

## CASE COMMENTARIES

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### BANKRUPTCY

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**Transfers from a trust account, made by a debtor to a creditor, may not be subject to the common law tracing requirement for the purpose of establishing that the transfer was not preferential.** *In re Appalachian Oil Co.*, Bankr. No. 09-50259, 2012 WL 1067731 (Bankr. E.D. Tenn. Mar. 23, 2012)

By Kourtney Hennard

In the preferential transfer context, when a creditor purports to be the beneficiary of funds held in trust by the debtor, the creditor may not need to trace the funds when the debtor made such transfers from a trust account, even if the funds originated from a general, commingled account.

In *In re Appalachian Oil Co.*, the Bankruptcy Court for the Eastern District of Tennessee considered which of fourteen fund transfers made by a debtor to a creditor could qualify as preferential transfers subject to avoidance and recovery under 11 U.S.C. § 547(b). The court held in favor of the creditor with respect to eleven payments made from a trust account, finding that these payments were trust funds and therefore ineligible for preferential transfer status. With respect to three payments made from the debtor's general account, the court held in favor of the debtor: because the creditor did not sufficiently trace the funds to show that they were trust funds collected on its behalf, the transfers were preferential transfers and were therefore recoverable by the debtor.

The debtor, Appalachian Oil Company, Inc. ("APPCO"), operated approximately 57 convenience stores in Tennessee, Virginia, and Kentucky, at which it regularly sold lottery tickets, including those supplied by the creditor, Kentucky Lottery Corporation ("KLC"). KLC would generally collect payments for lottery tickets sold in APPCO's Kentucky stores as follows: KLC would issue an invoice to APPCO each Tuesday for amounts due; on each Thursday, KLC would conduct an electronic funds transfer ("EFT") sweep of APPCO's trust account, which was maintained in the name of "[APPCO] in trust for the Tennessee Education Lottery Corporation." This trust account was also used for payments to the Tennessee and Virginia state lotteries. Though the trust account usually maintained a zero balance, funds would automatically be transferred from APPCO's general account to the trust account in order to satisfy the impending EFT sweeps. Importantly, APPCO did not segregate revenue acquired from its sales of Kentucky lottery tickets from other revenues, all of which it kept in the general account. During the 90-day period prior to APPCO's bankruptcy filing (the "preference period"), KLC successfully recovered eleven payments,

totaling \$273,491.82, through sweeps of the trust account. During that period, APPCO also made three payments, totaling \$92,923.42, from its general account to KLC via wire transfer.

Approximately six months after APPCO filed its voluntary petition for chapter 11 bankruptcy relief, it initiated this proceeding to recover payments made to KLC during the preference period. On cross-motions for summary judgment by KLC and partial summary judgment by APPCO, the court granted APPCO's motion, and denied KLC's motion, with respect to the three wired payments made from APPCO's commingled general account. The court found that those three payments constituted preferential transfers, but the eleven payments made from APPCO's trust account were trust funds and therefore were not preferential transfers.

The court applied § 1107(a) of the Bankruptcy Code, which allows a chapter 11 debtor in possession (here, APPCO) to exercise the rights of a bankruptcy trustee. These rights include the ability to avoid the transfer, under certain circumstances, of an interest of the debtor made during the 90-day preference period. To be subject to avoidance under 11 U.S.C. § 547(b), the transfer must be of the debtor's property. "Property of the debtor" is "property that would have been part of the estate had it not been transferred [by the debtor] before the commencement of bankruptcy proceedings." Per 11 U.S.C. § 541, property of the estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case," except "to the extent of any equitable interest in such property that the debtor does not hold." The Sixth Circuit has held that "[b]ecause the debtor does not own an equitable interest in property he holds in trust for another, that interest is not 'property of the estate.' Nor is such an equitable interest 'property of the debtor' for purposes of § 547(b)." Thus, the issue before the court was whether the particular funds APPCO used to pay KLC were held in trust and were therefore not property subject to the preferential transfer provision.

In the absence of controlling federal bankruptcy law, state law defines the substantive nature of the debtor's property interest. Under Kentucky law, the elements of an express trust are (1) the express intent to create a trust, (2) an ascertainable *res*, (3) a sufficiently certain beneficiary, and (4) a trustee who owns and administers the *res* for the benefit of the beneficiary. The court looked to Kentucky statutory and regulatory law, in addition to the language of the Retailer License Agreement ("the Agreement") entered into by APPCO and KLC, to conclude that an express trust was formed between APPCO and KLC. The court rejected APPCO's argument that the absence of trust segregation indicated there was no identifiable trust *res*, and therefore no trust. Citing the Sixth Circuit, the court explained that a trust agreement's failure to expressly require that trust funds be held in a separate account is "not a determining factor of whether a trust was formed." Instead, the segregation requirement is a basic fiduciary obligation, existing regardless of the trust agreement wording. Ultimately, the court held that "the fact that a trustee fails to segregate trust funds from non-trust funds does not destroy a previously created trust."

Finding that an express trust existed, the court turned to the issue of whether the *particular dollars* APPCO paid to KLC were trust funds dollars. According to the United States Supreme Court in *Begier v. Internal Revenue Service*, “[o]nly if the creditor was actually paid with the trust funds has there been no transfer of property of the debtor and therefore no preference.” APPCO argued that because it had commingled trust funds with other funds in a non-trust account, those trust funds lost their identity. Generally, in the case of commingled funds, the alleged beneficiary of the trust must sufficiently trace the trust property. If the beneficiary cannot do so, she becomes “merely a general creditor of the estate.”

Here, however, the court focused on the fact that payments to KLC came from the trust account rather than a general commingled bank account. Relying on cases from the Sixth Circuit and Georgia, and on the common law presumption that a trustee is restoring a beneficiary’s trust funds when it adds funds to a depleted trust account, the court held that KLC did not need to satisfy the tracing requirement. Because the weekly sweep method used by APPCO “in essence created a systematic, electronic means of restoring the trust funds that it should have been depositing in the trust account all along,” and because “[restored funds are] conclusively presumed to be trust funds . . . regardless of the source of [those] funds,” the court found it “irrelevant” that the trust account was established in trust for the Tennessee, rather than the Kentucky, lottery. Furthermore, because the trust account maintained a zero balance and merely acted as a flow-through for EFT sweeps, the funds never commingled in the trust fund. Moreover, the court concluded that even if funds had commingled in the trust account, such commingling would not alter the character of those funds, which would remain outside of the estate and be ineligible for preferential status.

Turning to funds APPCO paid to KLC via wire transfer from the general account, the court held that KLC failed to satisfy the tracing requirement with sufficient specificity. The court rejected KLC’s reliance on *Begier*. Though voluntary payment might sufficiently evince tracing in the unique trust-fund tax context of that case, *Begier*’s holding was inapplicable to APPCO’s voluntary wire transfers. Next, the court explained the Sixth Circuit’s application of the “lowest intermediate balance test” when trust funds are traced to a general bank account of the debtor, but it failed to apply the test. Finally, the court rejected KLC’s assertion that APPCO was judicially estopped from claiming that KLC must trace the payments. Because KLC could neither prove the elements of estoppel nor trace purported trust funds to APPCO’s general account, the court held that the three wire transfers were preferential.

Attorneys who represent debtors (or potential debtors) should heed the implications of this case. The court essentially held that the common law tracing requirement does not apply when transfers are made by the debtor from a trust account – perhaps *any* trust account, whether held expressly for the benefit of the creditor or some other entity. Thus,

this reduces the burden on a creditor to show that specific dollars were held in trust expressly for its benefit. The court downplayed the implications of commingling of funds in a trust account, focusing on the final *location* of the funds before transfer to the creditor, rather than the *path* of the funds before transfer. Even when funds are collected on behalf of a creditor and then commingle with other funds in a general account, those funds, once transferred to a trust account, may be exempt from assertions of preferential transfer. This apparently applies even if those funds are later commingled in the trust account.

Hence, where bankruptcy may be on the horizon, practitioners should advise their clients to pay creditors using a general (preferably commingled, where lawful) account rather than any trust account. Because the burden then rests on the creditor not only to trace the funds but to establish that a trust existed, the debtor likely has a better chance of recovering the funds as preferential transfers when paid from a general, commingled account.

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**A section 363 sale order under the United States Bankruptcy Code cannot bar a successor liability claim when enforcing the order would violate due process and bankruptcy procedure.** *In re Grumman Olson Indus., Inc.*, 467 B.R. 694 (S.D.N.Y. 2012)

By Andrew Hodgson

Section 363 of the United States Bankruptcy Code allows for the sale of a debtor's assets free and clear of all claims. The general rule is that, subject to certain exceptions, a successor corporation is not liable for a predecessor corporation's liabilities. The New Jersey "product-line" rule is an exception. Under that rule, a successor corporation is exposed to the liability of a predecessor corporation if a successor purchases and continues to market goods from a predecessor's "product-line." At issue in *In re Grumman* was whether a sale order purporting to sell assets free and clear of claims under Section 363 of the Bankruptcy Code could bar a state tort law claim based on successor liability when a claimant did not have notice of the debtor's bankruptcy proceedings because the claimant's injury, although resulting from the debtor's pre-bankruptcy conduct, did not occur until after the debtor's bankruptcy proceedings closed. The United States District Court for the Southern District of New York affirmed the order of the Bankruptcy Court, and held that a Section 363 sale order could not bar a state tort law claim if enforcing the order would violate due process and bankruptcy procedure.

Grumman Olson Industries, Inc. ("Grumman") manufactured products for the truck body industry. In late 2002, Grumman filed for Chapter 11 bankruptcy. Morgan Olson, LLC ("Morgan") manufactures products for the truck body industry. Morgan, through a predecessor, purchased some of Grumman's assets—the sale of which was memorialized in a July 1, 2003 Sale Order. The Sale Order stated that Morgan took those assets "free and clear of all claims" based on successor liability relating to Grumman's actions before the sale. Grumman and its unsecured creditors agreed to a joint liquidating plan on October 31, 2005. Thereafter, on December 29, 2006, the Bankruptcy Court closed Grumman's bankruptcy proceedings.

On October 15, 2008, Denise Frederico was injured in a truck accident while working for FedEx. Grumman allegedly manufactured the FedEx truck in 1994. Mrs. Frederico and her husband (the "Fredericos") filed a personal injury suit against Morgan in the New Jersey Superior Court on October 8, 2009. Morgan then brought an adversary proceeding in the Bankruptcy Court on March 24, 2010 to obtain declaratory and injunctive relief that would bar the Fredericos' claim in state court. The Fredericos amended their complaint on April 28, 2010 to include the allegation that Morgan inherited successor liability under New Jersey's "product-line" rule. Both parties moved for summary judgment.

The Bankruptcy Court, which answered only whether the Section 363 Sale Order immunized Morgan from successor liability, denied Morgan's motion for summary

judgment, granted the Fredericos' motion for summary judgment, dismissed Morgan's adversary complaint, and held that the order is not an absolute bar to the Fredericos' action. Morgan, under the authority of 28 U.S.C. § 158(a), appealed that decision to the United States District Court for the Southern District of New York. On appeal, the Court reviewed the decision *de novo* because the Sale Order involved a question of law and there were no genuine issues of material fact.

The Fredericos argued that bankruptcy law does not preempt New Jersey law if the Bankruptcy Court did not address their successor liability claim. Thus, because the Bankruptcy Court decided only the narrow issue that the Sale Order did not exonerate Morgan, the Fredericos' successor liability claim was not barred. Morgan countered that federal bankruptcy law is supreme to state tort law. Thus, because this case involves a conflict between federal bankruptcy law and state tort law, the Sale Order limiting liability entered under federal bankruptcy law should trump the Fredericos' state law action. Further, any decision to the contrary would violate longstanding bankruptcy policies—nullifying the priority scheme by letting an unsecured tort claimant move ahead of secured creditors and reducing the chance to maximize the value of the assets in bankruptcy.

Proper bankruptcy procedure allows a Section 363 sale order, like the one at issue, to bar claims arising from assets purchased from the debtor in a Chapter 11 bankruptcy. The Second Circuit broadly defined a "claim" to mean any legal obligation of a debtor that can be resolved in a bankruptcy proceeding. A "future claim" is a claim that arises after a bankruptcy proceeding closes but is based on the debtor's pre-bankruptcy conduct. A claim cannot, however, be resolved in a bankruptcy proceeding unless there is a connection between the debtor and the claimant before the bankruptcy. Thus, the general rule is that future claims can be barred because the claims cannot be discharged in a confirmation plan. Otherwise, bankruptcy courts will have to deal with deciding what notice must be provided to claimants who do not even exist. Yet, notice requirements are at the heart of bankruptcy procedure. Fundamental notions of due process generally prevent a party lacking notice from being bound by any orders that result from a bankruptcy proceeding.

To that end, the Court found that the Fredericos' would lose their fundamental right to due process in a bankruptcy proceeding if the Section 363 Sale Order was enforced to enjoin their claim. Thus, the Court affirmed the Bankruptcy Court's order granting the Fredericos' motion for summary judgment and dismissing Morgan's adversary complaint.

The Court side-stepped the preemption issue by framing its analysis on whether the Section 363 Sale Order conformed to bankruptcy procedures and due process, rather than on whether the Fredericos' claim had merit under New Jersey law. While the Court recognized the importance of Morgan's policy arguments, it countered with the argument that a bankruptcy court should not exercise absolute power to bar all future claims under the guise of (1) maximizing the value of assets in a bankruptcy or (2) protecting the priority

scheme. If the bankruptcy court had such expansive power, the purpose of bankruptcy law could be subverted by parties seeking bankruptcy protection for the wrong reasons. Further, the Court found that no matter how important those policies are to bankruptcy procedure, those policies could not rise to the importance of the fundamental right of due process.

While it is proper procedure for a Section 363 sale order to extinguish claims relating to successor liability, procedural due process issues prevent a party lacking notice of bankruptcy proceedings from being bound by any orders resulting from those proceedings. Here, the Fredericos did not obtain adequate notice to satisfy procedural due process because they had no notice at all. Without notice of the proceeding, the Fredericos could not discharge their claim in the bankruptcy proceeding. Thus, the Section 363 Sale Order could not act as a complete bar to the Fredericos' claim. In ruling, the Court made sure to point out that its decision did not decide under which circumstances a Section 363 sale order could bar a future claim, whether a future claims representative could absolve any due process issues, or whether Morgan is liable under the Fredericos' successor liability claim.

Bankruptcy practitioners and business entities should take heed of the Court's result. After this case, it is important to note that a Section 363 sale order is not a safety blanket. Although the Court did not speak to the validity of the successor liability claim, the Court sounded a victory for tort law by allowing the successor liability claim to move forward. As such, those involved in future Section 363 sale orders must be cognizant of the exposure to successor liability claims arising after the bankruptcy proceedings close, even though such claims or claimants did not exist at that time. There will, at a minimum, be an increased chance of having to defend against additional claims. Therefore, those entering into a Section 363 sale order should consider potential liability costs when purchasing a debtor's assets. Despite the narrow issue and outcome, the Court increased the uncertainty in bankruptcy law.

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**BUSINESS ASSOCIATIONS**

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**Corporate officers' side-businesses may be ensnared by the doctrine of corporate opportunity when courts broadly interpret the nature of the business of an officers' original corporation.** *Dweck v. Nasser*, C.A. No. 1353-VCL, 2012 Del. Ch. LEXIS 7, 2012 WL 161590 (Del. Ch. Jan. 18, 2012).

By Ryan Gardner

Primary among the fiduciary duties that a corporate officer owes a corporation is a duty of loyalty. The doctrine of corporate opportunity implicates this duty, as the officer's loyalty to a corporation requires forgoing business opportunities that the corporation may otherwise pursue. In *Dweck v. Nasser*, the Delaware Court of Chancery held that when an officer creates "parasitic companies" that feed off the business relationships and assets of the corporation that employs the officer, the officer violates the doctrine of corporate opportunity and breaches the duty of loyalty to the "host" company.

Gina Dweck and Albert Nasser were, respectively, the CEO and Chairman of Kids International Corporation ("Kids"), a clothing distributor whose primary business came from providing non-branded clothing for major retailers' in-house brands. Nasser owned a controlling 52.5% interest in the corporation, while Dweck was left unsatisfied with a 30% interest. When Dweck failed to persuade Nasser to give her more equity, she took action.

With help from Kids' president, Kevin Taxin and Kids' CFO, Bruce Fines, Dweck founded and operated Success Apparel LLC ("Success") in 2001 and Premium Apparel Brands LLC ("Premium") in 2004, while remaining the CEO of Kids. Without Nasser's knowledge, Dweck operated these two companies from within Kids' own facilities, using Kids' employees, and transferred many of Kids' existing and potential clients to Success and Premium. Additionally, during this period Dweck charged \$466,948 in expenses to Kids, of which at least \$171,966 was personal. As Kids' CFO, Fines approved the expense reimbursements even though he knew they were for personal expenses.

In early 2005, Nasser finally became aware of Dweck's activities and Dweck stepped down as Kids' CEO. However, Dweck, Taxin, and Fine proceeded with their prior activities and went on to organize a mass departure of Kids' employees, taking Kids' documents and remaining clients with them. With no employees or customers, Kids' new management was left scrambling, resulting in the eventual failure of the business in 2008.

Dweck and Nasser ultimately brought competing claims that the other had breached their respective fiduciary duties, along with a number of tort claims. Nasser additionally brought third-party claims against Taxin and Fine for their part in Success and Premium. Dweck's claims against Nasser were based on payments that Kids made to a number of companies that Nasser held an interest in. These payments were part of Kids' elaborate tax-



avoidance scheme, but the court chose to leave questions regarding these acts to the Internal Revenue Service, which was performing a concurrent investigation of Kids' finances.

Corporate officers owe a "duty of loyalty" to their company which is "[a]t the core of the fiduciary duty . . . ." Fiduciaries must "act [with] good faith . . . to advance the interests of [their] beneficia[r]ies," and must not "misappropriat[e] assets entrusted to [their] management and supervision." Additionally, "the doctrine of corporate opportunity" provides restrictions on when corporate officers may personally pursue business opportunities:

[A] corporate officer . . . may not take a business opportunity for his own if: (1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation's line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his [or her] own, the corporate fiduciary will thereby be placed in a position inimicable to his duties to the corporation.

In deciding the case, the court found that each party violated their duty of loyalty to Kids, but the majority of the court's scorn was directed towards Dweck and Taxin's usurpation of Kids' business in violation of the doctrine of corporate opportunity. Dweck put forth a number of defenses to the doctrine, but each was rejected in turn.

Dweck asserted that Success and Premium dealt in branded clothing as opposed to Kids' focus on non-branded clothing, thereby putting the corporations into distinct lines of business. The court held that "the nature of the corporation's business should be broadly interpreted," and found that Kids' would have had no problem branching into branded clothing. This was bolstered by the fact that Dweck's parasite companies actually used Kids' own resources and contacts to develop this business, leading to the conclusion that Kids' would have been able to handle the business itself.

Dweck also argued that Nasser consented to the competing businesses, but the court found Dweck's testimony on this subject conflicted with her earlier statements and ultimately unpersuasive. Testimony by both Kids' corporate counsel and Taxin pointed to the fact that Dweck led Nasser to believe that the businesses would not compete, and it was only upon this foundation that Nasser acquiesced to the formation of Success and Premium.

Dweck's final defense was that the Kids stockholders' agreement contained a "free-for-all" clause which permitted competition with Kids. In the alternative, Dweck proposed that an operating agreement from a prior company, in which both Nasser and Dweck were officers, contained a free-for-all agreement which was still operative upon Kids. The court first found that Nasser had expressly rejected eight separate drafts of the Kids stockholders' agreement because of the inclusion of the free-for-all clause, leading Nasser to not sign a stockholders' agreement at all. Secondly, the court found that the prior operating agreement was at best ambiguous, and as such, "[the] construction given to [the agreement] by the acts

and conduct of the parties . . . is entitled to great weight . . .” Thus, Dweck’s repeated attempts to have Nasser agree to a new free-for-all provision in the Kids stockholders’ agreement went directly against her contention that Nasser was already bound by such a clause from the prior operating agreement.

This case should serve as a cautionary tale to corporate officers and their legal counsel when starting new businesses. Although the particular violation of the doctrine of corporate opportunity in *Dweck v. Nasser* was both obvious and flagrant, courts may nevertheless broadly interpret the line of business in which a corporation either currently engages or may possibly expand. Such broad interpretation may potentially ensnare a wide range of side-businesses created by corporate officers. Officers should steer clear of this potential problem by choosing to target unrelated markets or by obtaining written consent from their current corporations. At the very least, officers should ensure that their side-businesses are kept physically and financially separate from their original corporation, such that there is no appearance they are leaching off of the original corporation.

Finally, *Dweck v. Nasser* is also a testament to the need for proper oversight by corporations’ board of directors. If Nasser had provided more direct oversight as Chairman and properly supervised the corporation and its officers, it is unlikely that Dweck and other officers could have set up parasitic corporations from within Kids without being noticed for years.

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**A security agreement containing an unauthorized signature is enforceable in the absence of an “intent to defraud” if the principal ratified the agreement and the security interest is otherwise perfected.** *Regions Bank v. Bric Constructors, LLC*, No. M2010-01898-COA-R3-CV, 2011 Tenn. App. LEXIS 211, 2011 WL 6288033 (Tenn. Ct. App. Dec. 13, 2011).

By Michael Cottone

In an agency relationship, an unauthorized contract may become valid if the principal ratifies it. However, in the context of a secured transaction, issues may arise about whether the lender holds a perfected security interest if a signature on a security agreement is falsified. In the current economic climate, lenders’ ability to successfully secure debt has increased importance, affecting both the viability of lending institutions and the availability of credit to individuals and businesses. The Court of Appeals of Tennessee, in *Regions Bank v. Bric Constructors, LLC*, considered some of these issues and strengthened the ability of creditors to protect their security interests by holding that a falsified signature does not invalidate a ratified, perfected security interest, so long as the signature is not used to work a fraud.

In *Regions Bank v. Bric Constructors, LLC*, the sole member of Bric Constructors, LLC, Patricia McIntosh (“Ms. McIntosh”), was the only party authorized under the LLC’s Operating Agreement to enter into loans on behalf of the LLC. In March of 2007, Ms. McIntosh authorized an “Equipment Line of Credit Note” with Regions Bank (“Regions”) under which Regions provided the LLC with credit secured by the equipment purchased with the capital. The LLC received four advances from Regions under this note that Ms. McIntosh did not authorize. The LLC used the proceeds to purchase a truck, to provide a loan to Ms. McIntosh to purchase an automobile titled in the LLC’s name, and to obtain capital after it purchased an excavator and related equipment. Regions subsequently filed a UCC-1 financing statement showing the security interest in the excavator and the related equipment. Someone other than Ms. McIntosh signed her name to the relevant documents for all four advances, but the LLC made the required payments on the advances until Regions and the LLC restructured the debt.

In December of 2007, Ms. McIntosh signed a “Fixed Amount Note” and security agreement changing the terms of the previous debt and pledging the truck, the automobile, and the excavator (the “Collateral”) as collateral. On the same day, she also signed an “Accounts Receivable Note” and security agreement to obtain a line of credit secured by the LLC’s accounts receivable. Shortly thereafter, Regions made an advance under the Accounts Receivable Note to the LLC of \$400,000, but it obtained no documentation that Ms. McIntosh authorized this advance. Nonetheless, the LLC paid Regions on all its debts through late 2008, when it went into default, and Regions accelerated the loan and requested that the LLC surrender the Collateral.

In early 2009, Regions filed suit to recover the balance of the loan and the Collateral. At trial, Regions' bank officer admitted that he obtained notarization of the documents even though Ms. McIntosh did not sign her name to them. However, the trial court found that because the LLC "accepted the benefits of the notes and continued to make payments on the notes for several months without objection, [it] ratified any unauthorized advances." Consequently, the trial court held that the LLC was "estopped from contending that any of the signatures of Ms. McIntosh were unauthorized," and ruled in favor of Regions. The LLC appealed, arguing, among other things, that the trial court erred in holding that Regions had a perfected security interest in the Collateral.

While a principal is generally not "bound by a contract made by a person who is not his agent, nor by a contract made by an agent who acted beyond the scope of the agent's authority," an unauthorized contract may become enforceable by ratification. Ratification requires that a principal (1) accepts the benefit of the unauthorized agreement, (2) has "full knowledge of the facts," and (3) expresses or implies agreement to the contract. In the context of a secured transaction, a lender must hold a perfected security interest to gain access to collateral in the event of a default.

On appeal, the Court of Appeals of Tennessee held that Regions acquired a perfected security interest in the Collateral and that the unauthorized signature of Ms. McIntosh's name to various documents did not invalidate this interest. However, the court of appeals also held that the trial court did not properly apply the "full knowledge" standard in determining whether the LLC ratified the advance under the Accounts Receivable Note, and it remanded the case.

First, the court determined that Regions held a valid security interest in the Collateral because Ms. McIntosh signed an independent agreement pledging these items as collateral, not, as the trial court reasoned, because she ratified the initial advances for their purchase. In considering the advance under the Accounts Receivable Note, however, the court held that for purposes of determining whether a corporate entity ratified a contract, satisfaction of the "full knowledge" requirement occurs when the "corporate board" or the "officers who would have had power to enter into the transaction in question" have knowledge of the "material circumstances" of the transaction. Because the trial court did not apply the proper standard, determine "whether Ms. McIntosh authorized the \$400,000 advance," or whether she "ratified the advance by remaining silent" while having knowledge of the advance, the court of appeals remanded the case on this issue.

The court also considered whether the unauthorized signatures of Ms. McIntosh's name on the documents that initially created the security interest in the truck and the automobile caused the Region's interest in the items to become unenforceable, seemingly an issue of first impression in Tennessee. After noting that Regions met all the statutory requirements to perfect a lien on the vehicles, the court looked to the criminal definition of

“forgery” to determine whether an unauthorized signature would invalidate a security agreement. The court found that without “intent to defraud,” an unauthorized signature would not invalidate an “otherwise perfected security interest.” Not finding any evidence of such intent, the court held that Regions had a perfected security interest in the vehicles.

The LLC also argued that Regions did not have a perfected security interest in the excavator because the description in the security agreement for the Fixed Amount Note and the related financing statement did not “reasonably identify” the excavator. However, the court of appeals agreed with the trial court that the description of the excavator was sufficient. The court noted that, under the UCC, descriptions of collateral need not be “exact and detailed,” but must “sufficiently indicate” the collateral. According to the court, “the parties were not confused” about which collateral was covered, and the description of the excavator “was sufficient to put an interested party on notice” of Regions’ security interest. Consequently, the court held on this issue that Regions had a perfected security interest in the excavator.

*Regions Bank v. Bric Constructors, LLC* illustrates two main points. First, in the case of financial transactions, not ensuring proper authorization of agreements can lead to expensive litigation. While the court strengthened the ability of lenders to access collateral, this decision does not completely protect them. Determining whether an agreement has been ratified is a highly factual inquiry, so, if an agreement was not properly authorized, a dispute has the potential to survive summary judgment, increasing expenses substantially. Moreover, in the case of secured transactions, if the court decides that ratification did not occur, a lender would lose access to collateral in addition to bearing litigation costs. Attorneys should therefore advise their clients to implement measures to ensure the proper parties sign all agreements, especially in the case of secured transactions.

Second, in the case of describing collateral in a security agreement or financing statement, using serial numbers will reduce the possibility of litigation over whether collateral is sufficiently described. Although the decision holds that serial numbers are not required to sufficiently describe collateral, the description must “reasonably identify” the collateral. This soft standard may increase the possibility of litigation over whether the description of the collateral is sufficient. Consequently, attorneys should advise their clients to treat the use of serial numbers as a best practice when describing collateral in security agreements and financing statements. To the same end, attorneys should also advise their clients to implement processes to double or triple check the accuracy of serial numbers used in describing collateral.

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**CONTRACTS**

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**Tennessee courts will hold the acting representative of a company personally liable for the company's debt when the contract in dispute displays a clear intent by the parties to bind the representative as a personal guarantor to the loan.** *84 Lumber Co. v. Smith*, 356 S.W.3d 380 (Tenn. 2011).

By Michael Craig-Grubbs

The acting representative of a company applying for a commercial credit account may be personally bound as an individual guarantor of the loan if the contract clearly states that the parties intend the representative's signature to bind him both as a representative and as a personal guarantor. Tennessee courts employ ordinary methods of contract interpretation when determining whether the parties intended to bind the acting representative of a company as a personal guarantor to the loan.

In *84 Lumber Co. v. Smith*, the Tennessee Supreme Court concisely addressed this issue. The president of Allstates Building Systems ("Allstates"), R. Bryan Smith, signed an application for a commercial credit account with 84 Lumber Company ("84 Lumber"). Directly above the signature line where Smith signed his name, the application states in capital letters that:

BY SIGNING BELOW I HEREBY CERTIFY THAT I AM THE OWNER, GENERAL PARTNER OR PRESIDENT OF THE ABOVE BUSINESS, AND I DO UNCONDITIONALLY AND IRREVOCABLY PERSONALLY GUARANTEE THIS CREDIT ACCOUNT AND PAYMENTS OF ANY AND ALL AMOUNTS DUE BY THE ABOVE BUSINESS, AND THAT I HAVE READ ALL OF THE TERMS AND CONDITIONS . . . OF THIS APPLICATION. . . .

84 Lumber accepted the loan application and extended credit to Allstates. Allstates defaulted on the loan and 84 Lumber filed suit against both Allstates and Smith. Smith and 84 Lumber both filed motions for summary judgment, and the trial court granted 84 Lumber's motion after finding that Smith had agreed to be a personal guarantor of the loan. The Court of Appeals reversed the trial court on Smith's appeal, holding that Smith acted only in a representative capacity when he signed the agreement, and therefore he could not be held personally liable for the amount owed.

Representatives who sign contracts generally are not personally bound to the contract. Whether a representative will be held personally liable depends on whether the contract reveals a "clear intent" to bind him. Therefore, if the contract does not specifically bind the representative as a guarantor, courts will presume that the parties did not intend to

hold the representative personally liable. Courts apply the ordinary meaning of the language contained within the four corners of the document to determine the intent of the parties.

The Tennessee Supreme Court in *84 Lumber* found that the “clear and unambiguous language” of the credit application left no room for questioning the intent of the parties. On appeal, the Court reversed the Court of Appeals and held that Smith’s signature personally bound him as a guarantor of the loan as well as the representative of Allstates. The Court parsed the application’s language quoted above, which begins by identifying Smith as the representative of Allstates, observing that “[a] non-natural entity can act only through the authority of a natural person” and the agreement appropriately delegated this representative authority to Allstates’s president.

The Court next highlighted the distinction contained in the contract between Smith’s role as the acting representative of Allstates and his agreeing to “unconditionally and irrevocably personally guarantee this credit account.” Applying the “ordinary meaning” of the language of this clause, the Court found that the only interpretation was that the parties intended for the representative signing the contract to also be personally bound as a guarantor of the loan. The Court concluded its concise analysis by reiterating the law’s assumption “that an individual who signs a contract is presumed to have read the contract and is bound by its terms” without mentioning the agreement’s clause to that effect or whether Smith made any claims of not having read or understood the terms of the contract. Because the law presumes all parties have read and understood a contract, this case did not turn on the inclusion or omission of such language in the contract itself.

For transactional lawyers in Tennessee, *84 Lumber* reinforces two well-established principles of contract law: 1) the ordinary meaning of the language contained in the contract itself forms the basis of determining the parties’ intentions, and 2) the law presumes that the parties have all read the contract and agree to be bound by its terms. In this case, Smith signed a contract that explicitly stated his agreement to personally guarantee the loan in addition to his accepting the loan as the representative of Allstates. From the standpoint of *84 Lumber*, this case demonstrates the effectiveness of a well-drafted and unambiguous contract, and for those representing clients similar to Smith, this case highlights the importance of securing the most favorable terms possible before entering into an agreement. Doing so will likely avoid results similar to this case and ensure that clients fully understand the implications of the terms to which they are agreeing. Ultimately, in this time of economic uncertainty, *84 Lumber* provides some measure of stability by reaffirming the sanctity of the written contract and the legal obligation of the parties to honor its terms or pay for its breach.

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**A contractor has an implied duty under contract to perform skillfully, carefully, diligently, and in a workmanlike manner and where that contract does not release the contractor from his duties under the contract, the contractor is liable for work delegated to a subcontractor.** *Fed. Ins. Co. v. Winters Roofing Co.*, 354 S.W.3d 287 (Tenn. 2011).

By Alex Williams

At issue in *Fed. Ins. Co. v. Winters*, is whether a contractor has an implied duty under contract to perform services “carefully, skillfully, diligently, and in a workmanlike manner,” and whether that contractual duty is delegable to subcontractors. The Supreme Court of Tennessee (“the Court”) held that a contractor’s implied duty to perform in a skillful, careful, diligent, and workmanlike manner is not delegable to a subcontractor.

The owners of a home hired Winters Roofing Co. (“the defendant”) to install a new roof on their home. The two parties entered into an oral agreement. The defendant delegated the installation of the roof to a subcontractor. A few months after the work was completed, the owners noticed that the roof had developed leaks. The defendant agreed to fix the leaks and again delegated the repair work to another subcontractor. The contract between the defendant and the subcontractor stated that “[a]ny and all work will be the responsibility of [the subcontractor],” and that “[a]ny and all leaks/damages caused by work performed ... will be [the subcontractors] responsibility to repair or replace.”

A fire broke out shortly after the second subcontractor finished the repair work because an open flame was used during the installation of a drain cover. Neither the contractor nor the subcontractor carried insurance. The owners’ property insurer, Federal Insurance, Co., held subrogation rights after paying for the resulting fire damage and brought this action against the defendant.

Federal Insurance claimed that the defendant was liable for the fire damage claim because the owners’ had not released the defendant from his contractual duties, duties that included an implied duty to install the roof “skillfully, carefully, diligently, and in a workmanlike manner.” The defendant denied liability and moved for summary judgment on the grounds that it had not breached an express provision of the contract and that it was not liable for work that it had subcontracted to an independent contractor. The trial court granted the defendant’s motion for summary judgment, but the Court of Appeals reversed, holding that summary judgment was not appropriate because the defendant had a “non-delegable duty to see that the work he was contractually obligated to perform was done in a careful, skillful, and workmanlike manner.”

A general rule exists in Tennessee for service contracts which implies an obligation to perform services “skillfully, carefully, diligently, and in a workmanlike manner” even in the absence of an express provision. The weight of authority in Tennessee and other



jurisdictions recognizes this duty, the breach of which constitutes a breach of contract. Generally, such contractual duties are delegable; however, the delegation of services does not, unless contractually provided otherwise, discharge the liability of the delegating party for breach of contract.

On appeal, the Tennessee Supreme Court held that the defendant had a duty to “skillfully, carefully, and diligently install and repair the [owners’] roof in a workmanlike manner,” because a valid contract existed between the defendant and the owner, and that the breach of the implied duty constitutes a breach of contract. The Court next addressed whether that implied duty could be delegated to a subcontractor.

Quoting the Supreme Court of Wisconsin in *Brooks v. Hayes*, the Court stated that “[t]he hornbook principle of contract law is that the delegation of the performance of a contract does not, unless the obligee agrees otherwise, discharge the liability of the delegating obligor ... for breach of contract.” The Court likewise adopted the reasoning of a Georgia Appellate Court in *Hudgins v. Bacon*, that “[i]t would be too easy for a builder-seller to avoid liability by hiring inexperienced crews, providing little or no supervision, and then claiming the culprit of any negligence was an independent contractor.” Therefore, the Court held that a contractor’s implied duty to perform in a skillful, careful, diligent, and workmanlike manner is not delegable to a subcontractor. The “delegation of the responsibility to perform the services did not release [the contractor] from liability” because, while the contractor lawfully delegated the services to a subcontractor, the contractor remained liable for duties under the contract because the contract with the owners did not expressly release the contractor of those duties.

The Court was clear in stating that the performance of service contracts can still be delegated, just that the delegation does not “relieve the contractor from the duties implicit in the original contract.” Additionally, because the contractor had contracted with the owner, the “rule immunizing a contractor from the acts of an independent subcontractor has no application to these separate contractual responsibilities.”

As *Federal Ins. v. Winters* illustrates, the practitioner in Tennessee must be mindful when drafting and negotiating contracts for service industries. The primary issue is that the practitioner must inform his clients that an implied duty exists to perform services “carefully, skillfully, diligently, and in a workmanlike manner,” and that this implied duty is nondelegable. As a result, practitioners must inform his clients that they will not be released from liability for a breach of that implied duty when performance is delegated to a subcontractor. In order to adequately protect their clients from liability, the practitioner should seek an express release in the original contract for the acts of a subcontractor. In order to provide further protection for their client’s interests, the practitioner should require that the subcontractor warrant that they are insured and provide indemnification to protect

the client. As a general rule, practitioners may also strongly suggest that contractor clients carry sufficient insurance for their services.

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**EMPLOYMENT**

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**Under the FLSA’s Salary-Basis Test, Employment Agreements Are No Longer the Relevant Starting Point; Salaried Employees Can Lose Exemption Status if the Employee Is Not Actually Paid.** *Orton v. Johnny’s Lunch Franchise, LLC*, 668 F.3d 843 (6th Cir. 2012).

By Ryan Franklin

The Fair Labor Standards Act (“FLSA”) requires employers to pay certain employees a minimum wage and to provide overtime compensation for employees who work over forty hours a week. However, workers employed in a “bona fide executive, administrative, or professional capacity” are exempt from these FLSA requirements. As a result, when an employee brings an action under the FLSA, employers may raise the affirmative defense that the employee is exempt. In *Orton v. Johnny’s Lunch Franchise*, the United States Court of Appeals for the Sixth Circuit held that in order for a salary-based employee to retain salaried-status under the “salary-basis test,” the employer must show that the employee actually “receive[d] . . . [a] predetermined amount” of salary or that the reduction or withholding of this amount was proper.

Appellant Orton served as the Vice President of Real Estate and Site Selection for Johnny’s Lunch Franchise (“JLF”), receiving a base annual salary of \$125,000. In 2008, JLF allegedly began having trouble meeting its payroll obligations. Orton alleged that in August 2008 JLF stopped paying him any wages although he continued working. On December 1, 2008, JLF formally laid off Orton along with the entire executive staff.

Subsequently, Orton filed suit against his employers, JLF and Anthony Calamunci (collectively “the Defendants”), under the FLSA, seeking damages for the lost wages he incurred between August and December 2008. The Defendants’ motion to dismiss was granted, and the district court found that Mr. Orton qualified as an exempt employee, meaning that he had no claim for backed wages under the FLSA. Orton appealed, challenging the district court’s application of the “salary-basis test.”

An employer asserting exemption as an affirmative defense has the burden of proving by “clear and affirmative evidence that the employee meets every requirement of an exemption.” Three “tests” must be satisfied for an executive, administrative, or professional employee to qualify as exempt: 1) a duties test; 2) a salary-level test; and 3) a salary-basis test. Accordingly, the salary-basis test was amended in 2004; the new version provides:

[a]n employee will be considered to be paid on a “salary basis” within the meaning of these regulations *if the employee regularly receives each pay period* on a weekly, or less frequent basis, a predetermined amount constituting all or part of the employee's compensation, which amount is not subject to

reduction because of variations in the quality or quantity of the work performed. Subject to the exceptions provided in paragraph (b) of this section, an exempt employee must receive the full salary for any week in which the employee performs any work without regard to the number of days or hours worked. Exempt employees need not be paid for any workweek in which they perform no work. An employee is not paid on a salary basis if deductions from the employee's predetermined compensation are made for absences occasioned by the employer or by the operating requirements of the business. If the employee is ready, willing and able to work, deductions may not be made for time when work is not available.

In sum, the regulation requires that an employer demonstrate that an employee “was paid: ‘(1) a predetermined amount, which (2) was not subject to reduction (3) based on quality or quantity of work performed.’” Thus, subject to the few exceptions, a salaried employee must be paid the predetermined amount if they perform any work. Improper reductions in salary can render a salary-based employee non-exempt if the facts show that “the employer did not intend to pay employees on a salary basis.”

On appeal, the Sixth Circuit reversed and remanded the district court’s decision to dismiss the complaint, finding that the lower court erred on two grounds. First, the district court failed to place the burden upon the Defendants to prove Orton’s exempt status. Secondly, the district court erred in their analysis of the “salary-basis test” by applying outdated law.

The Sixth Circuit pointed out that the district court did not even mention who had the burden of proving Orton was exempt. The district court concluded that Orton’s allegations did not suggest that he was no longer a salary-based employee. Thus, the district court applied the wrong pleading standard by focusing on the sufficiency of Orton’s complaint instead of placing the burden on the Defendants to demonstrate that Orton met all the requirements of exemption.

In regards to the salary-basis test, the Sixth Circuit determined that the district court applied the pre-2004 version, which states, “[a]n employee will be considered to be paid ‘on a salary basis’ within the meaning of the regulations *if under his employment agreement* he regularly receives each pay period . . . .” (emphasis added) As a result, the district court looked at Orton’s employment contract to determine if he was a salary-based employee. However, as previously stated, the new standard requires the court to look at the compensation actually received by the employee. Thus, the Defendants had the burden of proving that Orton actually received his wages for the alleged period, instead of simply relying on the employment contract. Next, if Orton did not, in fact, receive pay, then the Defendants would be required to show that their reduction of his salary was proper under the FLSA in order to retain the exemption. Because the Defendants did not meet their

burden of proof for either scenario, the Sixth Circuit found that the motion to dismiss was improperly granted.

*Orton v. Johnny's Lunch Franchise* clarified that the 2004 amendments to the “salary-basis test” require an employer to prove that they actually paid the wages due to a salary-based employee in order to meet the salary-basis test and, therefore, qualify for an exemption under the FLSA. As a result of this ruling, not even executive employees can be forced to work without receiving at least a minimum wage of some kind. Importantly, “[t]he regulation makes no exception for deductions in pay just because they were motivated by cash flow shortages.”

Furthermore, implicit in *Orton* is the fact that, even if an executive employee is willing to forego compensation for the good of the company when cash flow problems arise, an employer may not forego payment of wages because an employee’s FLSA rights cannot be waived. Additionally, an employer cannot simply demand that the employee stay home without pay in the face of cash-flow problems because “[a]n employee is not paid on a salary basis if deductions from the employee's predetermined compensation are made for absences occasioned by the employer or by the operating requirements of the business.” However, the *Orton* court suggests that businesses with these problems are not entirely without recourse; employers are not precluded from renegotiating, in good faith, lower salaries for such employees because the “predetermined amount” does not have to remain constant throughout the employment.

Therefore, if possible, restructuring the contracts of salaried employees will allow the employer to reduce their payment obligations without losing the exemption through “improper reductions.” Nevertheless, if the amount is reduced too much, then the “salary-level test” comes into play. Thus, especially considering the current state of the economy, business owners and their attorneys should be aware that if cash-flow issues arise that lead to payroll problems, caution must be taken to preserve the executive exemption of the FLSA.

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**REAL ESTATE**

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**Sporadic and non-pervasive violations of a restrictive covenant barring commercial use of residential property do not void restrictive covenants.** *Kerney v. Endres*, No. E2010-02217-COA-R3CV, 2011 WL 5331690 (Tenn. Ct. App. Nov. 7, 2011).

By Carter Lawrence

Restrictive covenants prohibiting the commercial use of residential property are not nullified by infrequent and limited violations. Furthermore, commercial activity that does not undermine the purpose of the restrictive covenant by altering the neighborhood's character is not the type of commercial activity barred by the restrictive covenant. The measure of commercial activity is not the size of a business, but its impact on the community in which it operates. Finally, although the law remains unsettled, it is likely that Internet-based businesses operated from homes located in neighborhoods governed by restrictive covenants will not run afoul of the covenant unless the business impacts the neighborhood's character.

The chief issue in *Kerney v. Endres* was whether the mere existence of a business in a neighborhood could nullify a restrictive covenant barring commercial activity on residential property. Plaintiffs Cassandra and Eric Kerney ("Plaintiffs") sued defendants Susan and Gary Endres ("Defendants"), alleging that Defendants were violating the neighborhood's restrictive covenant by operating a beauty salon in their home. Evidence at trial established that, in addition to Defendants' salon, several other businesses also operated in the neighborhood. The trial court held that Defendants were not in violation of the restrictive covenant. On appeal, the Tennessee Court of Appeals found that Defendants had violated the restrictive covenant, and remanded the case for determination of whether the restrictive covenant remained in effect.

On remand, the trial court held that the presence of several businesses within the neighborhood revealed that the restrictive covenant was no longer valid. The trial court found that the restrictive covenant was nullified by the neighborhood's abandonment of the covenant—rejection of the restrictive covenant through alteration of the neighborhood's character by the influx of businesses. Additionally, the trial court held that Plaintiffs violated the restrictive covenant by checking on their manufacturing business from their home computer.

The chief issue on appeal was whether the trial court erred in holding that the restrictive covenant was unenforceable due to community abandonment. Because sporadic and non-pervasive violations are not sufficient to establish community abandonment, the Court of Appeals held that there must be evidence of violations that undermine the purpose of the restrictive covenant by fundamentally altering the character of the neighborhood.

Whether the character of the neighborhood is altered is a question of fact determined by an affirmative answer to the following question: are the covenant violations so pervasive that enforcement of the covenant would impair the value of burdened lot without benefitting the adjoining lots?

In *Kerney*, although several businesses were located in the neighborhood, the restrictive covenant remained valid because the businesses' presence did not alter the neighborhood. First, three of the six identified businesses were only occasionally located within the neighborhood. Additionally, two businesses involved no more than their owners parking their vehicles at their respective homes and the third business operated for only eight weeks out of the year. Consequently, the Court of Appeals found that these three businesses had little impact on the neighborhood. Second, two of the other six identified businesses ceased to exist long before Plaintiffs moved into the neighborhood. The effect of these businesses was too sporadic to affect the nature of the community. Because there was only one sustained and pervasive violation of the restrictive covenant—the Defendants' beauty salon—the covenant was not abandoned.

A secondary issue on appeal was whether the trial court erred in holding that Plaintiffs' use of a home computer to check on their manufacturing business violated the restrictive covenant. Again, the Court of Appeals reversed the lower court's decision and held that Plaintiffs did not operate an Internet-based business from their home. The Court noted that Plaintiffs owned a manufacturing business located outside of the neighborhood and did not use their home computer to actively manage their business. Instead, Plaintiffs passively tracked inventory and accounts. To find a violation of a restrictive covenant through the passive management of a business from one's home would risk voiding all restrictive covenants in Tennessee. Wary of such a move, the Court held that Plaintiffs did not violate the restrictive covenant by checking on their business from their home computer.

As *Kerney* illustrates, the Tennessee Court of Appeals is unlikely to invalidate a restrictive covenant because of sporadic and non-pervasive violations of the covenant. Nevertheless, the determination that Plaintiffs' were not operating an Internet-based business left one issue unsettled: whether an Internet-based company may lawfully operate in a neighborhood controlled by a restrictive covenant. On one hand, it is reasonable to hold that operating an Internet-based auction company from a home violates restrictive covenants. Allowing such activity may, for example, result in delivery trucks frequently visiting the home and greatly increase traffic in the neighborhood. However, one can also imagine an Internet-based business that would probably not violate a restrictive covenant. Website designers might advertise, work, and bill without ever leaving their home. Because the *Kerney* holding demonstrates that the effect of a business matters more than its location, it is likely that future courts will look to a company's effect on the character of the neighborhood to determine whether it violates a restrictive covenant. Until that question is settled, attorneys would do well to advise clients operating Internet-based businesses to

avoid taking steps that might alter the character of the neighborhood such as avoiding home advertising, meeting with clients off-site rather than in-home, and consolidating shipping to reduce delivery truck traffic. Finally, and, perhaps most importantly, attorneys should consider advising clients wishing to run a business from their home to, as much as possible, remain on good terms with their neighbors.

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**SECURITIES**

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**The failure to make required disclosures under § 16(a) of the Securities Exchange Act of 1934 does not toll the § 16(b) two year statute of limitations on claims against insiders to divulge short-swing profits.** *Credit Suisse Secs. (USA) LLC v. Simmonds*, 132 S. Ct. 1414 (2012).

By Nathaniel Greene

In *Credit Suisse Secs. (USA) LLC v. Simmonds*, the United States Supreme Court addressed the applicable time period in which a shareholder or corporation could bring suit to force corporate insiders to pay back profits realized from short-term trading and to what extent that statute of limitations was subject to equitable tolling. Although the clear language provided in § 16(b) of the Securities Exchange Act of 1934 (the “Act”), as amended, requires a plaintiff to bring an action “within two years after the date the profit was realized,” questions remained as to whether the statute of limitations began to run before the filing of § 16(a) required disclosures of “short-swing” profits. The Supreme Court held that, despite the potential for “unscrupulous” insiders to delay filing past the two-year window to keep potential plaintiffs uninformed, failure to file § 16(a) disclosures should not extend the statute of limitations.

In *Simmonds*, Vanessa Simmonds (“Plaintiff”) brought over fifty actions against financial institutions that had underwritten several initial public offerings (“IPOs”) throughout the “late 1990’s and 2000” alleging that the institutions made short-swing profits through aftermarket sales after using various means to raise the aftermarket price of the securities above the IPO price. Plaintiff also claimed that the institutions and their insiders owned the requisite ten-percent share of the securities that triggered the reporting requirements under § 16(a) and that the parties failed to meet those requirements.

Plaintiff asserted that this failure to disclose, when viewed alongside the legislative goal in passing this portion of the Act, namely “curbing short-swing speculation by corporate insiders,” should allow for tolling of the statute of limitations. She claimed tolling should be permitted because § 16(a) disclosures “provide the information necessary to trigger § 16(b) enforcement.” It should be noted that, because Plaintiff filed her complaints in 2007, some of the alleged short-swing profits were realized well over a decade before the action was initiated.

Pursuant to § 16(b) of the Act, a security holder has a right of action against “the officers, directors, and certain beneficial owners of [a] corporation who realize any profits from the purchase and sale . . . of the corporation’s securities within any 6-month period.” Even if the short-swing profits are not a product of insider information, the corporate insiders face a strict liability standard that forces them to “disgorge” their profits after a

timely claim is filed under § 16(b). Furthermore, under § 16(a) of the Act, corporate insiders are required to divulge changes in their ownership interests on a document detailed in the Securities and Exchange Commission regulations.

In the case, the district court dismissed all of Plaintiff's actions. For a large number of the dismissals, the court pointed to the fact that the two-year statute of limitations had run "long before [Plaintiff] filed suit." However, the Court of Appeals for the Ninth Circuit, reversed, stating that the failure to file § 16(a) disclosures tolled the statute of limitations "regardless of whether the plaintiff knew or should have known of the conduct at issue." The Ninth Circuit explained that failure to toll the statute of limitations would allow unscrupulous corporate insiders to avoid § 16(b) lawsuits by acting to conceal necessary information from possible plaintiffs by simply failing to file § 16(a) reports. On appeal, in a unanimous 8-0 decision (with Chief Justice John Roberts not participating), the United States Supreme Court overturned the Ninth Circuit's decision and long-standing precedent, holding that the two-year statute of limitations provided in § 16(b) of the Act is not equitably tolled because of a shareholder's failure to make required disclosures under § 16(a). In support of its decision, the Court pointed both to the plain language of the statute and also to traditional requirements for equitable tolling.

When addressing the Ninth Circuit's decision, the Supreme Court explained that the lower court's decision was not supported by the language of the Act. The Court pointed out that, if Congress had really been concerned about potential insider abuses arising from the failure to file disclosures, it could have easily included language that "no such suit shall be brought more than two years after *the filing of a statement under subsection (a)(2)(C).*" However, the clear language of the Act calls for the statute of limitations to run when the profit is realized.

The Court then observed that, under traditional equitable tolling standards in cases regarding fraudulent concealment, the statute of limitations is only tolled until a litigant discovers or should have discovered the hidden facts that could form the basis of a claim. Furthermore, the plaintiff normally has to establish that she has been "actively pursuing" her rights. The Court points out that the Ninth Circuit's rule is wholly separated from these established principles because the failure to disclose tolls the statute of limitations regardless of if or when a plaintiff actually receives information of the insider profits.

The Supreme Court then shifted to highlight the particular inequities under the facts of this case. The Court showed the first flaw in Plaintiff's argument by pointing out that, if the § 16(a) disclosures were really required for potential litigants to be informed enough to file suit, it is curious that the Plaintiff was able to file when the underwriters in the present case still had not made these disclosures. The Court also noted that the parties disputed whether underwriters are even required to make § 16(a) disclosures. Assuming that the underwriters are not so required (an issue the Court took no position on in the present case),

the tolling rule offered by the Plaintiff would subject the underwriters to potentially indefinite liability. The Court concluded that, if Congress had intended this type of potentially perpetual liability, it surely would have included language to that effect in the Act.

Based on the plain language of the statute and what it saw as the inequitable nature of the Ninth Circuit's rule when applied to defendants arguably not even required to make § 16(a) disclosures, the Supreme Court reversed and remanded the case. However, the Court did not go so far as to read § 16(b) as providing a two-year "statute of repose," whereby tolling would not be allowed even in cases meeting the requirements of traditional equitable-tolling principles. The Court explained that it was split 4-4 on that issue.

Based on the Supreme Court's analysis, attorneys can reassure clients that the failure to make § 16(a) required disclosures will not alone open them up to potential liability indefinitely. However, attorneys should still advise clients who must or think they might be required to make § 16(a) disclosures that potential liability still exists beyond the two-year statute of limitations, at least for the time being. Attorneys also must diligently monitor future developments of the Court to see if they will address whether the two-year time period should be read as a statute of repose. Furthermore, attorneys representing plaintiff corporations or shareholders should advise clients that it is in the client's best interest to file § 16(b) claims within the two-year window. Although it may be possible for a plaintiff to persuade a court to extend the deadline based on equitable-tolling principles, future action by the Court might rule out even that possibility.

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**TAX**

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**Filing a joint tax return does not convert separate property into marital property or property held in tenancy by the entirety.** *Estate of Hunt v. Hunt*, No. E2011-01563-COA-R3-CV, 2012 Tenn. App. LEXIS 172, 2012 WL 917158 (Tenn. Ct. App. Mar. 15, 2012).

By Steven Fulgham

In *Estate of Hunt v. Hunt*, a decedent's estate sought declaratory judgment against the decedent's widow, contending that she possessed tax refunds that belonged to the estate. On appeal, the Tennessee Court of Appeals held that filing a joint tax return does not convert separate property into marital property or property held in tenancy by the entirety.

In 2006, Noel C. Hunt, III developed cancer and undertook to reduce the size of his taxable estate. Specifically, Hunt wired IRA funds into a trust account which he then used money to make "an estimated tax payment toward [his] income tax liability." Further, Hunt and his wife entered into an antenuptial agreement, which provided that "[a]ll wages, earnings and accumulations resulting from personal services or any other source before and during the marriage shall remain the separate property of each party . . . ."

Hunt succumbed to cancer on May 15, 2008, and after his death, his wife filed a joint income tax return. Because she had very little income, Mrs. Hunt received refunds of \$552 and \$33,658 from the State of Tennessee and the federal government, respectively. The executor of Mr. Hunt's estate believed that the refunds belonged to Mr. Hunt and therefore demanded that Mrs. Hunt transfer the checks to the estate. When she refused, the executor filed suit, seeking a declaration concerning ownership of the funds. Hunt's estate argued that under the antenuptial agreement, the refunds derived from the decedent's "separate property," and in response, Mrs. Hunt asserted that the filing of joint returns converted the funds into marital property or, alternatively, property held in tenancy by the entirety. At trial, the court noted that "[t]he income clearly came from . . . separate property of the deceased" and recognized that "simply filing a tax return does not change the underlying nature of the funds"; the trial court nonetheless relied on "the equity of the situation" and awarded Mrs. Hunt nearly half of the money.

Other state courts have considered whether filing a joint tax return transmutes separate property into marital property. For instance, in *In re Estate of Carson*, a New Jersey case decided by the Probate Division of the Camden County Court, a decedent's widow filed a joint income tax return under I.R.C. § 6013(a), which provides that "[a] husband and wife may make a single return jointly of income taxes under subtitle A, even though one of the spouses has neither gross income nor deductions . . . ." Both the decedent and his widow reported income, but the couple's tax credits arose from funds withheld from the decedent's earnings, not the widow's. The parties asked the court to decide whether the refund check

belonged to the decedent's estate or the widow, who argued that she was liable for any underpayment and should therefore receive any overpayment. The court held that the joint return did not alter ownership of the refund, reasoning that Congress enacted I.R.C. § 6013(a) to equalize married persons' tax burdens, not taxpayers' ownership rights, and that neither the Internal Revenue Code nor the Treasury Regulations indicated that the widow should receive the funds.

Similarly, in *In re Estate of Trecker*, the Wisconsin Supreme Court considered whether a wife, who had signed an antenuptial agreement, should receive an income tax refund over her husband's estate. The court held that the joint return did not create substantive property rights, noting that filing jointly created joint and several liability for underpayment but did not create a joint and several right to the refund. Likewise, a few federal courts have reached the same conclusion, such as the United States Bankruptcy Court for the Southern District of Ohio in *In re Colbert* and the United States District Court for the District of Connecticut in *In re Boudreau*.

Tennessee courts have considered whether filing jointly transmutes separate property into property held in tenancy by the entirety. In Tennessee, creation of a tenancy by the entirety requires four unities: the unity of interest, the unity of title, the unity of time, and the unity of possession. In *In re Larish*, the United States Bankruptcy Court for the Middle District of Tennessee held that filing a joint return does not convert entitlement to a tax refund into a tenancy by the entirety. The court reasoned that creation of a tenancy by the entirety requires an instrument of conveyance and that a joint tax return lacks operative words of conveyance.

On appeal, the Tennessee Court of Appeals held that the refunds derived from Mr. Hunt's separate property and that filing jointly does not transmute separate property into marital property or property held in tenancy by the entirety. First, the court noted that "the trial court specifically held that '[t]he income [from the 2008 tax returns] clearly came from . . . separate property of the deceased'" and concluded that "there is no dispute as to this finding." Second, the court discussed the cases outlined above—*In re Estate of Carson*, *In re Estate of Trecker*, *In re Colbert*, and *In re Boudreau*—and noted that "the majority of our sister states" and "our federal courts" have held that joint filings do not create property rights. The court then adopted the majority rule, stating that "we hold that the filing of joint income tax returns does not create any property right in the jointly filing spouse as a matter of law." Finally, the court followed *In re Larish*, concluding that the joint returns did not convert the refunds into property held in tenancy by the entirety; the court reasoned that filing jointly does not change the underlying nature of the funds and that the joint returns lacked operative words of conveyance. The court also noted that "there can be no conveyance of any property right as the Decedent, being deceased, could not have formed the intent to transfer property rights in the tax refunds to his widow."

As a practical matter, *Estate of Hunt* means that filing a joint tax return does not convert separate property into marital property or property held in tenancy by the entirety. Thus, if a married couple enter into an antenuptial agreement, file a joint income tax return, and receive an income tax refund, the funds belong to the spouse who earned the income from which the refund derived, assuming that “income” falls within the antenuptial agreement’s definition of “separate property.”

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