CASE COMMENTARIES

BANKRUPTCY

Debtor may not obtain confirmation of a Chapter 11 cramdown plan that provides for the sale of collateral free and clear of the Creditor's lien, but does not permit the Creditor to credit-bid at the sale. *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012).

By Nathaniel Greene

In *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, the United States Supreme Court addressed whether a bankruptcy court could confirm a nonconsensual Chapter 11 plan ("cramdown plan") over the objection of a class of secured creditors when the plan called for a sale of the secured property free and clear of the lien without allowing the lienholder to credit-bid at the sale. Based on the language contained in 11 U.S.C. § 1129(b)(2)(A), which contains the requirements for cramdown plans, the Court was faced with determining whether a detailed provision on selling collateral free of liens, which requires the lienholder be allowed to credit-bid, could be overcome by a later, more general provision that only requires the plan provide "for the realization by such holders of the indubitable equivalent of such claims." The Supreme Court held that the clear language in § 1129(b)(2)(A)(ii) ("clause (ii)") requiring the lienholder be allowed to credit-bid could not be overridden by the residual provision, § 1129(b)(2)(A)(iii) ("clause (iii)").

In *RadLAX Gateway Hotel*, petitioners RadLAX Gateway Hotel, LLC and RadLAX Gateway Deck, LLC (collectively "debtors") obtained a loan in 2007 to purchase the Radisson Hotel at Los Angeles International Airport and to construct a parking structure on an adjacent lot. As part of the loan agreement, the lender received a lien on all of the debtor's assets to secure the loan, and Amalgamated Bank ("creditor") served as trustee on the loan.

In 2009, the debtors ran out of funds before completing the parking structure and unable to find additional funding sources, were forced to halt construction. Shortly thereafter, the debtors filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. The following year, the debtors submitted a Chapter 11 plan to the United States Bankruptcy Court for the Northern District of Illinois. The plan called for the debtors' assets to be sold to the highest bidder. However, under the proposed auction procedures, the creditor would not be allowed to credit-bid, which is "bid[ding] for the property using the debt it is owed to offset the purchase price." Because the creditor would not agree to the proposed plan, the debtors sought to confirm their plan under the cramdown provisions of §1129(b)(2)(A).

For a cramdown plan to be deemed "fair and equitable" with respect to the nonconsenting creditor's claim, the plan must meet one of the requirements of §1129(b)(2)(A). Clause (ii) deals specifically with the requirements for property being sold free and clear of a lien, and it requires that the sale be conducted "subject to section 363(k)" and that the creditor receive a lien on the proceeds of the sale. Section 363(k), in turn, provides that "unless the court for cause orders otherwise," the creditor may credit-bid at the sale, up to the amount of its claim. In the alternative, under clause (iii), the requirements of §1129(b)(2)(A) are met if the plan provides the secured creditor with the "indubitable equivalent" of its claim. In *RadLAX Gateway Hotel*, because the debtors' plan did not allow for credit-bidding as required by clause (ii), the debtors sought confirmation of their plan under clause (iii) arguing that providing the creditor with the cash generated from the auction was the "indubitable equivalent" of its secured claim.

The Bankruptcy Court for the Northern District of Illinois denied the debtors' cramdown plan, concluding that the proposed auction procedures did not comply with §1129(b)(2)(A)'s requirements. The Bankruptcy Court certified an appeal directly to the United States Court of Appeals for the Seventh Circuit. The Seventh Circuit accepted the certification and affirmed, holding that §1129(b)(2)(A) requires a lienholder be allowed to credit-bid when a debtor sells an encumbered asset free and clear of a lien.

On appeal, in a unanimous decision, the United States Supreme Court affirmed the Seventh Circuit's decision that a cramdown plan that does not allow for a lienholder to credit-bid when a debtor makes a sale free and clear of the lien does not comply with §1129(b)(2)(A)'s requirements. The Court pointed out that the debtors' reading of §1129(b)(2)(A) allowing their cramdown plan to be confirmed based on clause (iii) while clearly failing the requirements of clause (ii), which deals specifically with the type of sale called for in their cramdown plan, is "hyperliteral and contrary to common sense." In support of its decision, the Court relied mainly on the general/specific cannon of statutory interpretation that says that, in most circumstances, the specific governs the general. In a situation such as the one presented in *RadLAX Gateway Hotel* where a general authorization and a more limited and specific authorization exist side-by-side, the terms of the specific authorization must be met because to do otherwise would allow the specific provision to be swallowed by the general one.

Applying the general/specific cannon to §1129(b)(2)(A), the Court explains that "clause (ii) is a detailed provision that spells out the requirements for selling collateral free of liens, while clause (iii) is a broadly worded provision that says nothing about such a sale." Therefore, the general language of clause (iii), although broad enough to include the sale of property free and clear of a lien, does not apply to this type of sale because it is specifically dealt with in clause (ii).

The Court then turns to the debtors' arguments against this application of the general/specific cannon. The debtors claimed that §1129(b)(2)(A) should be read as three distinct options available for confirming a cramdown plan where clause (iii)'s "indubitable equivalent" is the general rule that must be met and clause (ii) just lays out procedures that will always establish an "indubitable equivalent" in a sale of collateral free and clear of a lien. Under the debtors' interpretation, satisfying any one of the three options should be enough for confirmation of their cramdown plan.

The Court rejected this argument explaining that, although there are indeed three distinct options, the types of sale limits which clause applies. Rather than clause (iii) being a general safeguard provision applicable to every circumstance, the Court concluded clause (iii) is best read as a catch all provision that only applies to sales not addressed by the other two options. Because clause (ii) addresses debtors seeking to sell their property free of liens, the Court explained in that type of sale only the requirements of clause (ii) must be met and attempting to provide an "indubitable equivalent" under clause (iii) will not suffice. The Court concluded its analysis by explaining that *RadLAX Gateway Hotel* was an easy case because §1129(b)(2)(A) clearly proscribes the confirmation of a cramdown plan if the plan calls for the sale of collateral free of the lien where the creditor is not allowed to credit-bid. As such, the Supreme Court affirmed the decision of the Seventh Circuit Court of Appeals.

Based on the ruling in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, a transactional attorney can reassure creditor clients that a cramdown plan that does not allow secured classes to credit-bid when the collateral is being sold free and clear of liens will not be approved by a bankruptcy court. With debtor clients, a transactional attorney should explain the necessity of including a provision that allows the secured classes to credit-bid in this type of transaction and should, more generally, instruct clients that an attempt to circumvent the terms of a specific authorization by arguing compliance with the terms of a more general authorization will likely not suffice.

BUSINESS ASSOCIATIONS

Under Georgia law, the business judgment rule acts as an affirmative defense to claims of ordinary negligence and breach of fiduciary duty against officers and directors of banks. *FDIC v. Briscoe*, No. 1:11-CV-02303-SCJ, 2012 U.S. Dist. LEXIS 153603 (N.D. Ga. 2012).

By Will Hooper

In the wake of the recent financial crisis, many banks around the country failed and were placed into the receivership of the Federal Deposit Insurance Corporation ("FDIC"), which subsequently assumed the power to bring actions on behalf the stakeholders of those failed banks to recoup the stakeholders' losses. Pursuant to that power, the FDIC has initiated lawsuits against numerous parties, including the former officers and directors of failed banks. The cases against former officers and directors, however, have met some resistance in the form of common law business judgment rules that generally bar courts from imposing liability on officers and directors of corporations for ordinary negligence in making business decisions. In *FDIC v. Briscoe*, the United States District Court for the Northern District of Georgia held that Georgia's business judgment rule could act as an affirmative defense that is sufficient to dismiss a complaint against the former offices and directors of a closed bank alleging ordinary negligence and breach of fiduciary duty based upon ordinary negligence.

In *FDIC v. Briscoe*, the FDIC, acting as receiver for Haven Trust Bank ("Haven"), brought suit against fifteen former officers and directors of Bank (collectively, "Defendants"). The Georgia Department of Banking closed Haven in December of 2008 and the FDIC was subsequently appointed as receiver for Bank. Pursuant to Federal law, the FDIC, as receiver, was granted all rights, powers, and privileges of Haven and its account holders, depositors, and stockholders. The FDIC sought to exercise those rights to recover from Defendants approximately $40 million in losses suffered by Haven in connection with actions allegedly taken by Defendants while acting in their capacity as directors and officers of Haven.

The FDIC's complaint listed three specific counts related to Defendants' alleged imprudent actions: negligence ("Count I"); breach of fiduciary duty ("Count II"); and (3) gross negligence ("Count III"). Specifically, the complaint alleged that Defendants granted imprudent commercial real estate loans, granted improper loans to insiders, and made imprudent dividend payments to Haven's parent corporation. Additionally, the FDIC alleged that Defendants violated various laws and regulations, including the Financial Institutions Reform, Recovery, and Enforcement Act.

In response, Defendants filed a Motion to Dismiss the Complaint. In the motion, Defendants argued that Georgia's business judgment rule protects bank officers and directors from personal liability for both ordinary negligence and breach of fiduciary duty based on ordinary negligence, thus warranting dismissal of Counts I and II. Further, Defendants argued that the complaint failed to plead a valid claim for gross negligence under Count III.

Georgia's business judgment rule was articulated in *Flexible Products Co. v. Ervast*, 643 S.E.2d 560 (Ga. Ct. App. 2007) and *Brock Build*, *LLC v. Black*, 686 SE.2d 425 (Ga. Ct. App. 2009), which described the rule as a policy of judicial restraint that presumes that officers and directors of corporations act in good faith in discharging their duties. The *Flexible Products* court specifically held that Georgia's business judgment rule protects officers and directors from liability for ordinary negligence. Additionally, the *Brock Built* decision stated that, under the rule, allegations amounting to mere negligence are insufficient as a matter of law. Thus, Georgia's business judgment rule generally shields officers and directors from liability for claims of ordinary negligence unless it is established that they engaged in fraud, bad faith, or an abuse of discretion.

The United States District Court for the Northern District of Georgia began its analysis in light of the recent Supreme Court of the United States decisions *Ashcroft v. Iqball*, 556 U.S. 662 (2009) and *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007), which allow a complaint to be dismissed if the complaint does not state sufficient factual allegations to make a claim for relief plausible. After reviewing prior federal case law, the court found that Georgia's business judgment rule should be considered as either an affirmative defense or a presumption. Further, the district court noted that the Eleventh Circuit has held that a complaint may be dismissed when the complaint's allegations clearly indicate the existence of an affirmative defense. Thus, the district court in this case found that it is proper to consider the business judgment rule in a motion to dismiss as long as the applicability of the rule appears on the face of the complaint and does not depend upon additional evidentiary facts or upon law other than Georgia's.

Interpreting the *Flexible Products* and *Brock Built* decisions, the district court held that claims for ordinary negligence are not viable in Georgia courts where the business judgment rule is applicable. Thus, the issue of whether Counts I and II should be dismissed would turn on whether the business judgment rule was applicable in in this case.

Although no prior Georgia case directly applied the business judgment rule in the banking context, the Georgia Supreme Court specifically refused to impose liability on bank directors for exercising poor judgment in making loans in *Mobley v. Russell*, 164 S.E. 190 (Ga. 1932). Considering *Mobley* and the application of the modern articulation of Georgia's business judgment rule, the district court concluded that the rule should indeed apply in the banking context. Thus, because the FDIC specifically sought to impose liability upon Defendants on the basis of ordinary negligence in Counts I and II of the complaint, the district court applied the business judgment rule and dismissed the counts of ordinary negligence and breach of fiduciary duty based upon ordinary negligence.

In regard to the allegations of gross negligence in Count III, Defendants did not seek dismissal under the business judgment rule, which would generally not be applicable to actions characterized as grossly negligent. Instead, Defendants argued that the complaint failed to meet the threshold of plausibility under the *Twombly* and *Iqball* standard, and further argued that the complaint was insufficiently specific as to the actions of each individual defendant.

Analyzing the allegations of the complaint in light of Georgia's standard for gross negligence, which is an absence of the degree of care which even a careless man would exercise under the circumstances, the court held that the complaint alleged sufficient facts from which it was plausible that a jury could reasonably conclude that Defendants were grossly negligent. However, because the *Twombley* and *Iqball* standard had led several Federal courts to require that the factual allegations of a complaint provide each individual defendant with adequate notice of the specific grounds upon which the claim rests, the district court chose to exercise its discretion to require the FDIC to replead the complaint with more specificity in regard to the alleged actions of each defendant. Thus, the motion to dismiss the FDIC's allegations of gross negligence was denied, although the FDIC was ordered to replead the allegations in Count III of the complaint.

As the FDIC continues to investigate failed banks, the number of lawsuits brought against former officers and directors of those banks will surely continue to grow. Attorneys should be aware that Georgia's business judgment rule acts as an affirmative defense to the imposition of personal liability upon directors and officers of corporations, including banks. Therefore, when such allegations are made, attorneys should be prepared to raise the business judgment rule at the earliest possible stage of litigation as a basis to dismiss the complaint.

Transactional attorneys should still consider, however, that the business judgment rule does not function as an impenetrable shield to liability: it will not protect officers and directors of banks from accusations of gross liability, gross negligence, or fraud. Thus, transactional attorneys should still advise such officers and directors that although courts will not likely scrutinize their normal business decisions in conducting their respective duties, they must still vigilantly exercise their statutorily imposed duty of care to their respective organizations in order to avoid personal liability.

Although Delaware courts will not impose "default" fiduciary duties under the state's Limited Liability Company Act, a manager or controlling member of an LLC may be contractually liable for breach of fiduciary duty pursuant to the entity's operating agreement. *Gatz Props., LLC v. Auriga Capital Corp.*, No. 148, 2012 Del. LEXIS 577 (Del. 2012).

By Taylor Wirth

Traditionally, a manager or controlling member of a Delaware limited liability company (LLC) owes no statutory fiduciary duty to the LLC or its members absent contracted-for language in its governing instrument. Accordingly, Delaware courts grant considerable deference to an LLC's operating agreement to set forth the fiduciary duties of its managers and controlling members. But for the first time in *Auriga Capital Corp. v. Gatz Props., LLC*, 40 A.3d 839, 865 (Del. Ch. 2012), Delaware's Court of Chancery explicitly ruled that the state's LLC Act *does* impose fiduciary duties of loyalty and care on managers and controlling members of an LLC when the entity's operating agreement is silent. However, in *Gatz Props., LLC v. Auriga Capital Corp.*, the Delaware Supreme Court again addressed whether the LLC Act imposes "default" fiduciary duties on a manager or controlling member of an LLC, ultimately rejecting the lower court's holding with respect to default statutory fiduciary duties.

Gatz Properties, LLC ("Gatz Properties") and Auriga Capital Corp. ("Auriga") formed Peconic Bay, LLC ("Peconic Bay") as an investment vehicle to develop and lease property owned by William Gatz ("Gatz") to be used as a public golf course. Pursuant to its operating agreement ("the LLC Agreement"), Gatz Properties, a Gatz-controlled entity, would act as Peconic Bay's manager and controlling member. Gatz held majority control of Peconic Bay and owned the requisite ownership interest necessary to effectuate certain transactions, including a long-term sublease of the golf course. In 1998, Peconic Bay entered a thirty-five-year sublease with a third-party operator, but as a result of an economic downturn, the property's operator was unable to generate a profit.

By 2007, and in anticipation of the sublease's early termination, Gatz commissioned an appraisal of the property, which was found to be worth significantly more if developed than if used as a golf course. As a result, Gatz sought to reacquire the sublease and Peconic Bay's other assets himself, and rejected the offer of an interested third-party buyer. Gatz offered the minority members, including Auriga, 25% of each member's capital account balance. Gatz's counsel informed the minority members that under the LLC Agreement, the majority members could vote out minority members "so long as a fair price [wa]s paid for the interests of the minority members." Based on a subsequent appraisal conducted with misleading and incomplete information, Peconic Bay was found to have no net positive value, thus, any offer above zero would be "more than fair."

An auction for the property was held, but Auriga alleged that it was inadequately marketed and that the auctioneer was not informed about the previous third-party bid. Despite an attempt to enjoin the auction, Gatz successfully bid on the property, acquiring it for $50,000 and assumption of Peconic Bay's debt. The LLC's minority members collectively received only $20,985. Auriga and the remaining minority members brought an action in Delaware's Chancery Court, which ruled that Gatz had breached "both his contractual and fiduciary duties to Peconic Bay's minority members."

The Supreme Court of Delaware affirmed the Chancery Court's decision, ruling that Gatz owed contracted-for fiduciary duties to Peconic Bay and its minority members. To this end, the Court considered the LLC Agreement's requirement that transactions with affiliates (i.e., Gatz) necessitated a two-thirds approval of the non-affiliated members (i.e., Auriga and the other minority members) if the terms were "less favorable to the Company than the terms and conditions of similar agreements which could be entered into with arms-length third parties . . . ." Accordingly, the Court interpreted the LLC Agreement as (contractually) adopting the fiduciary standard of entire fairness, mandating that the managers of an LLC obtain a "fair price" for its members in a conflicted transaction between the LLC and an affiliate.

In affirming the Chancery Court's decision, the Supreme Court reasoned that "because the extent to which the process leading to the self-dealing either replicated or deviated from the behavior one would expect in an arms-length deal bears importantly on price determination[,]" the lower court correctly considered both fair price *and* fair dealing in its analysis, though the LLC Agreement spoke only to the transaction's price.

A more contentious outcome of *Gatz*, however, was the Supreme Court's consideration of whether the Delaware Limited Liability Company Act imposes "default" fiduciary duties upon managers of an LLC in the absence of contractually controlling language. Vacating the lower court's *sua sponte* determination that the statute imposed such duties, the Court stated that the Court of Chancery's statutory interpretation "must be regarded as dictum without any prejudicial value."

In support of its holding, the Supreme Court proffered five rationales for rejecting the trial court's analysis. First, the LLC Agreement contractually set forth Peconic Bay's fiduciary duties. Second, the Court of Chancery should have refrained from interpreting the statute as neither Gatz Properties nor Auriga asked the trial court to decide the issue, and as the Court noted, such interpretation is dictum that remains undecided. Third, the Supreme Court is not bound by *stare decisis*; neither a lower court's ruling nor a practitioner's reliance prevent the Court from "judicially excis[ing]" the lower court's interpretation. Fourth, statutory ambiguity regarding the imposition of fiduciary duties on a manager or controlling member of an LLC is best left to the state's legislature. Finally, the issue of statutory interpretation was non-justiciable and thus beyond the Court of Chancery's purview.

As a result of this decision, practitioners in Delaware are again left in an uncertain position with regard to the fiduciary duties of an LLC's manager or controlling member when the entity's operating agreement is silent; the issue of whether such default duties exist remains "one about which reasonable minds could differ." The rationale underlying *Gatz*, however, provides two key considerations for the transactional attorney when drafting an operating agreement. First, fiduciary duties will only be imposed if the governing instrument expressly sets forth their existence and scope. Because *Gatz* was decided on a contractual rather than statutory basis, practitioners must be careful and explicit in their drafting. Second, to adhere to the Court's entire fairness standard, transactional attorneys should consider drafting objective criteria to conform to the Court's notions of fair price and fair dealing. To prevent the type of conflicted manager transaction at issue in *Gatz*, an operating agreement should mandate the use of an independent third-party to perform a valuation and prevent self-dealing through stricter voting requirements and procedural roadblocks.

CONTRACTS

An option contract requiring a seller's repurchase of real estate is valid where the agreement is supported by adequate consideration, the option is exercised within a reasonable time, and an inconsistent remedial agreement is not legally established. *Shearer v. McArthur*, No. M2012–00584–COA–R3–CV, 2012 Tenn. App. LEXIS 766, 2012 WL 5399221 (Tenn. App. Nov. 5, 2012).

By Samuel Lewis

In *Shearer v. McArthur*, the Tennessee Court of Appeals addressed the enforceability of an option contract requiring the seller's repurchase of real estate by examining (1) whether the contract was supported by adequate consideration, (2) whether the option was exercised within a reasonable time, and (3) whether the party exercising the option waived the right to do so by pursuing an inconsistent remedy. After finding in favor of the purchaser on these three questions, the Court of Appeals affirmed the decision of the trial court and upheld the enforceability of the contract against the seller.

Paul and Patricia Shearer (collectively "the Shearers") brought suit against Fred McArthur and Robert Young, vice-president for sales and marketing, and sales agent, respectively, of Rarity Communities, Inc. ("Rarity"). At a promotional sales event on December 9, 2006, the Shearers purchased a lakefront lot from Nickajack Shores Holdings, LLC ("Nickajack") for $441,000, with Rarity acting as broker. During negotiations in which the Shearers expressed their hesitancy to purchase the property, McArthur and Young agreed to buy the property back from the Shearers if they later became dissatisfied with the purchase. To that end, the parties signed a written option agreement, separate and distinct from the lot purchase agreement, stating that McArthur and Young would repurchase the lot from the Shearers "at any time" for the original purchase price. The Shearers later maintained that they would not have purchased the lot without the existence of the separate option agreement.

In October 2008, the Shearers learned that the community marina Rarity planned to build in the lakefront development was to be constructed directly in front of the lot the Shearers had purchased in December 2006. The Shearers expressed their dissatisfaction to the president of Rarity, Michael Ross. Ross thereafter agreed to pay the Shearers' interest payments on the lot until he could afford to repurchase the lot itself. However, Ross and the Shearers did not make a written agreement for the repurchase. By the summer of 2009, Ross had made some 22 payments to the Shearers totaling approximately $91,000. Ross' financial situation, resulting from the decline of the real estate market, prevented him from making any further payments to the Shearers.

In January 2010, the Shearers attempted to exercise the option for McArthur and Young to repurchase the property. McArthur and Young subsequently denied having agreed to repurchase the lot. The Shearers initiated the lawsuit against McArthur and Young in the Chancery Court for Marion County in February 2010. A bench trial was held in September 2011, and, in March 2012, the court entered judgment in favor of the Shearers, finding the option agreement to be enforceable as written. McArthur alone appealed the decision of the trial court.

Tennessee law presumes that contracts made in writing are supported by adequate consideration, and the burden to overcome that presumption falls upon the party asserting the absence of consideration. Consideration exists where a promisee does something she has no legal obligation to do, or refrains from doing something that she has a legal right to do. Further, unless a particular time for performance is specified within a contract, courts will apply a reasonableness standard to the agreement. The statute of limitations for bringing contract actions in Tennessee is six years. In order to preclude a claim brought within that statutory period, a defendant must show gross laches consisting of an unreasonable and inexcusable delay in filing the action, a loss of evidence, and prejudice to the defendant. Finally, the election of remedies doctrine prevents a plaintiff from pursuing multiple remedies that are so inconsistent with one another that the pursuit of one necessarily negates the others.

On appeal, the Tennessee Court of Appeals found that the option agreement for McArthur and Young to repurchase the property from the Shearers was supported by adequate consideration, was exercised within a reasonable time, and was not waived by the Shearers' pursuit of an inconsistent remedy. As to the issue of consideration, the court found that the Shearers' purchase of the lot, resulting in commissions for McArthur and Young, was adequate consideration for the option agreement. In doing so, the court rejected McArthur's argument that a provision contained in the lot purchase agreement, stating that no other inducements to purchase had been made, invalidated the option agreement. The court reasoned that the provision applied only to the lot purchase agreement between the Shearers and Nickajack, and thus did not apply to the separate option agreement between the Shearers and McArthur and Young.

As to the reasonableness of the time it took for the Shearers to exercise the option, the court first noted that the agreement stated the Shearers could do so "at any time." Nevertheless, the court found that the Shearers had sought to exercise the option within a reasonable time. The court agreed with the trial court in finding that the unforeseen relocation of the marina, as well as Ross' attempt and failure to repurchase the lot, made the Shearers' delay in exercising the option reasonable.

Finally, as to the issue of inconsistent remedies, the court again agreed with the trial court and found that the Shearers did not elect remedies so as to waive the right to exercise the option. Specifically, the court found that Ross' agreement to make interest payments and ultimately repurchase the property did not constitute a legally enforceable remedy. Not only was there no written contract between Ross and the Shearers, but Ross was making the payments from multiple bank accounts, different from those of Rarity, and had only told the Shearers that he would "do what he could" to remedy the situation. As such, the court agreed with the trial court that no meeting of the minds occurred between Ross and the Shearers, and thus the agreement between them was not an enforceable contract.

This case demonstrates that Tennessee courts will uphold option contracts requiring sellers to repurchase property, even if such agreements are made by sales representatives simply as inducements to purchase. As such, counsel for real estate developers and similar businesses will do well to advise their clients of the binding nature of these agreements. Despite the seemingly innocuous nature of inducement option contracts, sellers should maintain accurate records that detail the terms of the agreements as much as possible. As with all contracts, the failure to document key terms and provisions will often lead to expensive and uncertain litigation.

Conversely, for prospective purchasers of real estate, this case instructs that when confronted with option contracts to repurchase, buyers should require that the agreements be memorialized and, if possible, that they be executed by more than one representative of the sellers. Further, such agreements should set out clear notice requirements, as well as specific time ranges for exercise and performance. Counsel for purchasers of real estate should advise their clients, first and foremost, to be skeptical of inducement-type option agreements, and to proceed cautiously should they choose to enter into them. Broadly speaking, this case exemplifies how, in an uncertain and ever-changing real estate market, both sellers and purchasers will benefit by retaining accurate documentation of all negotiations and agreements.

A general contractor may be entitled to receive payment for additional work performed under an agreed-upon, oral modification of an original construction contract despite a lack of writing evidencing such modification. *Song & Song Corp. v. Fine Art Constr. Co., LLC*, No. W2011-01708-COA-R3-CV, 2012 Tenn. App. LEXIS 381 (Tenn. Ct. App. June 14, 2012).

By Natalie Lubbert

Unforeseeable conditions and strict time constraints have created a widely accepted practice within the construction industry in which parties to a construction contract agree to perform additional work outside the scope of the original contract. The cost of any additional work is typically addressed by adding specific, negotiated provisions into the original contract. However, disputes nonetheless arise, as contractors often must perform additional work before written contract modifications can be executed and subsequently seek payment for the additional work performed. Such was the situation in *Song & Song Corp. v. Fine Art Constr. Co., LLC*, a case in which the Tennessee Court of Appeals addressed whether agreed-upon, oral modifications to an original contract within the construction context are enforceable despite the lack of an additional, signed writing specifying such modifications; the Court agreed with the trial court, holding that such oral modifications are indeed enforceable notwithstanding any sort of written evidence of such modifications.

In *Song & Song Corp. v. Fine Art Constr. Co., LLC*, Jin Y. Song ("Mr. Song") hired a general contractor to construct a "shell" of a building in which the top floor of the building was completed but the first floor remained unfinished. Mr. Song then hired Tae Young Shin ("Ms. Shin") to complete the unfinished first floor. Shortly after Ms. Shin began working on the building, a Shelby County Code Enforcement Officer issued a stop work order on the site due to the lack of fire dampers inside the ductwork above the first-floor ceiling as required by the county. Ms. Shin informed Mr. Song about the stop work order and the lack of fire dampers, claiming that there was no way to discover this defect simply by looking at the ductwork and that the initial contractor should have installed them. As a result, Ms. Shin installed the fire dampers and obtained the necessary approval from the Code Enforcement Officer.

Thereafter, Mr. Song provided Ms. Shin with a written "Incentive Agreement," stating that he would pay her an additional $5,000 if she obtained a temporary use and occupancy permit for the first floor in order for tenants to move in. Ms. Shin completed the work and passed the requisite mechanical, electrical, and plumbing inspections, but was fired just prior to the deadline for obtaining the final inspection necessary to receive the permit. Ms. Shin subsequently billed Mr. Song for the Incentive Agreement and the additional work performed.

Mr. Song then filed suit in the Chancery Court for Shelby County (TN) against Ms. Shin, alleging, among other claims, that she breached the parties' contract, largely for initially failing to discover the lack of fire dampers. Ms. Shin countered-claimed that it was actually Mr. Song who breached the contract by failing to pay the remaining balance for installing the missing fire dampers, which was allegedly additional work. After hearing testimony from both Mr. Song and Ms. Shin concerning their agreement, the trial court favored Ms. Shin's argument, concluding that the lack of fire dampers was clearly a "concealed condition" as defined within their original contract, and that Ms. Shin's testimony further indicated that she immediately notified Mr. Song of the problem.

On appeal, the Tennessee Court of Appeals agreed with the trial court's well-reasoned analysis that Ms. Shin did not breach the parties' contract, holding that the oral modification of the original contract between Mr. Song and Ms. Shin did not negate Mr. Song's obligation to pay for the additional work performed by Ms. Shin, despite the lack of writing evidencing such modification. Not only did the original contract between the parties provide that the work would be completed in accordance with drawings and specifications provided by Mr. Song, but those drawings reflected that fire dampers had already been installed during the first phase of construction.

Furthermore, if Ms. Shin encountered a concealed condition that was not reasonably anticipated by her at the time of execution of the contract, she was required to bring it to the attention of Mr. Song, which she indisputably did in this case. If the concealed condition required additional work by Ms. Shin to address or correct it, then the contract price was to be adjusted pursuant to Paragraph 10 of the contract, which provided that unless otherwise requested by Mr. Song in writing, Ms. Shin was to use her judgment in accomplishing the work. Mr. Song made no such written request but did, however, discuss with Ms. Shin the need and importance for the additional work to be done, and Ms. Shin used her professional judgment in installing the missing fire dampers as the situation warranted.

Paragraph 10 further specified that if Mr. Song requested that work be accomplished in such a way that its cost would exceed the allowance for such work, Ms. Shin would only be obligated to comply with the request upon payment of the additional costs in advance. Here, the Court of Appeals determined that Ms. Shin simply chose not to exercise her right to demand payment in advance, but rather billed Mr. Song for the additional work as it was completed, as nothing in the contract prevented her from doing so.

Mr. Song, on the other hand, cited several other paragraphs within the contract which he contended entitled him to relief. Providing the bulk of his argument, Mr. Song argued that Paragraph 20 expressly stated that any modifications to the contract were to be indicated in a separate written instrument executed by both parties. As such, he could not now be required to pay any additional amounts, including the $5,000 as promised in the Incentive Agreement since Ms. Shin never signed it. The Court of Appeals, however, determined that the concealed condition paragraph along with other provisions clearly addressed the situation in which additional work was to be performed and provided that the contract price would be increased accordingly. Citing and affirming extensive Tennessee case law, the Court held that even if the additional work and the Incentive Agreement were characterized as modifications to the original contract, they were nonetheless enforceable because both parties clearly agreed to them, despite the lack of an additional writing signed by both parties. Thus, those agreements were valid and enforceable, and Mr. Song could not avoid his obligations thereunder.

The ruling in this case has significant implications for transactional attorneys, particularly within the construction context. Such attorneys should be aware that while contract norms call for contract modifications to be executed via written, signed amendments, such is largely contrary to the norms of construction contracts. These industry-wide norms provide for an easier, more flexible means for contractors to fulfill their work obligations given the constantly-changing conditions and strict time constraints they typically work under. Thus, it becomes vitally important for transactional attorneys working in this context to not only inform their clients of their duties and obligations under the contract, but also to remind them that they may remain liable for any oral modifications of the original contract. Transactional attorneys should further urge their clients to see to it that all modifications are put in writing and signed by all necessary parties in order to ensure that all parties are in agreement with regard to all aspects of the modification, especially when additional costs are involved. Such will decrease superfluous litigation in which a property developer, like Mr. Song, is hoping to find a loophole to avoid his obligations.

INTELLECTUAL PROPERTY

The Bayh-Dole Act does not automatically convey title in a patent to a federal contractor in a federally funded project unless the contractor elects to retain title. *Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc.*, 131 S. Ct. 2188 (2011).

By Devon Holbrook

The basic tenet of patent law is that the rights in an invention belong to the inventor. However, in *Board of Trustees of the Leland Stanford Junior University v. Robert Molecular Systems, Inc.,* a question arose as to whether the University and Small Business Patent Procedures Act of 1980, more commonly known as the Bayh-Dole Act, overrides this basic tenet and automatically vests title to federally funded inventions in federal contractors. The Supreme Court of the United States held that the Bayh-Dole Act does not automatically confer title to federally funded inventions in federal contractors or permit contractors to unilaterally take title to such inventions.

Congress enacted the Bayh-Dole Act in 1980 to "promote utilization of inventions arising from federally funded research," "promote collaboration between commercial concerns and nonprofit organizations," and "ensure that the Government obtains sufficient rights in federally supported inventions." The Bayh-Dole Act achieves these aims by allocating rights in federally funded inventions between the federal government and federal contractors. Specifically, the Bayh-Dole Act allows contractors to retain title to any federally funded invention but does not guarantee title.

In 1985, a California-based research company called Cetus began developing research on methods for quantifying the blood-borne levels of human immunodeficiency virus ("HIV"), which causes acquired immune deficiency syndrome ("AIDS"). Cetus succeeded in developing a Nobel Prize winning technique known as the polymerase chain reaction ("PCR"), which allows billions of copies of DNA sequences to be made from a small initial blood sample.

In1988, Cetus began a collaboration with the scientists at Stanford University's Department of Infectious Diseases, testing the efficiency of new AIDS drugs. Around this time, Dr. Mark Holodniy joined Stanford as a research fellow in the department. As part of his new position, Dr. Holodniy signed a Copyright and Patent Agreement ("CPA") stating that he "*agree[d] to assign*" to Stanford "his right, title, and interest in inventions resulting from his employment at the University." Dr. Holodniy's research involved developing an improved method for quantifying HIV levels in a patient's blood samples using PCR. Because of his unfamiliarity with PCR, Dr. Holodniy's supervisor arranged for him to conduct research at Cetus. Cetus required that Dr. Holodniy sign a Visitor's Confidentiality Agreement ("VCA") in order to gain access to Cetus. The agreement provided that Dr.

Holodniy "*will assign and do[es] hereby assign*" to Cetus his "right, title and interest in each of the ideas, inventions and improvements" made "as a consequence of [his] access" to Cetus.

During his time at Cetus, Dr. Holodniy worked with Cetus employees to develop a PCR-based procedure for calculating the amount of HIV in a patient's blood. This technique allowed doctors to determine whether a patient was benefiting from HIV therapy. Dr. Holodniy returned to Stanford and, along with other University employees, spent the next several years refining the HIV measurement technique. During this period, Stanford obtained several written assignments of rights from the Stanford employees involved in this project and filed several related patent applications, ultimately obtaining three patents related to the HIV measurement process.

In 1991, Roche Molecular Systems ("Roche") acquired Cetus's PCR-related assets, including the rights to the VCA signed by Dr. Holodniy. Roche conducted several clinical trials before commercializing the HIV measurement procedure; Roche's kits are now utilized in hospitals and AIDS clinics around the world.

The Board of Trustees of Stanford University ("Stanford") filed suit in 2005 in the United States District Court for the Northern District of California against Roche claiming that Roche's HIV test kits infringed Stanford's patents. Roche responded that the VCA signed by Dr. Holodniy with Cetus gave the company co-ownership of the PCR-based procedure; therefore, Stanford lacked standing to sue for patent infringement. Stanford countered that the university had superior rights under the Bayh-Dole Act, rendering any assignment by Dr. Holodniy ineffective. The district court ultimately held that the Bayh-Dole Act automatically voided an inventor's rights in federally funded inventions and vested title in the federal contractor unless the contractor declined to take title.

On appeal, the United States Court of Appeals for the Federal Circuit reversed concluding that, while the CPA signed with Stanford constituted a promise to assign the rights to future inventions, the VCA signed with Cetus actually assigned Dr. Holodniy's rights in the invention to Cetus. The court found this to be a valid transfer of title through contract law. Additionally, the court held that the Bayh-Dole Act does not automatically void an inventor's rights, depriving Stanford of standing to challenge Roche's patents in the procedure.

The Supreme Court of the United States granted certiorari to consider whether the Bayh-Dole Act automatically confers title to federally funded inventions in federal contractors or authorize contractors to unilaterally take title to such inventions. With a strong majority, the Supreme Court agreed with the reasoning of the Federal Circuit and held that the Bayh-Dole Act does not automatically confer title in federal contractors.

Though the basic tenet of patent law is that the inventor maintains ownership interest in his or her invention, several legislative efforts have provided various means of conferring title to employers or other third parties. Pursuant to the Bayh-Dole Act, the federal government agency that grants federal funds for a research project receives from the contractor a "nonexclusive, nontransferable, irrevocable, paid-up license to practice." Some of the research conducted by Stanford was funded by the National Institute of Health; therefore, the research conducted by Stanford was subject to the provisions of the Bayh-Dole Act.

The Court found that the Bayh-Dole Act requires the federal contractor to meet several requirements in order to retain title to the federally funded invention. First, the contractor must disclose each invention to the relevant federal agency within a reasonable time. Next, the contractor must make a written election within two years after disclosure in which the contractor specifically opts to retain title in the invention. Finally, the contractor must file a patent application prior to any statutory bar date.

Most patent laws that pertain to title in the underlying invention specifically state that title automatically vests in the inventor or some third party. However, the Bayh-Dole Act provides that a federal contractor *may elect* to retain title in the underlying invention. Though Stanford required all employees, including Dr. Holodniy, to sign an agreement allegedly conveying title in the invention, the Court found that the CPA signed by Dr. Holodniy only agreed to convey title at a later date – not automatically like the VCA that Dr. Holodniy signed with Cetus.

In order to avoid a similar outcome as in *Roche Molecular Systems*, an employer must ensure the language of any employment agreement conveying title to the employer automatically transfers title to the employer instead of requiring the employee to convey title at a future date. Similar to the VCA signed with Cetus, a phrase such as "will and hereby does assign" should encompass all present and future patents that may be developed. Additionally, a company should establish an employment policy that requires all new employees to sign an employment agreement containing this assignment provision before employment commences. This should avoid future litigation concerning which party has the superior claim to the title in the subject invention. Additionally, the federal contractors must understand that, though the federal government automatically receives an interest in a federally funded project, an employer *must elect* to obtain an interest in the inventor's patent. Without this election, the Bayh-Dole Act does not automatically convey title to the federal contractor.

PROPERTY

A premature foreclosure filing against an unsophisticated consumer where the mortgagee anticipated the transfer of the note and mortgage is a false representation under the Fair Debt Collection Practices Act. *Wallace v. Washington Mutual Bank*, No. 10-3694 (6th Cir. 2012).

By Devin P. Lyon

In *Whittiker v. Deutsche Bank Nat'l Trust Co.*, 605 F. Supp. 2d 914 (N.D. Ohio 2009), the Ohio district court held that a false representation of a mortgagee's name when making a foreclosure filing was not a violation of the Fair Debt Collection Practices Act (the "Act"). However, in light of the fallout from the recent subprime mortgage crisis and the notoriously poor lending standards exhibited by many financial institutions, the Sixth Circuit Court of Appeals reached a different conclusion. In *Wallace v. Washington Mutual Bank*, the Sixth Circuit held that a mortgagee cannot anticipate the transfer of a note and mortgage, making a premature foreclosure filing against an unsophisticated consumer a false representation under the Act.

In *Wallace v. Washington Mutual Bank*, Betty Wallace ("Wallace") bought a home in Ohio with a mortgage from Norwest Mortgage ("Norwest"). Norwest and Wells Fargo later merged, with Wells Fargo accepting Wallace's mortgage payments. In early 2008, Wells Fargo sent Wallace an inaccurate notice that she was delinquent on her mortgage payments (Wallace was current at that time). In August of 2008, Wells Fargo transferred the note and allegedly delinquent mortgage to Washington Mutual Bank ("WaMu"). However, in July of 2008, thirty-four days before the actual transfer of the mortgage, WaMu's attorneys, Lerner, Sampson, & Rothfuss ("LSR"), filed a foreclosure action against Wallace, which inaccurately stated that WaMu held the note and the mortgage. Wallace did not respond to the foreclosure notice and incurred a default judgment against her. Wallace claimed that LSR's inaccurate statements caused her confusion when attempting to determine which bank actually held her mortgage, preventing her from timely resolving her delinquency. Her home was scheduled for a foreclosure auction in December of 2008. Upon learning of the scheduled auction, Wallace contacted LSR to negotiate a payment schedule for the loan. Although Wallace was able to delay the sale by approximately two months, negotiations were ultimately unsuccessful, resulting in the sale of her home.

Wallace filed a complaint against LSR and the banks for a false claim of ownership under the Act and the Ohio Consumer Sales Practices Act. She additionally claimed that LSR's false statement caused her emotional distress. Wallace stated that her mortgage had not been transferred to WaMu at the time of the foreclosure filing, making LSR's foreclosure filing false, deceptive, and misleading. However, the Ohio district court dismissed Wallace's complaint under Rule 12(b)(6) of the Federal Rules of Civil Procedure for failing to state a claim upon which relief may be granted.

LSR argued, and the district court agreed, that Ohio law allowed a bank to file foreclosure documents in anticipation of the assignment of title, so long as the filing bank became the titleholder before the foreclosure became final. In the district court's view, even if LSR's statements regarding the bank's holding of Wallace's title were false, misleading, or deceptive when made, the statements were true when the actual foreclosure occurred. Therefore, the court upheld a common law gap-filling interpretation of the Act—which had been district court precedent for some time—that assesses an allegedly false, misleading, or deceptive claim regarding a mortgage foreclosure at the time the foreclosure occurs instead of when the statements were made.

On appeal, the Sixth Circuit Court of Appeals held that an inaccurate representation of the mortgagee's name was a false and materially misleading statement under the Act. The Sixth Circuit referenced the Act's reasonable, unsophisticated consumer standard under § 1692(e) (explained in *Harvey v. Great Seneca Fin. Corp.*) to state that a determination of a false, deceptive, or misleading statement hinges on whether "the 'least sophisticated consumer' would be misled by defendant's actions." The court reasoned that the Act was intended to protect against any false statements that would likely mislead or confuse unsophisticated consumers. Here, LSR's foreclosure filing was allegedly false when made and misled and confused Wallace, allowing the plaintiff's claim to proceed. Additionally, the court did not uphold the district court's interpretation that a claim for a false, misleading, or deceptive statement can be resolved through an analysis of the parties' standing to sue.

The Sixth Circuit's decision in *Wallace* demonstrates a change in the judicial interpretation of the Fair Debt Collection Practices Act and requires attorneys to alter their litigation strategy. Claims under the Act can no longer be so quickly and easily dismissed through a 12(b)(6) motion. Additionally, the Sixth Circuit's more stringent analysis of false claims in mortgage foreclosure actions is indicative of the increased scrutiny being placed on the mortgage market in light of the 2008 financial crisis. Transactional attorneys in Tennessee should exert more caution in litigating false claims regarding mortgages and brace for less favorable judicial interpretations in defending mortgage transactions with unsophisticated consumers. By analyzing claims through a lens that is sympathetic to consumers, attorneys will be more successful in preempting courts' shifting standards toward consumer protection.

SECURED TRANSACTIONS

A valid contractor's mechanic's lien takes priority over other liens if the date of visible commencement of operations occurred prior to the recording of the other liens. *Anchor Pipe Co. v. Sweeney-Bronze Development, LLC*, No. M2011-02248-COA-R3-CV, 2012 Tenn. App. LEXIS 541, 2012 WL 3144638 (Tenn. Ct. App. May 22, 2012).

By Sye Hickey

When reviewing a trial court's decision regarding the priority of multiple liens in a development dispute, an appellate court will consider a number of factors, including the validity of the contractor's license, the type of the development property in dispute, whether there was a contract regarding the priority of the liens, and the validity and notice regarding the attachment of each lien. In *Anchor Pipe Co. v. Sweeney-Bronze Development*, the Tennessee Court of Appeals reviewed the trial court's order granting summary judgment for the defendant. After a thorough assessment of the facts, the appellate court concluded that the trial court erroneously made multiple findings of law. The appellate court then overturned the lower court and granted summary judgment in favor of the plaintiffs.

In January of 2007, James Thigpen ("Thigpen"), president of Anchor Pipe Company, Inc. ("Anchor"), was approached by Jeffrey Bronze ("Bronze") about doing work on the development of a subdivision in Gallatin, Tennessee. During these discussions, Bronze was acting on behalf of JSC, LLC, the owner of the development property. After obtaining the necessary information, Anchor, which had a valid contractor's license with a monetary limit of $750,000, submitted a bid of around $3.5 million to Bronze. In the process of accepting the bid, Bronze emailed Thigpen and informed him that he was in the process of securing a bank loan. Bronze requested that Anchor sign a release to the bank, giving the bank first title position. Thigpen agreed to sign the release and Anchor subsequently began work on the property in February 2007.

In May 2007, JSC transferred the title of the property to Sweeney-Bronze Development, LLC ("SBD"). Trust One Bank, which had provided a construction loan to SBD, recorded a deed of trust on July 24, 2007. However, the grantor on this deed of trust was not SBD, but a different entity, Sweeney-Bronze Holdings ("SBH"). Sixteen months after the initial agreement, in June 2008, Bronze informed Anchor that he could no longer pay for the work, and Anchor stopped working. As of June 27, 2008, SBD had paid anchor over $650,000 for work on the project. On July 1, 2008, Anchor recorded a notice of lien against the property in the amount of $703,192.84. Four months later, in November 2008, a deed was recorded transferring title of the property from SBD to SBH. On the same day, the bank recorded an amended and restated deed of trust, once again listing SBH as the grantor of the deed.

On June 10, 2009, Anchor recorded an amended lien for a total claim of $625,864. One week later, Anchor filed an amended complaint in the Circuit Court for Sumner County, naming SBD, SBH, Bronze Construction, JSC, Bronze, Jeffrey Sweeney, JSC, and the bank as defendants. Anchor alleged breach of contract, unjust enrichment, and enforcement of lien, among other claims. Anchor sought a declaratory judgment that its lien took priority over the bank's deed of trust.

Anchor and the bank subsequently filed cross-motions for summary judgment, which were heard by the trial court in August 2011. After careful consideration, the trial court made two critical findings: first, that Anchor was not properly licensed for the project and could only recover for documented expenses; and second, that the January 2007 emails between Bronze and Thigpen constituted an agreement by Anchor to subordinate its lien to the bank. The trial court then concluded that the bank was entitled to summary judgment and dismissed Anchor's claims.

On appeal, the Tennessee Court of Appeals reversed and remanded. The appellate court first found that the trial court erred in its classification of an unlicensed contractor. Relying on the Tennessee Supreme Court's decision in *Helton v. Angelopolous*, the appellate court noted the difference between unlicensed contractors and contractors bidding above the monetary limit of their license. After a short policy discussion of the monetary limit, the appellate court found that despite exceeding the limit on its license, Anchor was still a licensed contractor. The court went even further, stating that even if Anchor were unlicensed, it would have retained its lien rights. In doing so, the appellate court examined the construction of Tennessee Code Annotated § 62-6-128 and determined that outside the context of single-family residential construction, the fact that a contractor is unlicensed does not result in the forfeiture of the contractor's lien.

After finding that Anchor had a valid license and had not forfeited its lien rights, the Tennessee Court of Appeals concluded that the January 2007 emails between Bronze and Thigpen were insufficient to constitute an agreement by the contractor to subordinate its lien to the bank. Relying on its own holding in *Jones v. Lemoyne-Owen Coll.*, the appellate court stated that an agreement to subordinate lien rights must satisfy the elements of a valid contract, and that an agreement to agree to something in the future is not generally enforceable. Therefore, because Anchor did not receive any consideration for an agreement to subordinate its rights, there was no mutual assent to definite terms between the parties. Thus, the court concluded, the agreement to subordinate rights was void and unenforceable.

Next, the Tennessee Court of Appeals took up the issue of whether the trial court should have granted summary judgment for Anchor. This inquiry primarily focused on the two deeds of trust filed by the bank. In examining the 2007 deed of trust, the court determined that because SBH and not SBD, the true owner of the property at the time, appeared as the grantor on the deed, the deed itself was void. Relying on its prior holding in

Levine v. March, the appellate court found that the 2007 deed failed to convey an interest in the property and that registration of the deed could not correct this defect. The court also dismissed the bank's argument that the 2007 deed was effective because SBH, the parent company of SBD, was acting as either an agent or in joint venture with SBD. The court concluded that nothing in the 2007 deed and nothing in the record supported these contentions.

Finally, the Tennessee Court of Appeals addressed the priority of Anchor's July 2008 lien and the bank's November 2008 deed of trust. In looking to Tenn. Code Ann. § 66-11-104(a) for guidance, the court pondered the question of whether the date of visible commencement of operations occurred prior to the bank's recording of the November 2008 deed. While it was undisputed that Anchor had built multiple permanent structures on the property prior to November 2008, the bank contended that the statute excluded Anchor's work because it related to the installation of drainage lines. After giving meaning to every word and phrase employed by the statute, the appellate court determined that the utility exclusion in the statute did not apply to the aboveground structures built by Anchor as part of the overall drainage system. Therefore, the appellate court concluded, Anchor's lien should take priority over the bank's lien. The court then remanded the case to the trial court with an instruction to grant summary judgment in favor of Anchor on the issue of lien priority.

The Tennessee Court of Appeals' decision in *Anchor Pipe Co.* provides straightforward legal significance. When examining a lien priority dispute on appeal, an appellate court will examine the validity of the contractor's license, the type of the development property in dispute, whether there was a contract regarding the priority of the liens, and the validity and notice regarding the attachment of each lien. Trial courts are encouraged to make similar inquiries; when done properly, the findings of a trial court will usually be upheld by appellate courts. Thus, Tennessee attorneys involved in lien priority disputes must be aware of the statues enacted by the Tennessee General Assembly. Additionally, in order to make the strongest possible argument, these attorneys should be cognizant of their clients' actions, and how those actions comply with the procedural requirements set forth by case law. Finally, Tennessee attorneys forced to litigate these disputes must have a fundamental knowledge of Tennessee's validity and notice requirements with respect to liens.

Under Tennessee precedent, a subsequent mortgagee is not a bona fide purchaser for value without notice until that mortgagee records its deed; thus, a first mortgagee has priority if it records before a subsequent purchaser without notice. *Equity Mortgage Funding, Inc. v. Haynes*, No. M2011-01717-COA-R3-CV 2012, Tenn. App. LEXIS 182, 2012 WL 982958 (Tenn. Ct. App. 2012).

By Andrew Hodgson

The general rule in Tennessee is that a senior mortgage has priority over other claims except as against a bona fide purchaser for value without notice of the senior mortgage. In *Equity Mortgage Funding, Inc. v. Haynes*, the Court of Appeals of Tennessee held that a grant of summary judgment in favor of a first mortgagee on the issue of priority was proper where the undisputed material facts establish (1) that the first mortgagee recorded its deed of trust prior to the second mortgagee and (2) that the first mortgagee negated an essential element of equitable estoppel. At issue was the priority between two deeds of trust when the following events occurred in order: the first mortgagee executed a deed of trust; then, the second mortgagee executed a deed of trust; then, the first mortgagee recorded its deed of trust; and then, the second mortgagee recorded its deed of trust. The Court, in deciding this case, limited the situations when the subsequent bona fide purchaser for value exception applies in a priority contest under the Tennessee recording statutes.

Joe Haynes sold a piece of commercial property (the "property") to Charles Jason Jones and Angela Felts (collectively the "Buyers") on August 7, 2008. Mr. Haynes financed $450,000 of the $500,000 purchase price of the Lebanon, Tennessee property. In return, the Buyers executed in favor of Mr. Haynes a promissory note listing an indebtedness of $450,000 and a deed of trust (the "Haynes deed of trust") listing the commercial property as security for the promissory note. Mr. Haynes decided to let the Buyers' closing agent record the warranty deed and deed of trust. On October 6, 2008, the Buyers' closing agent recorded the warranty deed with the Wilson County Register's Office, but the closing agent did not record the deed of trust.

In November 2008, the Buyers applied for a $250,000 loan on the property from Equity Mortgage Funding, Inc. ("EMF"). During the loan process, the Buyers represented to EMF that they did not purchase the property with borrowed funds and that there were no liens on the property. Acting on the Buyers' representations, EMF approved the loan after reviewing the August 2008 settlement statement and conducting a title search. At the November 26, 2008 loan closing, EMF agreed to lend $250,000 to the Buyers, and the Buyers executed in favor of EMF a deed of trust (the "EMF deed of trust") on the property. The title company shipped the EMF deed of trust to the register's office the next business day—December 1, 2008—via Federal Express. On December 2, 2008, the register's office received and recorded the EMF deed of trust.

Sometime between the August 7, 2008 closing and the December 2, 2008 recording of the EMF deed of trust, Mr. Haynes discovered that the closing agent did not record the Haynes deed of trust. Mr. Haynes took steps to reach the Buyers—contacting Mr. Jones and waiting in the parking lot at Mr. Jones' business. When Mr. Haynes finally spoke with Mr. Jones, Mr. Jones promised to record the deed of trust the next day. Mr. Jones did not record the deed of trust that next day. Thereafter, Mr. Haynes retained counsel. Mr. Haynes' counsel managed to record the Haynes deed of trust on December 1, 2008. Shortly afterward, Mr. Haynes' counsel informed Mr. Haynes that a title search showed the Haynes deed of trust recorded on December 1, 2008 and the EMF deed of trust recorded on December 2, 2008.

EMF filed a declaratory action against Mr. Haynes in March 2010 seeking a determination that the EMF deed of trust had priority over the Haynes deed of trust. In September 2010, the court allowed EMF to add Joseph M. Swanson as an additional plaintiff to the action because Mr. Swanson was the trustee of a charitable remainder trust that was the assignee of the EMF deed of trust. EMF moved for summary judgment in June 2011. Mr. Haynes responded to the motion for summary judgment with affidavits of himself and his counsel. The affidavits set forth facts that EMF did not dispute—including that the Haynes deed of trust was recorded on December 1, 2008.

The trial court denied EMF's motion for summary judgment on July 1, 2011 and *sua sponte* granted summary judgment for Mr. Haynes because there were no disputed material facts and EMF failed to establish any of the elements of equitable estoppel. Thus, the trial court found that the Haynes deed of trust had priority because it was recorded before the EMF deed of trust. EMF appealed arguing that the Haynes deed of trust, despite an earlier recording date, was null and void against EMF under Tenn. Code Ann. § 66-26-103 because EMF was a subsequent mortgagee for value without notice. In the alternative, EMF argued that equitable estoppel barred Mr. Haynes from asserting priority.

On appeal, the Court of Appeals of Tennessee held that the trial court did not err in granting summary judgment in favor of Mr. Haynes because precedent establishes that Mr. Haynes has priority under the recording statutes, and that Mr. Haynes negated essential elements of equitable estoppel. The appellate court noted that it had to decide *de novo* whether Mr. Haynes was entitled to judgment as a matter of law because there were no genuine issues of material fact. The general rule in Tennessee is that a senior mortgage has priority over other claims except as against a bona fide purchaser for value without notice of the senior mortgage.

EMF first argued that the Haynes deed of trust is null and void against its deed of trust due to the subsequent bona fide purchaser exception to the general rule. Tennessee precedent, however, holds that a party is not a bona fide purchaser until that party records its instrument. Thus, to become a bona fide purchaser and meet the exception to the general rule, a purchaser must be the first to record. Here, the undisputed facts establish that Mr. Haynes recorded before EMF. Therefore, the Haynes deed of trust has priority over the EMF deed of trust.

EMF's alternative argument was that the doctrine of equitable estoppel prevents Mr. Haynes from asserting priority. In Tennessee, the doctrine of equitable estoppel requires that the non-asserting party: (1) falsely represented or concealed material facts; (2) intended that the asserting party would act on the falsely represented or concealed material facts; and (3) had actual or constructive knowledge of the true facts. The non-asserting party must negate an essential element of equitable estoppel for the court to grant summary judgment to the non-asserting party.

Here, Mr. Haynes filed several affidavits, and EMF did not dispute any of the facts stated in those affidavits. The affidavits state that Mr. Haynes had no knowledge of the EMF deed of trust before he recorded the Haynes deed of trust on December 1, 2008, and that Mr. Haynes did not know that his deed of trust was unrecorded until December 1, 2008. Thus, the undisputed material facts affirmatively negated the first and second elements of equitable estoppel. The Court held that it was not an error to grant summary judgment in favor of Mr. Haynes.

Real estate practitioners, mortgage lenders, and property owners should take heed of the Court's result. The Court upheld Tennessee precedent and prevented a mortgagee from claiming bona fide purchaser for value status under Tenn. Code Ann. § 66-26-103 until after the mortgagee recorded its deed of trust. Thus, as the facts in this case demonstrate, a subsequent mortgagee that otherwise rests assured that it is a bona fide purchaser for value could lose out in a priority contest when a first mortgagee finally records after the subsequent mortgagee executes its deed of trust. The Court's decision adds uncertainty for a potential mortgagee between executing and recording a deed of trust—even where the potential mortgagee took all of the appropriate steps. Mortgage lenders and title insurance companies may wish to add provisions to deal with this infrequent yet costly situation. Despite the result in favor of the first mortgagee, the facts emphasize the risk involved with entrusting the recording of a deed of trust to a third party. Tennessee practitioners would be wise to conduct a title search soon after a closing to ensure that a deed of trust is on record to reduce the chance that a potential subsequent purchaser for value records and takes priority under Tenn. Code Ann. § 66-26-103.

TAX

The extended statute of limitations period under I.R.C. 6501(e)(1)(A) does not apply to gross income understatements of over twenty-five percent stemming from basis overstatements. *U.S. v. Home Concrete & Supply*, LLC, 132 S. Ct. 1836 (2012).

By Cade Morgan

At issue in *U.S. v. Home Concrete & Supply, LLC* was whether a three year or six year statute of limitations period for tax assessment in I.R.C. § 6501(e)(1)(A) applied to gross income understatements of over twenty-five percent due to basis overstatements. In *Home Concrete*, a taxpayer understated its gross income by more than twenty-five percent because the basis of property it sold was overstated, and the Internal Revenue Service (the "Service") assessed a tax on Home Concrete's understatement after the three-year period expired but before the six-year period closed. On appeal, the U.S. Supreme Court affirmed the Fourth Circuit's ruling that the six-year statute of limitations period for bringing a tax assessment does not apply to gross income understatements arising from basis overstatements.

The facts of the case were undisputed. During the 2000 tax year, the respondent, Home Concrete & Supply, LLC ("Home Concrete"), overstated its basis in property that it sold. Because of this overstated basis, Home Concrete understated its gross income from the sale of the property by more than 25% percent in its return for the 2000 taxable year. The Service assessed Home Concrete's deficiency after three years but within six years of Home Concrete filing its return pursuant to its interpretation of section 6501 of the Internal Revenue Code ("Code"), which sets forth the statute of limitation for tax deficiency claims. Home Concrete brought the assessment to trial and argued that the Service did not properly assert the tax within the proper statute of limitations period.

Under the applicable sections of the Code at the time of Home Concrete's return, the Service generally must assess taxpayer deficiencies within three years after the taxpayer files its return. However, if the taxpayer omits from his or her gross income for the taxable year "an amount properly includable . . . which is in excess of 25 percent of the amount of gross income stated in the return," the government may assess a tax on the omitted amount within six years after the taxpayer files the return. At trial, the U.S. Court of Appeals of the Fourth Circuit held that the six-year period for the Service's assessment did not apply to misstatements of gross income due to basis overstatements. The Government appealed the ruling, and the U.S. Supreme Court granted a writ of certiorari.

The Court held that the extended statute of limitations period under I.R.C. § 6501(e)(1)(A) does not apply to gross income misstatements arising from basis overstatements. The Court derived its holding from its ruling in *Colony, Inc. v. Commissioner*, where it interpreted similar statutory language in the 1939 version of the Code.

In *Colony*, the Court held that the time period extension for the Service to assess a tax on taxpayer deficiencies was not applicable to misstatements stemming from basis overstatements according to its interpretation of the 1939 version of the Code. While it recognized that basis overstatements could reduce gross income just as omission of taxable items, the *Colony* Court stated that reducing gross income due to overstated basis was not the same as omitting taxable items in gross income calculations. After making its determination, the *Colony* Court commented that its conclusion "was in harmony" with the then recently authorized language of Code section 6501(e)(1)(A).

The Court concluded that the *Colony* ruling was the determinative factor in its conclusion favoring Home Concrete. Because section 6501(a) is a "reenactment of the 1939 provision that *Colony* interpreted" and the "operative language is identical" to the 1939 provision, the Court concluded that it would be difficult to reinterpret the language of section 6501 without overruling *Colony*, therefore violating the principal of *stare decisis*.

The Court rejected the Government's assertion that changes to the provision in the 1954 reenactment warrant the Court to reinterpret the provision. The Government argued that additions to nearby Code sections imply that the base language of section 6501(a) includes misstatements stemming from basis overstatements, and therefore, the Court should reinterpret Code section 6501(e)(1)(A). The Court found that the Government's argument was "too fragile to bear the significant argumentative weight" to warrant the reinterpretation.

However, the Court focused more of its opinion to the Government's argument that Treasury Regulation § 301.6501(e)-1 (2001) overturns *Colony's* interpretation. Treasury Regulation § 301.6501e-1(a)(1)(iii) says, in part, that "an understated amount of income resulting from an overstatement of unrecovered cost or other basis constitutes an omission from gross income." Using the holding of *National Cable & Telecommunications Assn. v. Brand X*, the Government argued that a court's prior construction of a statute "trumps" an agency's construction of the same statute only if the court's "decision holds that its construction follows from the unambiguous terms of the statute . . . ." Following the *Brand X* holding, the Government contended that because *Colony* found the language of the 1954 reenactment was not "unambiguous," the Treasury's determination under Treasury Regulation § 301.6501(e)-1(a)(1)(iii) must control.

The Court determined that the Government's argument misplaced *Brand X*'s rationale for an agency's deference over previous judicial construction: agencies fill statutory gaps where a statute is ambiguous. In turn, the Court points to *Chevron, U.S.A., Inc. v. National Resources Defense Council, Inc.* stating "a court, employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect." The Court found that *Colony*'s interpretation of the statute addressed Congress's intention and, by *Colony*'s opinion, such interpretation of the 1939 Code section was "in harmony" with the language of Code section 6501. Thus, the Court determined there was no gap for the Treasury Department to fill in interpreting Code section 6501 by way of regulation section 301.6501(e)-1(a)(1)(iii), effectively overriding section 301.6501.

Two other opinions were filed with the plurality opinion. Justice Scalia's delivered a concurring opinion agreeing with the judgment that *Colony*'s interpretation controls but found that the opinion's determination regarding the applicability of Treasury Regulation § 301.6501(e)-1(a)(1)(iii) unnecessarily complicated. Justice Kennedy's dissenting opinion, which Justices Ginsburg, Sotomayor, and Kagan joined, found that the changes made to the statute in the 1954 reenactment "lead[ ] . . . to the permissible conclusion that [the statute's text] would have a different meaning going forward," and, in light of these changes, concluded that the Treasury Department's interpretation in section 301.6501(e)-1(a)(1)(iii) should control.

The decision in *U.S. v. Home Concrete & Supply, LLC* significantly affects the Service's ability to assess taxes on deficiencies because the extended statute of limitations period does not apply to gross income misstatements over twenty-five percent arising from basis overstatements. Generally, the decision should provide some relief to transactional and tax attorneys who question the accurate valuation of their client's bases in property disposed. However, because the extended statute of limitations has been foreclosed by the decision, the Service may be more vigorous in auditing taxpayers within the ordinary three-year period where taxpayer bases in property sold are questionable. The decision underscores the importance that taxpayers and counsel must adequately ascertain an appropriate bases for properties sold or disposed in efforts to avoid Service inquiry related to gross income understatements.