage in the event of such

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[6] The court held the statutory phrase "increase of hazard" to be synonymous with the policy phrase "increase in hazard."

proceedings, a provision to that effect should most certainly be explicitly included in the policy agreement. In more general terms, if an insurance company wishes to classify occurrences that do not physically affect the insured residence, as to increase the probability of damage to the residence, as an "increase in hazard" under the policy, such classifications must be explicit in the policy agreement.

In closing, the Tennessee Supreme Court has indicated that it will construe the phrase "increase in hazard" quite narrowly and will not supplement a policy through broadening this phrase. Any argument in favor of such broadening is likely a waste of both a practitioner's time and a client's resources, unless the practitioner can prove that the actions (or omitted actions) at bar caused a physical change in the property that increased the probability that the property would be destroyed.

LABOR & EMPLOYMENT

Where an individual is an employee at-will, execution of an employment contract under duress is immaterial to its implementation. *Cummings, Inc. v. Dorgan*, No. M2008-00593-COA-R3-CV, 2009 Tenn. App. LEXIS 639, 2009 WL 3046979 (Tenn. Ct. App. Sept. 23, 2009).

By Jennifer L. Milam

In *Cummings, Inc. v. Dorgan*, the threshold issue was whether a contract signed by an employee under the threat of termination constituted duress. Whether a contract alters the original employment agreement or merely changes the outlined compensation will determine whether employment at-will exists; and if employment at-will is present, then duress is irrelevant. In the present case, whether Dorgan ("Defendant") was entitled to damages for commission payments and unpaid vacation days hinged on the appellate court's understanding of Defendant's employment and whether he was forced to sign a revised contract limiting the aforementioned benefits. If Defendant operated as an employee at-will, then Cummings, Inc.'s ("Plaintiff") legal right to termination trumped any assertion of duress. Because Plaintiff and Defendant agreed that employment at-will governed the relationship, the crucial issue became whether a revised contract between the parties changed this relationship. To understand the significance of the document's characterization, it is necessary to examine the factual circumstances of the case.

In *Cummings, Inc.*, Defendant was employed as a salesperson by Plaintiff from January 1987 until January 2006. During his 19-year employment, Defendant

managed YUM! Brands, Inc., one of Plaintiff's major clients. In 1998, Defendant signed a contract (the "Original Contract") with Plaintiff, which laid out the terms of his employment, compensation for commissions, and a non-compete clause. In July 2004, Defendant was asked to sign a revised contract (the "Revised Contract"), which contained significant differences pertaining to Defendant's compensation for commissions. The Revised Contract also extended the non-compete clause for an additional one-year period. Both the Original and Revised Contracts stated that Defendant could be terminated "at any time for cause without advance notice."

In 2004, Defendant was presented with another contract (the "2004 Contract"), which he resisted signing based on significant compensation disparities. According to Defendant, he relented to Plaintiff's pressures to sign the 2004 Contract based on the threat of termination. Shortly after signing the 2004 Contract, Plaintiff requested that Defendant relocate to Nashville to be closer to Plaintiff's headquarters. When Defendant declined, Plaintiff terminated Defendant's supervision of YUM! Brands. Shortly thereafter, in January 2006, Defendant tendered his resignation.

A competitor company hired Defendant, and Defendant began soliciting business of YUM! Brands on behalf of his new employer. In response, Plaintiff filed the instant lawsuit, charging Defendant with breach of the 2004 Contract, including breach of the non-compete agreement. The trial court granted a preliminary injunction to prevent Defendant's further solicitation of YUM! Brands. In response, Defendant claimed breach of contract, tortious interference with his business relationship, and violation of § 50-2-103(a)(3) of the Tennessee Code for Plaintiff's failure to compensate Defendant for his accrued vacation days.

Upon consideration of the facts, the trial court held that Defendant signed the 2004 Contract under duress, thus voiding the document. As a result, Plaintiff was required to pay damages to Defendant for unpaid compensation. The trial court, however, upheld the validity of the revised non-compete agreement and ordered Defendant to cease solicitation of business from YUM! Brands until expiration of the requisite two-year period. Plaintiff appealed the trial court's determination that Defendant signed the Revised Contract under duress, resulting in Plaintiff's liability for commission compensation under the Original Contract.

Tennessee courts have long recognized that contracts, even if valid, cannot be enforced if the contracting party acted under duress. Duress exists "when one by the unlawful act of another is induced to make a contract or perform some other act

which deprives him of the exercise of free will." Contracts are valid only if the document was "entered into freely, with the voluntary assent of the parties making it." Both physical and economic duress will nullify a contract.

Tennessee courts only void contracts made under duress if the party asserting the contract does not have a legal right to exercise the threatened assertion. For instance, employment-at-will "recognizes the right of either the employer or the employee to terminate the employment relationship at any time, for good cause, bad cause, or no cause at all, without being guilty of a legal wrong." Tennessee courts assume employment at-will exists unless a term within the contract states to the contrary.

Based on the significance of employment at-will to the establishment of duress, the court interpreted the revised contract to determine whether Defendant was an employee at-will. If the contract's language is clear and unambiguous, "then its literal meaning controls the outcome of a contract dispute, and the court may not look beyond the four corners of the contract to ascertain the parties' intention." However, if the contract's language is ambiguous, then "a court may look beyond the four corners of the document and consider extrinsic evidence in order to determine the parties' intention . . . ."

In the present case, the court examined the subject document to determine whether its terms clearly and unambiguously constituted an employment contract. The court noted that the Original Contract, the Revised Contract, and the 2004 Contract were not titled as employment agreements. The 2004 Contract's language failed to establish whether an employment contract was intended. For instance, the document contained a statement that it was "not an Agreement to employ [Defendant] for any specified length of time." However, another provision noted that Defendant could only be terminated *for cause*, which is indicative of an employment agreement.

Based on these disparities, the court concluded that the 2004 Contract was ambiguous; thus it was forced to look beyond the literal language of the document and "consider the rules of construction and extrinsic evidence of the parties' intent." Trial testimony from Plaintiff's representatives and Defendant revealed that the 2004 Contract was understood to be a compensation agreement, not an employment agreement. All parties agreed that Defendant was an employee at-will. Defendant, however, argued that despite his at-will employment, the Revised Contract's compensation provisions, rather than the provisions within the 2004 Contract,

should be followed since the latter contract was signed under duress. The Tennessee Court of Appeals disagreed.

Following its analysis, the court reversed the trial court's holding that the 2004 Contract was executed by Defendant under duress, and was therefore unenforceable.[7] Because the court determined that Defendant was an employee at-will, it held that execution under duress was immaterial to the contract's implementation. Thus, the court held that thee 2004 Contract remained in full force and effect throughout Defendant's employment. Since the contract was effectual, the court remanded the case to the trial court to address Defendant's claims that Plaintiff breached the revised contract by ceasing to pay Defendant's commissions.

The holding in *Cummings, Inc. v. Dorgan* is a warning to transactional attorneys to prepare documents with care and detail. If the contracts in this case had been explicitly labeled as employment or compensation agreements, and had used consistent wording throughout, then the court would not have ventured outside the four corners of the document in its analysis. Clearly, this appellate court's reliance on the contract and interpretations of its literal meaning underscores the importance of careful, meticulous contract drafting. Transactional attorneys must heed the analysis in the present case, and note the significance associated with revised contracts regarding employment details and principles of employment at-will. The drafting attorney should avoid speculative judicial scrutiny of contracts by clearly labeling the document, especially if the contract contains revisions intended to change the nature of the agreement.

In *Cummings*, *Inc.* the employer was fortunate that the parties' intentions aligned with the document's purpose. This, however, will not always be the case. The subject employer only succeeded in avoiding damages because Defendant failed to understand how his employment at-will nullified his own claims. Aside from providing a valuable lesson in the importance of unambiguous contract drafting, the ultimate significance of the present case will be more clearly understood following remand and the trial court's examination of Defendant's claim regarding Plaintiff's possible breach of the now judicially supported, and enforceable, 2004 Contract.

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[7] As a result of this holding, the other issues raised by Plaintiff were irrelevant. Also, the issues raised by Defendant pertaining to his compensation for commissions and payment for accrued vacation days, were undermined by the holding.

REAL ESTATE

Where a lease contains an option to renew, but does not specifically prescribe the time and method for exercising the option, the lessee may exercise it by retaining control of the property after expiration of the original lease term and paying the required rent in a timely manner. *Ellis v. Pauline S. Sprouse Residuary Trust*, No. E2009-654-COA-RM-CV, 2009 Tenn. App. LEXIS 414, 2009 WL 1871930; 2009 WL 1871930 (Tenn. Ct. App. June 30, 2009).

By Ryan W. Barry

In *Ellis v. Sprouse Residuary Trust*, the Tennessee Court of Appeals addressed whether the statute of frauds requires preparation of a second written instrument to renew a written lease agreement where the agreement includes an option to renew, but does not specify how or when the option must be exercised. The court also addressed whether a plaintiff's own testimony is sufficient evidence to support a claim for compensatory and punitive damages despite the plaintiff corroborating such evidence with hearsay testimony. On remand, the court held that the statute of frauds did not require preparation of a new lease after the tenant had effectively exercised his option to renew. The court also held that the tenant's own testimony was sufficient evidence to support a claim for compensatory and punitive damages, regardless of corroborating hearsay testimony.

In *Ellis*, Mike Ellis was an experienced farmer who grew crops on his 177-acre farm, and on an additional 800-900 acres of leased land. In 1997, Ellis entered a written, five-year lease agreement ("Agreement") for 103 acres of farmland ("Property") signed by himself and the owner of the Property, Mary Bagwell. Of the 103 acres, only 60 were suitable for farming. The lease was set to expire on December 31, 2001. Ellis had an option to renew the lease for an additional five-year period, but the Agreement did not specify how or when the option was to be exercised. Each year from 1997 to 2004, Ellis paid the annual lease fee in a timely manner and farmed 60 acres of the Property. Bagwell accepted each annual payment.

Kerry M. Sprouse was an experienced real estate salesman and developer who purchased the Property from Bagwell in 2004. Ellis informed Sprouse that he had a lease on the Property through December 2006 and that the 60 farmable acres were currently planted in corn. Shortly thereafter, Sprouse drove an automobile across the field of waist-high corn, prompting Ellis to seek retribution from Sprouse

for damage to his crop. Sprouse told Ellis he would be allowed to harvest what was left of his crop, after which he must vacate the Property. Furthermore, Sprouse warned Ellis that if he "caused any trouble, [Sprouse] would plow under his then-existing crop." Ellis then vacated the property and prepared to file suit.

Ellis filed suit against Sprouse, seeking compensatory damages for trespass in 2004 and for lost profits in 2005 and 2006 resulting from Sprouse's violation of the renewed lease by forcing Ellis to vacate the Property in 2004. A jury found that Ellis had effectively renewed the lease through December 2006, and awarded him compensatory damages of $534 for trespass in 2004 and $82,000 for lost profits in 2005 and 2006. The compensatory awards were equal to the exact amount that Ellis projected as his losses. The jury also awarded $30,000 in punitive damages based solely on testimony from Ellis that Sprouse had taken no steps to remedy his wrongdoings and that he had incurred $17,000 in attorney's fees.

Sprouse appealed to the Tennessee Court of Appeals, which affirmed in part, reversed in part, vacated in part, and remanded to the trial court. The court affirmed the compensatory award of $534 for trespass. The court, however, found that Ellis could not exercise his option to renew the lease by actions taken after the original lease had expired. Ellis therefore had no right to occupy and use the Property in 2005 and 2006; hence the court reversed the $82,000 award for lost profits. Finally, the court found that although a punitive award was justified, $30,000 was excessive in light of a mere $534 in compensatory damages. Therefore, the court vacated the punitive award and remanded for a new trial regarding the sole issue of punitive damages for the 2004 trespass.

Ellis filed application for permission to appeal to the Tennessee Supreme Court, which granted permission and reversed and remanded. The Court relied on its previous ruling in *Carhart v. White Mantel & Tile Co.*, 123 S.W. 747 (Tenn. 1909) to hold that Ellis had effectively exercised his option to renew the lease through 2006. Under *Carhart*, when a lease contains an option to renew but does not specifically prescribe the time and method for exercising the option, the lessee may exercise the option by remaining in possession of the property after expiration of the initial lease term and by paying the required rent in a timely manner. On the contrary, a lessee must exercise an option to renew before expiration of the original lease term *only when* the option specifically requires the lessee to do so. Using the *Carhart* standard, the Court reversed the ruling that Ellis had failed to effectively renew the lease. Upon request by Sprouse, the Court remanded to the Court of Appeals for consideration of several issues, including whether the statute of frauds requires

preparation of a new lease when exercising an option to renew and whether Ellis presented sufficient evidence to support his claim for lost profits and for punitive damages.

On remand, the Tennessee Court of Appeals affirmed the judgment of the trial court in its entirety, which entailed $82,534 in compensatory damages and $30,000 in punitive damages. In order to affirm the trial court's ruling, the court first had to resolve whether the statute of frauds requires preparation of a new written instrument to renew an earlier lease agreement. The court relied on *Womble v. Walker*, 181 S.W.2d 5 (Tenn. 1944), in which the Tennessee Supreme Court held that where a lessee effectively exercises a written, signed option to renew a lease, all the conditions and covenants of the former lease continue and therefore render the need for a new lease unnecessary. Before the Tennessee Supreme Court remanded the present case, it ruled that Ellis effectively exercised his option to renew the lease. Therefore, using the *Womble* standard, the court held that the terms of the original lease continued for an additional five years and that the statute of frauds did not apply.

Next, the court turned to whether Ellis presented sufficient evidence to support his claim for lost profits. Sprouse argued that estimates of lost profits were based solely on statements made to Ellis by out-of-court parties; thus all evidence was hearsay testimony and the jury verdict could not stand. The court noted, however, that Ellis drew from his own experience as a farmer to present lost profits estimates and that he only noted testimony from outside sources as a means of corroborating his own findings. Previous case law provides that a farmer's own testimony regarding lost profits is competent proof of damages and that the credibility and weighing of such testimony must be left to the jury. Here, the jury weighed Ellis's testimony and found in his favor; thus the court found no reason to alter the trial court's decision to submit Ellis's proof of damages to the jury.

Finally, the court addressed whether Ellis presented sufficient evidence to support his claim for punitive damages. Sprouse argued that punitive damages were not proper because Ellis only proved nominal damages of $534. As noted above, however, on remand the court determined Ellis proved an additional $82,000 in compensatory damages for lost profits. The court therefore found no reason to alter the award of $30,000 in punitive damages as excessive. The court further noted that Ellis's testimony that Sprouse threatened to plow under his crops was sufficient evidence to allow the jury to conclude that Sprouse had the conscious objective of removing Ellis from the Property regardless of his rights. The court therefore affirmed the trial court's punitive award of $30,000.

Ellis illustrates the importance of detail and clarity in drafting real property lease agreements. A lease containing an option to renew must be clear as to how and when the option is to be exercised. Otherwise, the default rule set forth in *Carhart* – which is affirmed in *Ellis* – clearly provides that the lessee need only continue possession of the property and payment of rent to renew the lease. Furthermore, the statute of frauds does not require a new written agreement when an option is exercised in such a manner; rather, the original lease terms continue to control. To avoid possible confusion and disputes, Tennessee attorneys should advise their clients to specifically define in the lease both how and when a lessee must exercise an option to renew.

Finally, *Ellis* briefly draws attention to the fact that a plaintiff's testimony alone can be enough to send a claim for compensatory and punitive damages to the jury despite using hearsay testimony as corroborative evidence. As such, Tennessee defense attorneys must be sure to raise all objections regarding hearsay for specific pieces of evidence and they must advise their clients that threats and other hostile words toward the plaintiff could aid a jury in returning a verdict for the plaintiff.

SECURITIES

A private right of action exists for violations of § 10(b) of and Rule 10b-5 under the Securities Exchange Act where a plaintiff can establish a material misrepresentation by the defendant, scienter, a relationship between the misrepresentation and the purchase or sale of a security, reliance upon the misrepresentation, economic loss, and loss causation. *Ind. State Dist. Council of Laborers v. Omnicare, Inc.*, 583 F.3d 935 (6th Cir. 2009).

By Andrew Sumner

The issue presented in *Indiana State District Council of Laborers v. Omnicare, Inc.* dealt with whether securities investors could recover damages resulting from fraudulent and misleading statements issued by a major corporation. Although § 10(b) of and Rule 10b-5 under the Securities Exchange Act of 1934, as amended (the "Act"), prohibit "fraudulent, material misstatements in connection with the sale or purchase of a security," proving that a company actually issued fraudulent statements, establishing a relationship between the fraudulent statements and subsequent damages, and determining when certain exceptions apply can be difficult. Here, the United States Court of Appeals for the Sixth Circuit looked at the nature of a corporation's misleading statements and determined that the corporation was

not liable for several reasons. Specifically, the court found that the statements were entitled to safe-harbor protection from liability under § 10(b) and Rule 10b-5 because the statements were "forward looking," that the statements were not material because they were "mere corporate puffery," and that the plaintiffs failed to establish a relationship between the corporation's statements and a subsequent drop in the corporation's stock price.

In *Omnicare*, investors who had purchased Omnicare, Inc. ("Omnicare") securities between August 2, 2005 and July 25, 2006 ("Plaintiffs"), brought a class-action suit against Omnicare, a national pharmaceutical provider, along with several of its officers and board members, claiming that Omnicare violated § 10(b) of and Rule 10b-5 under the Act. The Plaintiffs maintained that in anticipation of an upcoming industry-wide transition to Medicare Part D, Omnicare issued deceptive press releases and made misleading conference calls on August 3 and November 2, 2005. In each communication, Omnicare emphasized that it was prepared for the Medicare Part D transition and stated that it had been working extensively to educate its employees and potential prescription drug plan providers about the transition. Plaintiffs contended that these statements were misleading because, in actuality, Omnicare had failed to take the necessary steps to prepare itself for the Part D transition, and that as a result, Omnicare was forced to spend an additional $9.8 million on the transition.

Next, Plaintiffs alleged that Omnicare committed fraud by failing to disclose an ongoing contractual dispute with United Health Group ("UHG"), a major prescription drug plan provider. Plaintiffs further claimed that because Omnicare did not reveal the dispute until May 18, 2006, growth predictions issued by Omnicare in February and April 2006 were misleading.

In addition, Plaintiffs alleged that Omnicare failed to comply with generally accepted accounting principles ("GAAP") when it issued statements reporting record revenues in 2005 and early 2006. Plaintiffs claimed that such figures were artificially inflated because of "improper revenue recognition, . . . overvaluation and improper recognition of receivables, . . . overvaluation of inventories, and . . . the failure to establish, in a timely manner, litigation settlement reserves with respect to government investigations."

Lastly, Plaintiffs challenged the lawfulness of Omnicare's drug recycling and drug substitution programs. Within these programs, Plaintiffs alleged that Omnicare illegally repackaged drugs with different expiration dates and also replaced less

expensive doses of medications with more costly doses. Plaintiffs asserted that, because these programs were illegal, Omnicare made materially misleading statements when it assured investors that it was complying with the law. Plaintiffs noted that after these assurances were made, the government raided Omnicare's facilities several times, resulting in Omnicare settling two lawsuits for $52.5 million and $49.5 million, respectively.

Pursuant to § 10(b) of and Rule 10b-5 under the Act, a plaintiff has a right of action if he or she can prove the following: that the defendant made a material misrepresentation; that a relationship existed between the material misrepresentation and the acquisition of the security; reliance on the misrepresentation; economic loss; and loss causation. A plaintiff can prove loss causation by establishing a relationship between the misrepresentation and any subsequent economic loss. A plaintiff must also show scienter, which requires that the plaintiff "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." Next, a plaintiff must identify the speaker and the misrepresentations, establish when and where the misrepresentations were made, and explain why he or she considered the statements material and fraudulent. Materiality may be demonstrated by establishing, with a substantial likelihood, "that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information available."

Exceptions to these rules absolve companies from liability if the statements involve "mere corporate puffery" or "corporate optimism." The exceptions also protect corporate projections and estimates concerning future economic performance with a safe harbor. Such statements are only fraudulent if they are material, if the defendant had actual knowledge that the statements were misrepresentations, and if the communications did not include future projections or "meaningful cautionary statements."

In this case, the district court granted Omnicare's motion to dismiss and found that Plaintiffs' allegations concerning Omnicare issuing misleading Medicare Part D preparedness statements and violating GAAP were not sufficient because Plaintiffs failed to prove loss causation. The district court also found that Omnicare's statements concerning the legality of its actions were "soft," that disclosure of such actions was not required, and that no inference of scienter existed. Finally, the district court found that because the lead Plaintiff sold its securities before any misleading communications were issued, the Plaintiffs had no standing to sue Omnicare concerning its failure to reveal the UHG contract dispute.

On appeal, the United States Court of Appeals for the Sixth Circuit affirmed each of the above district court decisions. Concerning Omnicare's alleged misrepresentations about its Medicare Part D preparedness, the court agreed that Plaintiffs failed to show loss causation, noting that instead of explaining how or why Omnicare's misrepresentations had caused a drop in the value of its stock, Plaintiffs attributed the decrease in the stock's value to the government raids on Omnicare's facilities. Similarly, the court found that Plaintiffs did not sufficiently plead loss causation when proving that Omnicare violated GAAP. Although Plaintiffs presented multiple violations, the court found that the complaint failed to show how or when any of the violations were "recognized by or revealed to the market."

Next, regarding Plaintiffs' claims that Omnicare failed to disclose its dispute with UHG, the court found that Plaintiffs did not satisfy the requirements of § 10(b) and Rule 10b-5 because Plaintiffs did not allege a material misstatement or omission and never explained why Omnicare was obligated to reveal its contract dispute with UHG earlier than it did. The court also held that because Omnicare's statements were "forward-looking," the statements were protected by a safe harbor, and that because the statements were "mere corporate puffery," they were not material.

Lastly, the court rejected Plaintiffs' allegations that Omnicare made misrepresentations through claims of legal compliance, stating that "companies have no duty to opine about the legality of their own actions." The court also found that because Omnicare made a "generic claim that they complied with the law without any specifics," such information was "soft" and "no disclosure [was] required despite the generalized claim of 'legal compliance.'" Although a company may be liable if it issues a claim of legal compliance with actual knowledge of the claim's falsity, in this case the court held that Plaintiffs did not show that Omnicare knew its claims were false.

As the court's decision in *Indiana State District Council of Laborers v. Omnicare, Inc.* demonstrates, a plaintiff and his or her counsel should never forget that loss causation must be established in order to recover damages resulting from a corporation's fraudulent statements. To adequately prove loss causation, attorneys should advise their clients that a causal connection between a corporation's material misrepresentation and any subsequent loss must exist. Likewise, plaintiffs' attorneys should inform their clients that only *material* misrepresentations or omissions by a corporation generate a right of action for violation of § 10(b) and Rule 10b-5, and that a plaintiff must also establish scienter, a relationship between the misrepresentation and the purchase or sale of a security, reliance upon the

misrepresentation, and economic loss. By failing to take these measures, an investor who relies on fraudulent statements to buy or sell corporate securities may be unable to recover any resulting damages. On the other hand, transactional attorneys representing corporations should assure their clients that "forward-looking" projections and statements of "mere corporate puffery" or corporate optimism are permissible and that such statements do not constitute a violation of § 10(b) of and Rule 10b-5 under the Act.

To bring a claim for false and misleading statements under the Tennessee Securities Act, a plaintiff does not have to prove reliance on the representations or omissions of the defendant. A misstatement or omission is "material" for purposes of the action if there was a substantial likelihood that a reasonable purchaser or seller would have considered it important. *Green v. Green*, 293 S.W.3d 493 (Tenn. 2009).

By Will Woods

Section 48-2-122(a)(2) of the Tennessee Code, part of the Tennessee Securities Act of 1980 (the "Act"), makes it unlawful for any person involved in the sale or purchase of securities to make an "untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading." The rationale behind this statute is to prevent parties from utilizing fraud or misrepresentation in transactions. The language in this statute, however, fails to clearly define what constitutes a "material fact."

In *Green v. Green*, the Tennessee Supreme Court attempted to outline the parameters of materiality with regard to securities transactions. The court also attempted to clarify the requirements for bringing a cause of action for rescission due to fraud or misrepresentation. It held that the right of action for false and misleading statements in a securities transaction under the Act did not require the plaintiff to prove reliance on the representations or omissions of the defendant. The court further held that under the Act, the test for "materiality" of a misstatement or omission was an objective one, and that such a misstatement or omission was "material" if there was a substantial likelihood that a reasonable purchaser or seller would have considered it important.

The pertinent facts in *Green* involve the sale of 22,000 shares of stock in Champs-Elysees, Inc. (the "Company"), a closely held and family-operated

corporation. The stock was sold by Edna Green, founder of the corporation, to Wesley Green, Edna's son and president of the corporation. In October 2005, citing the Company's continual financial and managerial problems, Wesley attempted to purchase Edna's 22,000 shares of the Company's stock. Wesley told Edna that by purchasing her 22,000 shares, he would be able to acquire a controlling interest in the Company, and would thus be better able to acquire the necessary investment capital from external sources to prevent the Company from going bankrupt.

During several of the conversations Wesley had with Edna concerning his purchase of the stock, Wesley convinced her that by selling her shares to him, she would be released of any secondary liability to AmSouth Bank for a $75,000 corporate line of credit that was extended to the Company. Although Edna told Wesley that she did not believe she would be personally liable for the line of credit, she admitted that after discussing the issue with Wesley, she was convinced that she might actually be obligated on the line of credit. On October 24, 2005, Edna agreed to sell her stock to Wesley, and on October 27, Edna signed a bill of sale, which transferred her 22,000 shares to Wesley for $8,000. Wesley gave Edna a check for $2,000, which served as a down payment on the purchase.

Mark Green, Wesley's brother and a director at the Company, was unaware of Wesley's purchase of Edna's stock until after Edna had signed the bill of sale. Upon learning of the sale, Mark convinced Edna that she should instead consider selling her stock to Art Fourier, another director at the company. Mark claimed that Fourier would be able to offer more money than Wesley had in exchange for the stock. On October 28, 2005, the day after Edna signed the bill of sale, Edna delivered a letter to Wesley that rescinded the sale of her 22,000 shares to him. In a letter to Wesley dated November 2, 2005, Edna returned Wesley's down payment check of $2,000.

Wesley, however, refused to rescind the bill of sale signed by Edna, and claimed in a November 11 board meeting that he had legally acquired Edna's stock. At the same meeting, Edna claimed that Wesley had induced her into the sale of the stock by representing to her that she would remain personally liable on the company's line of credit at AmSouth Bank if she did not sell her stock to him. During this meeting, Wesley was removed as a director and officer of the corporation.

On November 14, Wesley filed a suit in chancery court in which he sought declaratory and injunctive relief against Edna, Mark, and Fourier, as well as

temporary restraining orders to prevent the sale of any of the Company's stock. The court refused to grant the injunction with regard to Edna, concluding that the October 27 bill of sale signed by her was both an unenforceable and unconscionable document. The court also declined to enjoin Edna from selling or transferring her stock, holding that (1) the October 27 bill of sale was invalid on its face; (2) Wesley had an adequate remedy at law; and (3) Wesley had failed to demonstrate a substantial likelihood of success on the merits.

After intervention by the Company on behalf of Edna and a subsequent counterclaim filed by Wesley, Edna and the Company moved for summary judgment on Edna's counterclaim for rescission under § 48-2-122(b)(1) of the Tennessee Code. The court granted this motion, ruling that Wesley had violated § 48-2-121(a)(2) based on the following: that (1) Wesley had represented to Edna that she was obligated under the Company's line of credit at AmSouth Bank; (2) this representation was false; (3) this representation was made in connection with the transfer of Edna's stock; and (4) when viewed objectively, this representation was material to the transaction. The court also noted that the disagreement over whether Edna had relied on Wesley's representation was not material with regard to Edna's rescission claim. On appeal, however, the court of appeals ruled that the chancery court had erred when it granted summary judgment in favor of Edna as to her rescission claim under § 48-2-122(b)(1). The court of appeals reasoned that rescission claims under this section required the claimant to prove reliance on representations made by the defendant.

After a subsequent appeal by Edna and the Company, the Tennessee Supreme Court affirmed the holding of the court of appeals, although it held that the court had erred by inserting a requirement of reliance into § 48-2-122(b)(1) of the Tennessee Code. Under this section, a seller will be entitled to rescission if: (1) the seller returns the consideration received; (2) the seller demonstrates that the purchaser violated § 48-2-121(a); (3) the seller proves that he or she was unaware of the purchaser's violation of § 48-2-121(a); and (4) the purchaser fails to prove that he or she did not know, and in the exercise of reasonable care could not know, about the violations of § 48-2-122(a). The court noted that although § 48-2-122(b)(1) clearly states that in order to be entitled to rescission, a seller must not be aware that a purchaser's statements are untrue, neither § 48-2-122(b)(1) nor § 48-2-121(a) contain any language that would require a seller to rely on representations made by the purchaser.

Noting the plain language of the statutes, the court thus refused to insert an

implicit reliance requirement as an element of the right of action. The court further noted that its interpretation of the statutes, which allows sellers of securities in Tennessee to use state law to rescind transactions based on fraud, deceit, or misrepresentation without proof of reliance, did not conflict with federal law, even though a party in a similar situation would be required to prove reliance if a claim was being pursued in a United States District Court.

In addition to resolving the issue of reliance, the court also delineated the standard for materiality with regards to § 48-2-121(a)(2). The statute prohibits the making of any "untrue statement of a material fact" or failure to "state a material fact." The court first held that the test for the materiality of a statement or omission is an objective one, explaining that the basic test of materiality in the context of securities law is "whether an average reasonable person would attach importance to the misinformation in determining his choice of action in the transaction in question."

The court then addressed the issue of whether a finding of materiality requires that the purchaser or seller in question "would" or simply "might" consider the given misinformation as being important in making a decision. The court held that the proper test for determining the materiality of a given representation or omission is the "substantial likelihood" standard, which states that misinformation or omission of a fact is material if there is "a substantial likelihood that a reasonable purchaser or seller would consider it important in deciding whether or not to purchase or sell."

The Tennessee Supreme Court's ruling in *Green* clarifies the elements necessary for filing suit under the Act. For one, *Green* demonstrates that a plaintiff is not required to prove reliance on representations or omissions made by the defendant in a claim for false and misleading statements in a securities transaction. Also, the ruling elucidates the framework for determining materiality in an action for false and misleading statements under the Act. The test of materiality is an "objective" one, which makes a statement or omission material if there is a "substantial likelihood that a reasonable purchaser or seller would consider it important."

Transactional attorneys should familiarize themselves with this standard, and therefore enable themselves to better evaluate representations or omissions made by clients and other parties to a given transaction. Transactional attorneys should also advise their clients to take additional precautions when making representations to

third parties, as reliance is no longer required to be proven under the Act.

TAX

A corporation may be subject to franchise and excise taxes on its advertising revenues derived from publications distributed within the state, even though the corporation's business activity is performed substantially outside the state. *BellSouth Adver. & Publ'g Corp. v. Chumley*, No. M2008-01929-COA-R3-CV, 2009 Tenn. App. LEXIS 576, 2009 WL 2632773 (Tenn. Ct. App. Aug. 26, 2009).

By Emily Leebron Foster

Corporations are subject to franchise and excise taxes for the privilege of doing business in Tennessee. For corporations conducting business and deriving income from multiple states, the proportion of the corporation's earnings subject to Tennessee franchise and excise taxes are determined according to §§ 67-4-2012 (excise) and 67-4-2111 (franchise) of the Tennessee Code. If specific and unusual circumstances exist, however, the Commissioner may impose an alternative equitable method for apportioning a corporation's earnings for the purpose of determining its franchise and excise tax obligations. In *BellSouth Advertising & Publishing Corp. v. Chumley*, the Tennessee Court of Appeals held that the Commissioner was justified when she deviated from the statutory formulas in determining the corporation's taxes related to its advertising income derived from publications distributed, but not produced, within Tennessee.

The Uniform Division of Income for Tax Purposes Act ("UDITPA"), adopted by Tennessee, provides a basis for the allocation and apportionment of taxes for corporations doing business in multiple states. In Tennessee, the overall apportionment ratio is based upon the proportion of assets, payroll, and sales attributable to the business conducted and income derived in the state. Of particular interest in *BellSouth* is the applicability of the sales factor for advertising services, which are classified as sales other than sales of tangible personal property. Under §§ 67-4-2012(i)(2) and 67-4-2111(i)(2) of the Tennessee Code, Tennessee applies the cost of performance method for these types of sales to determine whether the sales factor is included in the overall apportionment ratio. For example, if a greater proportion of the corporation's business activities are performed outside of the state, then the sales are not deemed as sales within the state for purposes of franchise and excise taxes. Under these circumstances, the sales factor element of the apportionment ratio is zero.

BellSouth Advertising and Publishing Corporation ("BellSouth") generated approximately $897 million in advertising income from the production and distribution of its telephone directories in Tennessee between 1997-2001, and paid only $296,140 (0.03%) in franchise and excise taxes. BellSouth contended that the proper basis for determining whether the advertising revenue was apportioned to Tennessee for purposes of franchise and excise taxes was the cost of performance method. BellSouth emphasized that for the earnings it generated from its advertising services in Tennessee, the sales activities, although conducted in Tennessee, were not conducted by BellSouth employees, but rather by independent contractors who were subject to Tennessee franchise and excise taxes. Additionally, the company conducted substantially all of its production activities for the directories outside of Tennessee. Thus, based on the Tennessee statutory formulas and cost of performance methodology, BellSouth excluded the revenues from advertising services from the sales factor in the apportionment ratio.

Under § 67-4-2014 of the Tennessee Code, however, the Commissioner is granted discretion to determine whether a variance to the statutory formula and methodology is appropriate. Thus, in 2004, the Tennessee Commissioner issued a variance to BellSouth's franchise and excise taxes for the period 1997-2001 to better reflect the extent of BellSouth's business activities in the state. The variance was based on a sales factor that included the advertising revenue generated from the directories distributed in Tennessee, rather than the cost of performance method. The Commissioner determined that the resulting increase in BellSouth's franchise and excise taxes for the five-year period was nearly $10 million, plus interest of approximately $3 million. The issue before the Tennessee Court of Appeals was whether the Commissioner's tax assessment, which apportioned BellSouth's revenue using a sales factor based on BellSouth's Tennessee advertising revenues rather than cost of performance, was proper in determining BellSouth's franchise and excise tax liability.

On appeal, the court held that the Commissioner was justified in issuing a variance to BellSouth for franchise and excise taxes based on advertising revenues generated within the state, rather than the statutory cost of performance methodology. The court affirmed the Commissioner's discretion in issuing a tax variance, and looked to the intent of UDITPA in evaluating the Commissioner's specific action. The court noted that in the development of UDITPA, the framers acknowledged that for some business activities the statutory formulas and underlying methodologies would not adequately reflect the extent of the business activity in the

state. In particular, the framers recognized that taxes on service activities, such as advertising services, would warrant a variance from the statutory formula. The aberration with advertising services is that the costs may be incurred in one state while the corporation derives its revenues primarily from distribution in other states. And under the statutory cost of performance methodology, although a business benefits from the privilege of doing business within a particular state, it would be free from that state's franchise and excise taxes.

Although the court appreciated BellSouth's argument that the Commissioner could deviate from the cost of performance methodology simply to generate greater tax revenues for the state, the Tennessee rules and regulations explicitly provide for such discretionary actions, as long as those actions are justified. The legislature recognized that not all situations will fit nicely into the statutory formulas, and therefore, granted the Commissioner authority to deviate when the facts and circumstances warrant. The *BellSouth* court concluded that the Commissioner demonstrated that the variance issued to BellSouth was warranted as BellSouth's business activities were substantially performed outside the state, but it derived its revenues primarily from customers and the distribution of its product within the state.

The decision in *BellSouth* affirms the Commissioner's discretion in determining the basis for the apportionment of a corporation's income for franchise and excise taxes. In particular, corporations may be taxed on advertising revenues generated within a particular state, although the corporation performs its production and sales activities in another state. Although the decision in *BellSouth* affects corporations paying franchise and excise taxes in Tennessee, the implications are potentially broader as other states that have adopted UDITPA may file suit. Thus, attorneys and tax practitioners in Tennessee and beyond should advise their clients of potential tax obligations under *BellSouth*, particularly for those clients that provide services in multiple states, but the related assets, personnel, and activities are outside of those states.

Despite statutory formulas, which provide some certainty for businesses, corporations doing business in multiple states may be subject to greater franchise and excise taxes for certain privileges. Whether states will aggressively seek to realize franchise and excise taxes due to them from companies generating advertising income from print medium distributed within their state may be a moot issue. In today's world, consumers and businesses rely more on the Internet for their purchase-and-sale decisions than on telephone directories or other print sources.

Nevertheless, attorneys and tax practitioners should assess whether their clients' business model will subject them to a potentially greater franchise and excise tax liability as determined under *BellSouth*.

Income earned outside the state by a non-domiciliary subsidiary corporation as a result of the parent corporation's redemption of outstanding stock held by the subsidiary is not taxable under Tennessee excise tax law, unless the two entities share a unitary business relationship. *Blue Bell Creameries, L.P. v. Chumley*, No. M2009-00255-COA-R3-CV, 2009 Tenn. App. LEXIS 655, 2009 WL 3126249 (Tenn. Ct. App. Sept. 29, 2009).

By Erin Jackson Wallen

State excise tax assessments on income earned outside the state must conform to the Due Process and Commerce Clauses of the United States Constitution. In order to clarify these constitutional requirements, the Supreme Court developed the "unitary business principle" as the standard for determining what out-of-state income may be taxed. In *Blue Bell Creameries, L.P. v. Chumley*, the Tennessee Court of Appeals held that a state excise tax assessment on a non-domiciliary subsidiary corporation based on out-of-state income earned as a result of the parent corporation's redemption of outstanding stock was unconstitutional because the subsidiary and its parent corporation did not share a unitary business relationship.

In *Blue Bell Creameries*, Blue Bell Creameries, USA ("Blue Bell"), a Delaware corporation, formed Blue Bell Creameries, L.P. (the "Taxpayer"), a limited partnership domiciled in Texas, as part of a corporate reorganization in 2000. Blue Bell created Taxpayer to assume the business of Taxpayer's predecessor, which consisted of "producing, selling and distributing ice cream in multiple jurisdictions, including Tennessee." The ice cream business was "controlled, managed, and conducted" by Taxpayer's predecessor prior to the reorganization and by Taxpayer afterward. Blue Bell served as a holding company and parent corporation of Taxpayer's predecessor and continued to serve the same function for Taxpayer. Also, due to the reorganization, Blue Bell became an S corporation and allowed eligible shareholders to contribute their Blue Bell shares to Taxpayer in exchange for a limited partnership interest in Taxpayer.

In 2001, the majority of Blue Bell's shareholders contributed their stock to Taxpayer in return for a limited partnership interest, and Blue Bell then made a cash

payment to Taxpayer in order to redeem the contributed stock. This transaction produced a capital gain of $119,909,317 to Taxpayer, which it classified as "nonbusiness earnings" on its 2001 Tennessee Franchise and Excise Tax Return. The Tennessee Department of Revenue (the "Department"), however, deemed the capital gain a "business earning" that "should have been included in Taxpayer's apportionable income subject to the [Tennessee] excise tax." After losing an objection and paying the tax, interest, and penalties allegedly owed, Taxpayer filed suit against the Department in 2006, seeking a refund on the ground that the tax assessment was unconstitutional.

The trial court ruled in favor of Taxpayer, finding that Taxpayer and its parent corporation were not part of a unitary business relationship and that the tax assessment was, therefore, unconstitutional. The Department appealed, arguing that the capital gain at issue was constitutionally taxable because the stock acquisition and redemption were part of a unitary business plan between Taxpayer and Blue Bell, in that "everything done by each entity was orchestrated together to further the single ice cream business of which both [were] a part."

On appeal, the Tennessee Court of Appeals affirmed the trial court's holding that Taxpayer and Blue Bell did not share a unitary business relationship and that the Department's excise tax assessment was, therefore, unconstitutional. The court first acknowledged that the Supreme Court's "unitary business principle" is to be used in any formula to "apportion corporate revenues for tax purposes." Under this principle, a state may not tax out-of-state income unless it is earned from a business activity that is unitary with the taxpayer's activity conducted within the state. Essentially, a unitary business is one whose parts are too closely connected and necessary to each other to warrant distinct consideration as independent units, and the courts have created various tests for recognizing such a unitary relationship.

The court first analyzed Taxpayer's case under the "hallmarks of a unitary relationship" test, which requires examination of several factors such as the centralization of management, the functional integration among the business's basic operations, and the economies of scale. As for the first factor, the court found that there was insufficient centralization of management of the entities to find a unitary business relationship. Although Blue Bell indisputably owned Taxpayer, and though there was evidence of an overlap in the management of the entities, the record did not show that Blue Bell had sufficient control over Taxpayer's activities in Tennessee. In fact, the Department admitted that the actual operation of the ice cream business conducted in Tennessee was "controlled, managed, and conducted" by Taxpayer, not

Blue Bell.

Turning to the second factor, the court concluded that Taxpayer and Blue Bell were not functionally integrated when the record lacked evidence that Taxpayer realized any benefits from the reorganization or the stock redemption which "contributed to [its] operations or which [it] depended on in performing its operations." Instead, the record indicated that the reorganization was designed solely to allow Blue Bell to become an S corporation, obtain favorable tax treatment for its remaining shareholders, and avoid registering and reporting expenses. Additionally, the court disagreed with the Department's contention that the two entities were necessarily functionally integrated, since Blue Bell, as a pure holding company of Taxpayer, "would 'have no reason to exist' without Taxpayer's operation." Dismissing the contention that holding companies are never separate businesses from their subsidiaries, the appellate court stated that a holding company and its subsidiary must display the requisite interrelationship or interdependence among their basic operations in order to be unitary.

Moreover, the appellate court found that, although a flow of value between the entities may indicate a unitary business, Taxpayer's contribution to Blue Bell of the income it earned from the ice cream business was insufficient to prove functional integration between the entities, because "one component may 'add to the riches' of the corporation and yet remain a discrete business enterprise."

Finally, the court found insufficient economies of scale to deem the entities unitary, given the lack of evidence showing that Blue Bell had provided "central services," such as staff functions, payment of employees' salaries, workman's compensation coverage, or legal services, to Taxpayer in any way that undermined Taxpayer's "operational independence." Again, the court emphasized the Department's own admittance that Taxpayer, not Blue Bell, "controlled, managed, and conducted" the actual operation of the business.

Upon determining that Taxpayer and its holding company, Blue Bell, did not satisfy the hallmarks of a unitary relationship test, the appellate court considered the "operational function" test, which the Supreme Court created in recognition of the concept that apportionment might be constitutional in some situations where an asset is part of a taxpayer's unitary business, even though no unitary business relationship exists between the payor and payee. Under this test, apportionment requires that "the capital transaction serve an operational rather than an investment function." Finding that the capital gain realized by Taxpayer was distributed to its

partners, who were entitled to the income since they were in possession of the stock at the time it appreciated, the court held that this capital gain was not used as operational funds and was therefore not constitutionally taxable under the operational function test.

The decision in *Blue Bell Creameries, L.P. v. Chumley* should alert Tennessee attorneys to the constitutional limitations imposed when a state seeks to tax a taxpayer that conducts business within the state on out-of-state income. Providing insight into the analysis required under the "unitary business principle," the case suggests that a unitary relationship will not exist when a taxpayer that conducts activity within the state, rather than its parent or holding corporation or other out-of-state entity, actually controls, manages, and conducts the operation of the business. Tennessee attorneys should also note that the mere existence of a parent and subsidiary relationship does not necessitate a finding of a unitary business relationship and that the interrelationship or interdependence among the business's basic operations, as well as the flow of value or goods between the entities, must be scrutinized, as in any other case, in order to determine whether a business is unitary and subject to state taxation on out-of-state income.