

CASE COMMENTARIES

CONTRACTS

In Tennessee, where a provision requiring consent to assign an agreement is silent as to the standard of conduct governing a party's decision whether to consent, an implied covenant of good faith and fair dealing requires the parties to act in a commercially reasonable manner in making such decision. *Dick Broad. Co. v. Oak Ridge FM, Inc.*, 395 S.W.3d 653 (Tenn. 2013).

By Amanda Butterworth

In Tennessee, it is well established that common law imposes a duty of good faith and fair dealing in the performance and enforcement of contracts. It is equally well established that where the language of a contract is clear and unambiguous, effect must be given to the intent of the parties. While several jurisdictions continue to follow the traditional common-law view that consent clauses that are silent as to the anticipated standard of conduct in assignment provisions allow the parties to arbitrarily refuse consent, many jurisdictions now follow a modern view requiring that the parties act in good faith and a commercially reasonable manner. In *Dick Broadcasting*, the Tennessee Supreme Court addressed whether an implied covenant of good faith and fair dealing applies to require a non-assigning party to act with good faith and in a commercially reasonable manner in refusing to give consent for the assignment of an agreement where the agreement is silent regarding the anticipated standard of conduct in withholding consent.

This case arose out of an agreement between Dick Broadcasting Company (“DBC”) and Oak Ridge FM, Inc. (“Oak Ridge FM”). Both companies were licensees for various radio stations in Knoxville, Tennessee, and surrounding areas. In 1997, DBC and Oak Ridge FM entered into three separate but related agreements including a Time Brokerage Agreement, a Consulting Agreement, and a Right-of-First-Refusal Agreement (“ROFR”) that gave DBC the right to purchase at a discount substantially all of Oak Ridge FM’s assets used in the operation of its radio station. While all three agreements contained assignment provisions, the ROFR, the central agreement at issue, was assignable only with the written consent of Oak Ridge FM. This provision was silent regarding the expected standard of conduct of Oak Ridge FM in withholding consent.

Three years later, DBC sought to sell most of its radio station assets, including the ROFR with Oak Ridge FM, to Citadel Broadcasting Company (“Citadel”). However, when Oak Ridge FM learned of the proposed deal, it

refused to consent to the assignment. Despite DBC's offer to guarantee Citadel's obligations under the ROFR, Oak Ridge FM continued to withhold consent. DBC ultimately finalized the deal with Citadel only after a \$10 million reduction in sales price, without assignment of the ROFR.

DBC brought suit against Oak Ridge FM alleging that Oak Ridge FM breached the ROFR by "wrongfully and unreasonably withholding consent" to the assignment in order to attempt a more profitable agreement with Citadel. DBC also alleged that "[an] implied covenant of good faith and fair dealing applied to the [ROFR] and that [Oak Ridge FM] breached the agreement by failing to act reasonably and in good faith." While Oak Ridge FM admitted to withholding consent, it denied any breach of contract.

The trial court granted Oak Ridge FM's motion for summary judgment, holding that an implied covenant of good faith and fair dealing was not applicable to the ROFR and that Oak Ridge FM, therefore, did not breach the ROFR by refusing consent. The Tennessee Court of Appeals, however, vacated the award of summary judgment, holding that an implied covenant of good faith and fair dealing did indeed apply to the ROFR and that summary judgment was improper due to genuine issues of material fact. On appeal, the Tennessee Supreme Court upheld the court of appeals' ruling.

Under de novo review, the Tennessee Supreme Court analyzed whether an implied covenant of good faith and fair dealing applied to the silent consent clause, first noting that, as early as 1922, Tennessee courts imposed an implied condition of reasonableness in contracts. In *Robeson & Weaver v. Ramsey*, 245 S.W. 413 (Tenn. 1922), the court considered a case where a party claimed to have an absolute right to find the sale of land "unsatisfactory" and rejected a standard allowing the parties to act "capriciously" in making such a determination. Where the agreement was silent as to the standard of conduct anticipated by the parties, the court held that the parties must act in a commercially reasonable manner.

Citing the Restatement (Second) of Contracts and accepted contract law principles in other jurisdictions, the Tennessee Supreme Court further noted that Tennessee law has firmly established an implied covenant of good faith and fair dealing in the performance and enforcement of every contract. The court referenced *Town & Country Equipment, Inc. v. Deere & Co.*, 133 F. Supp. 2d 655 (W.D. Tenn. 2000), in which the United States District Court for the Western District of Tennessee imposed a reasonableness and good faith requirement upon an assignment provision with a silent consent clause. In *Town & Country*, the agreement between the parties provided that the dealer could only assign the agreement with the prior consent of Deere. When Deere refused to approve

assignment to anyone other than Deere's preferred buyer, the dealer sued. The district court cited the well-established implied duty of good faith and fair dealing under Tennessee law and held that Deere did not have the right to "unreasonably limit or interfere with the sale."

Oak Ridge FM argued that the ruling in *Town & Country*, echoed by other jurisdictions referenced in *Dick Broadcasting*, represents a "minority rule." Oak Ridge FM asserted that the majority of courts addressing the issue of a silent consent clause have applied a traditional common-law view that parties may refuse consent "arbitrarily or unreasonably." The Tennessee Supreme Court disagreed, finding that "the former 'majority rule' approach has steadily eroded over time and is now a minority position among the courts that have considered the issue." While fourteen jurisdictions continue to follow the older view that a party may arbitrarily or unreasonably refuse consent under a silent consent clause, seventeen jurisdictions have adopted the "modern" position, imposing an implied duty of good faith and fair dealing when interpreting a silent consent clause.

Oak Ridge FM further argued that the trial court was correct in finding that imposing a duty of good faith and fair dealing on the consent clause "would . . . in effect . . . add a new provision to the contract which the parties were free to add themselves." The court again disagreed, noting that the obligation of good faith and fair dealing does not expand or add additional contractual obligations, but rather "protects the parties' reasonable expectations as well as their right to receive the benefits of their agreement." Moreover, at the time the parties entered into this agreement, Tennessee law had firmly established that the covenant of good faith and fair dealing is implied in every contract. The court stated the established rule, recently reaffirmed in *Ellis v. Pauline S. Sprouse Residuary Trust*, 280 S.W.3d 806 (Tenn. 2009), that the law existing at the time and place of a contract becomes a part of the contract and, "in the absence of evidence of a contrary intention, the parties must be held to have contemplated the application of that law to the terms of their agreement." Thus, the *Dick Broadcasting* court found that "the application of the duty of good faith and fair dealing is . . . a matter of enforcing the parties' agreed-upon contract, and refusing to apply the duty would . . . vary the terms of the . . . agreement." (internal quotation marks omitted). The court concluded that, "when [an] agreement does not specify the standard of conduct for withholding consent, a party's decision to refuse consent must be made in good faith and in a commercially reasonable manner."

The Tennessee Supreme Court's ruling in *Dick Broadcasting* is an important reminder to transactional attorneys that Tennessee law imposes a duty of good faith and fair dealing on the enforcement of *every* contract. Parties are free to

contract for any standard of decision-making that does not offend public policy; however, if they wish to allow conduct that deviates from established principles, they must explicitly do so in their written agreement. This holding clearly articulates that under Tennessee law, the implied covenant of good faith and fair dealing will be applied to all consent provisions absent the parties' explicit intent to avoid such imposition. Therefore, attorneys must be sure to include a clear standard of conduct clause within an assignment consent provision in any contract in which the parties do not wish to be bound by the implied covenant of good faith and fair dealing.

CONTRACTS

In Tennessee, a liquidated damages provision that does not bear a reasonable relationship to the amount of damages that are likely to result from a breach of the agreement is an unlawful penalty and will not be enforced. *Bachour v. Mason*, No. M2012-00092-COA-R3-CV, 2013 Tenn. App. LEXIS 366; 2013 WL 2395027 (Tenn. Ct. App. Nov. 8, 2012).

By Jacob Spangler

In *Bachour v. Mason*, the Tennessee Court of Appeals considered whether a provision in a real estate sale contract entitling the buyer to retain a certain large portion of the contract price in the event of the seller's default was enforceable in light of the provision's admittedly "arbitrary" nature. While the reasons it cited were different from the dispositive factors considered by the trial court, the court of appeals nevertheless affirmed the trial court's judgment, refusing to enforce the provision and ordering the buyer to deliver the full contract price.

In June 2007, Jalal Bachour ("Bachour") entered into a contract with Devin Mason ("Mason") and Craig Mears ("Mears") to purchase two adjacent lots, which Bachour intended to later sell at a profit. The initial contract price was \$300,000. In August of the same year, the parties executed an addendum to the agreement, which separated the purchase price of the two lots, with the prices totaling the sum of \$300,000. According to the addendum, the price of one of the lots was \$275,000, and the other was set at \$25,000. That same month, Bachour entered into another contract to sell both lots to a third party wishing to build an Auto Zone auto parts store at a price of \$325,000. This agreement was contingent upon Bachour's successful closing of the purchase from Mason and Mears.

In October, Mason and Mears entered into an agreement with Southern Villages, Inc. ("Southern Villages"), under which Southern Villages would construct roads adjacent to the lots. Immediately before closing the \$275,000

purchase and sale of the first lot, Bachour presented Mason and Mears with a new contract for sale, which provided that only \$200,000 of the purchase price was due at closing, and that the remaining balance of \$75,000 would become due and payable within thirty days of the completion of the roads. The new contract further provided that if the roads were not completed by July 1, 2008, Mason and Mears would forfeit the entire \$75,000 payment. Bachour presented the contract on the day of closing and told Mason and Mears that if they did not accept the terms of the new agreement, he would leave the deal. Mason and Mears accepted the new contract and the sale was closed on the same day; accordingly, Bachour delivered only the \$200,000 sum required by the new contract.

Construction on the roads began in May 2008, and a public official declared the roads completed on June 30, just one day before the deadline in the agreement. Bachour employed an engineer shortly thereafter to perform an independent inspection of the roads, and although the engineer concurred that the roads were technically completed, he found that “shoulder work, grading[,] and drainage were still in progress and far from completion.” On August 5, 2008, Bachour filed a complaint against Mason and Mears seeking a declaratory judgment that the roads were not completed by the July 1 deadline and that Mason and Mears therefore were not entitled to the \$75,000 balance on the purchase and sale contract.

In his pre-trial depositions, Bachour referred to the \$75,000 sum as a “penalty” or as “a heavy penalty,” and stated that he wished that the “penalty” was higher, “like \$150,000.” At trial, Bachour declined to refer to the figure as a penalty, instead calling it an “incentive” to finish the road quickly. Nevertheless, Bachour still acknowledged the payment as arbitrary and “not based on any particular estimate of potential damages.” The potential damage that Bachour cited was an alleged decrease in the value of the property due to the road’s arguable non-completion, amid a time of falling real estate prices. The chancery court held that the new contract presented on the day of closing was invalid for want of new consideration to make it enforceable. Bachour appealed the decision.

As discussed in the court of appeals’ opinion, Tennessee “has always placed a high value on the freedom to contract.” Parties to a contract are free to agree to whatever they wish, subject only to the condition that “the contract is not against public policy.” An appropriate liquidated damages provision is consistent with Tennessee’s public policy, as it contemplates real damages that “are likely to be uncertain and not easily proven.” However, liquidated damages provisions are “subject to close scrutiny because of the public policy against

forfeitures.” There must be some evidence of a reasonable relationship between the amount of the liquidated damages calculation and the actual amount of damages that might reasonably be expected to arise out of a breach of the agreement. In the absence of such a reasonable relationship, courts will interpret the provision as a penalty for breach rather than a liquidated damages provision. Such penalties are contrary to the public policy of Tennessee, and are hence unlawful and unenforceable.

On appeal, the Tennessee Court of Appeals held that the provision in the new contract bore no reasonable relationship to the actual damages that might be reasonably expected, and therefore refused to enforce it against Mason and Mears. In search of evidence of a reasonable relationship, the court turned to the facts of the case that led to the agreement and compared them to the provision’s terms, checking for any significant correlation. However, the court found “no evidence to support [Bachour’s] contention that the [\$75,000] figure bears any relation to the potential damages he likely would have suffered.” Bachour referred to the provision as “a penalty” and “a heavy penalty” and stated that he wished he had asked for a greater figure in his deposition. Bachour himself even described the number as “arbitrary,” and at no point attempted “to justify it in terms of the magnitude of his losses.” Despite his statements that he should have asked for more in damages, the court found that, at the time of the trial, Bachour still had not suffered any actual damages. The court also found that the parties had not discussed the amount listed in the provision, as Bachour showed it to Mason and Mears on the day of closing and apparently refused to negotiate any of its terms. Finally, the court found that the deadline specified was of no material significance to any damages that Bachour might have suffered. Although Bachour had already entered into an agreement under which he would promptly resell the lots to Auto Zone after closing, there was no evidence that Auto Zone had required completion of the roads by any date. This made the date seem arbitrarily chosen as well.

These factual observations informed the court’s conclusion that the \$75,000 figure “was just an arbitrary figure that [Bachour] plucked from thin air.” Finding no reasonable relationship between the terms of the provision and the potential damages that Bachour might reasonably have suffered, the court interpreted the provision as an unlawful penalty rather than a liquidated damages provision, and thus refused to enforce it. Accordingly, it affirmed the judgment of the trial court. Following this decision, the Tennessee Supreme Court tacitly expressed its approval when it denied Bachour’s application to appeal. *Bachour v. Mason*, No. M2012-00092-SC-R11-CV, 2013 Tenn. LEXIS 845 (Tenn. Oct. 16, 2013).

Transactional attorneys working in Tennessee can use the reasoning of *Bachour v. Mason* to direct their drafting of liquidated damages provisions. Because these provisions must bear a reasonable relationship to the actual damages that might reasonably be suffered in the event of a breach, drafters would be well-advised to illustrate that relationship to the best of their abilities. There is perhaps no better way of accomplishing this than by working evidence directly into the terms of the agreement. In conjunction with a liquidated damages provision, a drafter could integrate the exact calculation method used to arrive at the figure. This would demonstrate how the figure came to be and contravene any assertion that the number was selected arbitrarily. The more detailed the calculation, the less room there will be to question its validity. Also, drafters may wish to note specifically, by way of recitals, that the parties agree that actual damages will be uncertain and difficult to prove, and that they have jointly negotiated to arrive at the provision that exists in the contract. Through careful drafting, transactional attorneys should be able to set aside any doubts as to a liquidated damages provision's origin and enforceability.

FEDERAL TAX

Severance payments made to terminated employees that vary based on the employees' seniority or type of work performed and are not linked to the receipt of state unemployment benefits are taxable wages under FICA. *In re Quality Stores, Inc.*, 693 F.3d 605 (6th Cir. 2012), *rev'd*, *U.S. v. Quality Stores, Inc.*, 12-1408, 2014 WL 1168968 (U.S. Mar. 25, 2014).

By Karen Anderson

In hearing *In re Quality Stores, Inc.*, the Court of Appeals for the Sixth Circuit considered whether severance payments made by a corporation to its salaried and hourly employees who permanently lost their jobs when the company filed for bankruptcy constituted Supplemental Unemployment Benefits ("SUB") payments under federal law and whether SUB payments are taxable under the Federal Insurance Contributions Act ("FICA").

Since the 1950s, companies have had the option to supplement funds received from state unemployment programs by issuing SUB payments to their employees *after* they are laid off. SUB payments are not intended to compensate employees for any specific work performed, though the amount received may increase along with years served at a company.

In 2001, Quality Stores, Inc., then America's largest agricultural-specialty retailer, filed for Chapter 11 bankruptcy. In doing so, the company closed nearly

four hundred stores and twelve distribution centers, as well as terminated positions for all its employees—more than seventy-five—in its corporate office. Quality Stores granted severance payments to all of its employees whose positions were involuntarily terminated through two set severance plans. Initially, Quality Stores reported the severance pay it issued as gross income to its employees, declaring it as “wages” on W-2 forms and withholding federal income tax. Additionally, it paid the employer’s share of the FICA tax. All employee wages are subject to the FICA tax, which is paid by both the employer and employee and is used to fund the federal Social Security and Medicare programs.

Later, Quality Stores sought a refund from the Internal Revenue Service (“IRS”) on the \$1,000,125 it paid in FICA taxes. It argued that the severance payments it gave to its employees whose positions had been involuntarily terminated did not qualify as “wages” under FICA and were instead SUB payments.

In pursuit of a tax refund, Quality Stores brought suit against the IRS in the United States Bankruptcy Court for the Western District of Michigan and received permission from nearly two thousand former employees to pursue FICA refunds on their behalf as well. The bankruptcy court granted summary judgment in favor of Quality Stores. The Government appealed to the U.S. District Court for the Western District of Michigan, which affirmed the bankruptcy court’s ruling against the Government. The Sixth Circuit heard the case *de novo* because it originated in bankruptcy court where a ruling was made solely based on stipulated facts and cross motions for summary judgment.

In considering this case, the court of appeals first addressed whether SUB payments are wages. The court began this analysis by deducing what distinction Congress intended to make between SUB payments and wages. Starting with the Supreme Court’s decision in *Coffy v. Republican Steele*, 100 S. Ct. 2100, 2102 (1980), the *Quality Stores* court found that SUB payments are not related to services performed, because, by definition, employees only qualify for such payments after they are no longer employed by the company. Conversely, the Internal Revenue Code (“I.R.C.”) defines wages under FICA in I.R.C. § 3121(a) as “all remuneration from employment” where money is paid for a service worked. This essentially mirrors the definition for “wages” used for federal income tax purposes in I.R.C. § 3401(a).

Further showing its intent, Congress addressed SUB payments for purposes of federal income tax in a subsection titled “Extension of withholding to certain payments other than wages,” in I.R.C. § 3402(o). Additionally, Congress stated in I.R.C. § 3402(o)(1) that a SUB payment “shall be treated *as if it*

were a payment of wages” for income tax purposes. (emphasis added). The title of the section and plain meaning of the statute imply that Congress saw SUB payments as distinct from wages for income tax purposes.

The court reasoned that because SUB payments are not wages for income tax purposes and FICA defines “wages” the same way as it is defined for income taxes, then SUB payments are not considered wages for FICA either. The court supported this reasoning through the ease of administration argument that the Supreme Court asserted in *Rowan Companies, Inc. v. United States*, 101 S. Ct. 2288 (1981). The *Quality Stores* court relied on *Rowan* to find that, because Congress defined “wages” identically in the income tax and FICA statutes, the term was assumed to carry the same meaning in both contexts.

The next step in the court’s analysis was to determine what distinguishes a payment as a “SUB payment.” Based on I.R.C. § 3402(o)(2)(A), the *Quality Stores* court identified five elements of a SUB payment: (1) an amount paid to an employee; (2) pursuant to an employer’s plan; (3) because of an employee’s involuntary separation from employment, whether temporary or permanent; (4) resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions; and (5) which is included in the employee’s gross income. The court found that *Quality Stores*’ severance payments met each of these five elements. The payments were made pursuant to a specific plan following the permanent termination of employment that was the direct result of a reduction in force and discontinuation of a plant and was included in gross income under I.R.C. § 61 because it enriched the recipients.

The Sixth Circuit held that, under Congress’s five-part definition of SUB payments in I.R.C. § 3402(o)(2)(A), the severance payments *Quality Stores* made qualified as SUB payments. Furthermore, the court held that it is the clear intent of Congress that SUB payments are distinct from wages and therefore not subject to the FICA tax. This holding was driven by applying “clear congressional intent” based primarily on the plain meaning of two statutes—I.R.C. §§ 3121(a) and 3402(o)—to find that SUB payments are distinct from wages. Congress defined “wages” as payment for work performed, but individuals do not qualify for SUB payments until they are no longer employed and thus unable to perform any services. The court held that *Quality Stores* and its former employees who joined the suit were entitled to a refund for the amount paid in FICA tax.

In 2013, the Supreme Court granted a writ of certiorari and, in 2014, it eventually rejected the lower courts’ distinction between severance payments and taxable wages in I.R.C. § 3402(o) for FICA purposes. Instead, the Supreme Court held that severance payments made to terminated employees can be taxable

wages. Under I.R.C. § 3121(a)-(b), FICA defines “wages” as “all remuneration for employment,” where “employment” is “any service . . . performed . . . by an employee for an employer.” The Court emphasized that, like in *Social Security Board v. Nierotko*, 327 U.S. 358 (1946), the term “service” in I.R.C. § 3121(b) includes the entire employer-employee relationship for which compensation is paid to the employee, not merely work actually done directly for compensation. Severance payments fall within these parameters, because they can be made only to former employees, and they are made in consideration of past employment. This reasoning implicated the payments in this case, as the amounts paid by Quality Stores went only to its former employees and were based on the individual recipients’ length of service and position at the company. Additionally, the severance payments were not connected to the former employee’s receipt of state unemployment benefits. For these reasons, the Court found that Quality Stores’ severance payments are included in FICA’s definition of wages, and thus subject to the tax.

Retracing the Congressional intent of I.R.C. § 3402(o), the Court also found that the statute “does not narrow the term ‘wages’ under FICA to exempt all severance payments.” Consistent with *Rowan*, the definition of “wages” should be substantially the same for purposes of FICA and income-tax withholding in the interest of “simplicity of administration and consistency of statutory interpretation.”

Quality Stores could have two important implications for transactional attorneys. First, this case gives clear instructions for the treatment of severance payments under FICA. Severance payments made to terminated employees that vary based on the employees’ seniority or type of work performed and are not linked to the receipt of state unemployment benefits are taxable wages under FICA.

Second, on a more theoretical level, this case gives transactional attorneys a means to reign-in IRS overreach. Throughout the Sixth Circuit’s opinion in *Quality Stores*, the court references “clear congressional intention” as a reminder to the IRS that its role is to enforce laws without writing new ones. When Congress has clearly stated its intentions, the IRS must listen. In its closing in *Quality Stores*, the Sixth Circuit went to great lengths to distinguish what the role of the IRS is *not*. The court filled nearly all its short conclusion with a reminder that, “[w]hile the Supreme Court may ultimately provide us with the correct resolution of these difficult issues under the law as it currently stands, only Congress can clarify the statutes concerning the imposition of FICA tax on SUB payments.” Although the Supreme Court reversed the holding of the Sixth Circuit, they followed a

similar analysis, also emphasizing the significance congressional intent has when interpreting the Internal Revenue Code. However, unlike the Sixth Circuit, the Supreme Court also stressed Congress's goal of ease of administration and simplicity within the law. Nevertheless, future transactional attorneys can reference *Quality Stores* to emphasize the limited powers of the IRS.

FEDERAL TAX

Following substance over form, the Supreme Court held that the U.K. windfall tax can be predominately characterized as an excess profits tax, and is therefore creditable against U.S. federal income taxes under Internal Revenue Code § 901(b)(1). *PPL Corp. v. C.I.R.*, 133 S.Ct. 1897 (2013).

By Michael Crowder

PPL Corporation ("PPL") was part-owner of a privatized U.K. company subject to the U.K. "windfall" tax, and claimed a credit for its share of the windfall tax bill in its 1997 U.S. federal income tax return, relying on Internal Revenue Code ("I.R.C.") § 901(b)(1), which states that any "income, war profits, and excess profits taxes" paid overseas are creditable against U.S. income taxes. In *PPL Corp. v. Commissioner*, the Supreme Court addressed whether the windfall tax could be predominately characterized as an income, war profits, or excess profits tax through analysis of the formula used to calculate the windfall tax.

I.R.C. § 901(b)(1) provides that any "income, war profits, and excess profits taxes" paid overseas are creditable against U.S. federal income taxes. Treasury Regulation § 1.901-2(a)(1), which codifies longstanding doctrine dating back to *Biddle v. Commissioner*, 302 U.S. 573, 578-79 (1938), interprets this section to mean that a foreign tax is creditable if its "predominant character . . . is that of an income tax in the U.S. sense," meaning that if a foreign tax operates as an income, war profits, or excess profits tax for most taxpayers, it is generally creditable. Additionally, foreign tax creditability depends not on the way a foreign government characterizes its tax but on whether the tax, if enacted in the U.S., would be an income, war profits, or excess profits tax.¹ Giving further form to these principles, Treasury Regulation § 1.901-2(a)(3)(i) explains that a foreign tax's predominant character is that of a U.S. income tax "[i]f . . . the foreign tax is likely to reach net gain in the normal circumstances in which it applies." Three tests set forth in the regulations provide guidance in making this assessment.² These tests

¹ See Treas. Reg. § 1.901-2(a)(1)(ii).

² See Treas. Reg. § 1.901-2(b)(1).

indicate that net gain consists of realized gross receipts reduced by the significant costs and expenses attributable to such gross receipts. Accordingly, net gain means net income. Therefore, Treasury Regulation § 1.901-2 provides that a foreign tax that reaches net income, or profits, is creditable.

In *PPL Corp. v. Commissioner*, petitioner PPL was part-owner of South Western Electricity plc. During the 1980's and 1990's, the U.K.'s Conservative Party controlled Parliament and privatized a number of government-owned companies. As part of the privatization, many companies were required to continue providing services at the same rates they had offered under government control for a fixed period, typically their first four years of private operation (the "Initial Period"). The companies were still permitted to increase profits during this period, but because of the fixed rates, could only do so by operating more efficiently. Responding to market incentives, many of the companies became dramatically more efficient and earned substantial profits in the process.

In 1997 the Labor Party took control of Parliament and adopted a tax on any of the so-called "windfall" profits earned during the Initial Period. South Western Electricity was one of twelve government-owned electric companies that were privatized in 1990 and that were subject to the tax. South Western Electricity's total U.K. windfall tax burden was £90,419,265. In its 1997 U.S. federal income-tax return, PPL claimed a credit under I.R.C. § 901 for its share of the windfall tax bill. The Commissioner of Internal Revenue (the "Commissioner") rejected the claim, but the Tax Court held that the U.K. windfall tax was creditable for U.S. tax purposes under I.R.C. § 901. The Third Circuit reversed, and the Supreme Court granted certiorari.

The 1997 Parliament calculated the tax imposed on the "windfall" profits using a formula where the tax amount = $23\% \times [365 \times ((P/D) \times 9) - V]$, where D equals the number of days a company was subject to fixed rates, P equals the total profits earned during the Initial Period, and V equals the value of the company during the Initial Period. The Third Circuit held that the tax did not qualify under I.R.C. § 901 in large part because it believed the tax reached some form of valuation rather than net income or profits. The Third Circuit looked no further than the Labor government's assertion that the term $[365 \times (P/D) \times 9]$ represented what the companies' values should have been given the assumed price-to-earnings ratio of nine (which was selected because it was the lowest average price-to-earnings ratio of any of the windfall-tax-liable companies during the initial period), and that, therefore, the entire formula simply imposed a tax on the difference between what the companies' values should have been and what they actually were.

The Supreme Court disagreed and concluded that the predominant character of the windfall tax was that of an excess profits tax, and as such, it qualified under I.R.C. § 901. The Court reasoned that the Labor government's conception of value as a backward-looking analysis of historic profits was not a "recognized valuation method" and was "fictitious." Rather than a tax on value, the Court held that the windfall tax was a tax on realized net income and asserted that the tax calculation formula confirmed this result. The Court algebraically rearranged the tax calculation formula to have the tax amount = $51.71\% \times [P - (V/9) \times 4.0027]$. The Court observed that, under this arrangement, $[(V/9) \times 4.0027]$ represented the amount of total "acceptable profits," in effect meaning that a company was to be taxed on profit that exceeded one-ninth of the company's value multiplied by 4.0027. Therefore, this rearrangement of the tax calculation formula had the effect of taxing the difference between a company's actual profits (P) and what its profits *should* have been. In other words, at least for the companies that had 1,461-day Initial Periods,³ the tax formula's substantive effect was to impose a 51.71% tax on all profits earned above the threshold. This, the Court concluded, was a classic excess profits tax and qualified for treatment under I.R.C. § 901.

In light of this decision, transactional attorneys and tax attorneys alike should be aware that, in terms of characterizing a tax, the Supreme Court will not hesitate to follow substance over form, especially when the form being followed is "fictitious" or does not use a "recognized method." More specifically, U.S. courts are not bound by the tax base that foreign taxes purport to adopt. Such a rigid construction is unwarranted, and cannot be squared with the principle that "tax law deals in economic realities, not legal abstractions." Despite what a tax proposes to reach in form, if a single algebraic reformulation of the tax formula substantively reaches income or profits, even if other reformulations are possible, then such a tax will likely qualify under I.R.C. § 901(b)(1).

³ It should be noted that five of the thirty-two companies had different lengths for their initial periods. In her concurrence, Justice Sotomayor found that both the tax rate and the excess profits threshold differed for companies with different initial periods. Because of these differences, she concluded that the tax was really a tax on "average profits" rather than a tax on excess profits. She reasoned that average daily profits multiplied by a price-to-earnings ratio is a recognized way of approximating value, rather than a way of approximating income, and as such, this tax would not qualify under I.R.C. § 901. However, this reasoning could not apply in this case because the Government rejected the notion that the "outlier" companies were relevant to the creditability analysis, and so Justice Sotomayor joined with the majority.

INSURANCE

Under Tennessee law, an insurer claiming no duty to defend and indemnify an insured contractor must prove that the contractor's faulty work did not cause any damage to components other than the ones the contractor installed and that the faulty work was not performed by a subcontractor. *Forrest Const., Inc. v. Cincinnati Ins. Co.*, 703 F.3d 359 (6th Cir. 2013)

By Kevin Davis

In *Forrest Construction, Inc. v. Cincinnati Insurance Co.*, the United States Court of Appeals for the Sixth Circuit considered whether an insurer owed a duty to defend and indemnify an insured contractor. Specifically, the court considered if there was a genuine issue of material fact as to whether the contractor's faulty construction of the foundation of its client's residence triggered a duty for the insurer to defend and indemnify the contractor. The court held that the insurer owed a duty to defend and indemnify the contractor because the insurer failed to prove that the contractor's faulty work did not cause damage to components other than the ones the contractor installed and that the faulty work was not performed by a subcontractor.

This case began when Forrest Construction, Inc. ("Forrest") filed suit against Cincinnati Insurance Co. ("Cincinnati"), alleging that Cincinnati breached the parties' contract by failing to defend and indemnify Forrest in a faulty construction lawsuit. Prior to the lawsuit, Forrest and Cincinnati agreed to a standard commercial general liability ("CGL") policy. The CGL policy imposed a duty on Cincinnati to "pay those sums that [Forrest] becomes legally obligated to pay as damage because of bodily injury or property damage." Furthermore, Cincinnati had a duty to defend Forrest against any suit alleging that Forrest's faulty construction caused property damage.

While the CGL policy imposed a duty on Cincinnati to indemnify and defend Forrest, the CGL policy limited this duty by narrowly defining property damage and by limiting the scope of liability. The CGL policy stated that "property damage" only occurs if there is "physical injury" to a piece of tangible property. "Physical injury" was then defined to include all loss of use of tangible property, even tangible property that was not harmed physically. Furthermore, the CGL policy limited Cincinnati's duty to indemnify and defend by limiting the scope of the policy's coverage. The CGL policy contained a "your work" exclusion provision which stated that Cincinnati was not obligated to indemnify

and defend Forrest if the property damage arose from work performed by Forrest. However, the CGL policy contained a subcontractor exception which stated that the “your work” exclusion does not apply to property damage that arose from work performed by a subcontractor on Forrest’s behalf.

In 2004, Forrest was hired to build a residence for James and Debbie Laughlin (the “Laughlins”) in Brentwood, Tennessee. Forrest and the Laughlins disagreed over the amount the Laughlins owed Forrest for its work on their residence. As a result, Forrest filed suit against the Laughlins. The Laughlins responded with a countercomplaint alleging that Forrest negligently constructed the residence, causing significant cracking in the foundation. Forrest notified Cincinnati of the Laughlins’ counter-complaint and requested that Cincinnati defend and indemnify them in the matter.

Cincinnati denied that it owed Forrest a duty to defend and indemnify, arguing that, while the Laughlins’ countercomplaint alleged physical damages, the alleged damages fell within the “your work” exclusion provision. Cincinnati also stated in its refusal letter that it owed no duty to indemnify and defend because the countercomplaint did not state that a subcontractor performed Forrest’s construction work, which would trigger the subcontractor exception. As result of Cincinnati’s denial of coverage, Forrest filed suit against Cincinnati, alleging breach of contract. Both parties moved for summary judgment, and the United States District Court for the Middle District of Tennessee granted summary judgment for Forrest. Consequently, Cincinnati appealed.

On appeal, the United States Court of Appeals for the Sixth Circuit granted summary judgment in favor of Forrest. The court held that Cincinnati had a duty to defend Forrest against the Laughlins’ counterclaims. In reaching its decision, the court considered whether there was genuine issue of material fact as to whether Cincinnati had a duty to defend Forrest. The court first examined whether the CGL policy covered the damage that occurred to the Laughlins’ residence. The court defined “property damage” as damage that occurred to a component other than those that either the insured contractor installed or hired a subcontractor to install. The court then referenced *Travelers Indemnity Co. v. Moore & Associates*, 216 S.W.3d 302, 310 (Tenn. 2007), and found that “faulty workmanship” occurred when damages are only for replacement of a defective component the contractor installed or hired a subcontractor to install. Furthermore, the court noted that there is a significant legal distinction between property damage and faulty workmanship. If property damage occurred, then Cincinnati had a duty to defend Forrest under the CGL policy. However, if the

damage resulted from faulty workmanship, then Cincinnati had no duty to defend Forrest under the CGL policy.

Having examined the legal distinction between property damage and faulty workmanship, the court found that the countercomplaint sufficiently alleged property damage. The countercomplaint alleged that the installed components caused significant cracking in the foundation of the Laughlins' residence. In light of this allegation, the court found that property damage had occurred because the installation caused physical damage to components other than the ones installed.

After finding that there was property damage, the court considered whether coverage was negated by the "your work" exclusion. It first noted that the "your work" exclusion excluded coverage when the insured party performed the construction work. It noted that the countercomplaint alleged that Forrest "performed, or caused to be performed," defective work. The court found that this language implied that Forrest may have hired a subcontractor who performed the defective work. Thus, the court recognized that the subcontractor exception applied and thereby defeated the "your work" exclusion. Thus, the court held that Cincinnati had a duty to defend and indemnify Forrest.

In light of the *Forrest* decision, transactional attorneys should be cognizant of the fact that, even though a "your work" exclusion may initially preclude coverage under a CGL policy, they must prove that an insured contractor did not hire subcontractors whose faulty work actually caused property damage. It is not enough for transactional attorneys to argue that a subcontractor exception does not apply because the complaint against the insured contractor does not explicitly state that subcontractors were used by the insured contractor. Such attorneys must prove that the property damage was not caused by a subcontractor, but rather by the insured contractor itself.

REAL ESTATE

In Tennessee, allegations in a court filing provide neither sufficient notice nor opportunity to cure to allow a lender to subject a defaulting borrower to personal liability for the outstanding debt on a non-recourse loan. *Fed. Nat'l Mortg. Ass'n v. TN Metro Holdings XII*, No. M2012-01803-COA-R3-CV, 2013 Tenn. App. LEXIS 330, 2013 WL 2146440 (Tenn. Ct. App. May 14, 2013).

By Drew Clark

In *Federal National Mortgage Association v. TN Metro Holdings XII*, the Tennessee Court of Appeals determined whether a borrower was given sufficient

notice of a default that would subject both the borrower and its key principal to personal liability under a non-recourse loan. The borrower, TN Metro Holdings XII ("TN Metro"), owned an apartment complex upon which the Federal National Mortgage Association ("FNMA") foreclosed. Although the loan was non-recourse, there were two exceptions to the non-recourse provision that would subject both TN Metro and its key principal, Selim Zherka ("Mr. Zherka"), to personal liability for the debt. FNMA did not provide notice that TN Metro had defaulted in such a manner as to render TN Metro and Mr. Zherka personally liable until after the deed of trust had been foreclosed and the property sold at a foreclosure sale.

On April 25, 2007, TN Metro executed a promissory note in the amount of \$8,616,000 in order to buy an apartment complex in Hendersonville, Tennessee. As security, TN Metro executed a deed of trust, security agreement, and assignment of rents (collectively, the "Security Instruments") in favor of the lender. Although the promissory note was non-recourse, it provided for personal liability of TN Metro and its key principal in two situations: (1) if, after default, TN Metro failed to pay the lender all rents to which the lender was entitled or misapplied such rents as provided for in the Security Instruments; or (2) if TN Metro transferred the property in a manner that was considered an Event of Default under the Security Instruments. The Security Instruments stated that the creation of any lien on the property constituted a transfer that was an Event of Default. The Security Instruments also provided that the "[l]ender shall provide [TN Metro] written notice of any Non-Monetary Default" and that "[TN Metro] shall have a period of thirty (30) days" after receiving such written notice in which to cure the default. Furthermore, the Security Instruments stated that any non-monetary default "shall not be deemed to have occurred" until TN Metro's opportunity to cure had expired.

On March 2, 2011, FNMA filed a complaint for foreclosure and damages against TN Metro for failure to make payments on the loan.¹ The foreclosure was granted and the property was sold in a foreclosure sale on June 1, 2011 for \$4.1 million. Following the sale, FNMA filed an amended complaint alleging that the outstanding debt on the note as of June 1, 2011 was \$9,498,221.59, of which \$4.1 million had been satisfied by the foreclosure sale, leaving a deficiency in the amount of \$6,784,519. The amended complaint further alleged that TN Metro and Mr. Zherka were personally liable for the deficiency because (1) TN Metro

¹ The promissory note and Security Instrument were initially executed in favor of Sovereign Bank. Although not explicitly stated in the opinion, it seems that the note and Security Instruments were later assigned to FNMA.

failed to pay the rents from the property that were due to FNMA, and (2) TN Metro allowed the property to become encumbered by a number of liens. FNMA alleged that these actions by TN Metro constituted Events of Default under the Security Instruments. Upon FNMA's motion for summary judgment, the trial court found that the allegations of the amended complaint satisfied the Security Instruments' notice requirement for non-monetary defaults. As such, the trial court granted summary judgment in favor of FNMA and found both TN Metro and Mr. Zherka to be jointly and severally liable for any deficiency.

On appeal, the Tennessee Court of Appeals held that the allegations of FNMA's amended complaint did not constitute effective notice as required by the Security Instruments. In coming to this conclusion, the court relied on basic principles of contract interpretation. Because courts presume that the intent of the parties is specifically expressed in the contract itself, the court sought to determine if the terms of the contract were ambiguous. The court found that the repeated use of the word "shall" was not ambiguous and clearly showed that FNMA was required to give TN Metro both notice and an opportunity to cure. In the absence of such notice and opportunity to cure, the Security Instruments provided that no Event of Default actually occurred. The court noted that the intent and purpose of the notice and cure requirements was to avoid default and subsequent litigation. Furthermore, the legal authority cited by FNMA to justify substituting the amended complaint for actual notice were not applicable to the specific facts of the case at bar. Finally, while failing to find any ambiguity in the terms of the Security Instruments, the court stated that even if ambiguities existed, they should be construed against FNMA as the drafter of the document. For these reasons, the trial court's ruling was overturned.²

The ruling in this case does little to change the current state of the law in Tennessee. In reaching its conclusion, the Tennessee Court of Appeals relied on long-settled principles of contract interpretation. To the extent that the current FNMA standard forms contain provisions similar to those at issue in this case, transactional attorneys should be aware that the mandatory notice and opportunity to cure requirements imposed upon lenders will be enforced by the courts. Although the court implied that allegations in a complaint may satisfy a notice requirement in certain circumstances, it would behoove lenders to provide adequate notice of a default and an opportunity to cure before bringing borrowers into court.

² The court also dealt with the question of whether genuine issues of material fact existed in the case at bar. Because that aspect of the ruling dealt solely with the standard of summary judgment and not any aspect of transactional law, it has not been discussed.

REAL ESTATE

For purposes of an inverse condemnation action against a municipality, an executory contract between developers and a homeowners' association can convey a compensable interest in property to the homeowners' association even if legal title remains in the developers. *Willowmet Homeowners Ass'n, Inc. v. City of Brentwood*, M2012-01315-COA-R3-CV, 2013 WL 2152522, 2013 Tenn. App. LEXIS 336 (Tenn. Ct. App. May 16, 2013).

By Nathaniel Foxworthy Greene

In *Willowmet Homeowners Association, Inc. v. City of Brentwood*, the Tennessee Court of Appeals addressed whether a homeowners' association was entitled to compensation under the Tennessee inverse condemnation statute where a municipality purchased property from two developers after the developers had previously contracted to transfer the same property to the homeowners' association. In its determination of whether inverse condemnation was available to the homeowners' association, the court was faced with determining whether an executory contract conveyed a compensable interest in the property to the homeowners' association even though legal title remained in the developers. The Tennessee Court of Appeals held that the executory contract acted to shift equitable title to the homeowners' association, and the association was therefore entitled to compensation for its valuable property interest.

In *Willowmet*, Centex Homes and Tiara Development, LLC (the "Developers") developed Willowmet, a residential subdivision located in Brentwood, Tennessee, in 2000 and 2001. As part of the development process, the Developers recorded a Declaration of Protective Covenants, Conditions, and Restrictions for Willowmet (the "Declaration") on August 24, 2001. Acting in accordance with the Declaration, the Developers subsequently incorporated the Willowmet Homeowners' Association (the "Association") in December of 2001. In addition to the requirement that the Developers create the Association, the Declaration also mandated that, prior to the sale of the first lot of the subdivision, the Developers had to convey all of the open space of Willowmet to the Association. Although the first lot was conveyed to an individual lot owner on March 28, 2002, the Developers did not convey any of the open space to the Association until 2011.

Furthermore, before the 2011 conveyance of the open space to the Association, the Developers were approached by the City of Brentwood (the

“City”) because the City needed to acquire a portion of the open space of Willowmet in order to widen a public road. After the City conducted a title search, which revealed the previously recorded Declaration, the Developers each granted the City an easement to widen the road in exchange for compensation from the City. These two “Right-of-Way and Easement Conveyances” were promptly recorded. Soon thereafter, the Developers conveyed their remaining interests in the open space of Willowmet to the Association by quit-claim deed. On June 17, 2011, the Association initiated an inverse condemnation action against the City seeking compensation for its lost property rights in the open space the City had purchased.

In Tennessee, inverse condemnation “is the popular description for a cause of action brought by a property owner to recover the value of real property that has been taken for public use by a government defendant even though no formal condemnation proceeding has been instituted.” Furthermore, a “taking” for inverse condemnation purposes consists of an action taken by the government authority that “destroys, interrupts, or interferes with the common and necessary use of the real property of another.” This right of inverse condemnation is codified at Tennessee Code Annotated section 29-16-123, and the statute provides that, if the government authority has taken possession of the land, the property owner is entitled to a jury determination of the damages and, additionally, a sum determined by the court to “reimburse such [owner] for reasonable costs, disbursements and expenses, including reasonable attorney . . . fees” incurred as part of the inverse condemnation proceeding. However, if the ownership status of an inverse condemnation plaintiff is challenged, the burden is on the plaintiff to prove that it has an ownership interest in the property.

In the Williamson County Circuit Court, the City and the Association filed competing motions for summary judgment, and the circuit court dismissed the action on the City’s motion. The court concluded that the inverse condemnation statute did not apply because the City obtained the property under color of title. The circuit court further concluded that, even if the inverse condemnation statute applied, the Association did not own any compensable property rights in the open space conveyed to the City, and thus, summary dismissal would still be appropriate.

On appeal, the Tennessee Court of Appeals reversed the trial court’s decision and remanded the case with instructions to grant the Association’s motion on the City’s inverse condemnation liability and for a determination of the Association’s damages. With regard to the trial court’s “color of title” argument, the court of appeals found that, even though the documents executed by the

Developers may have purported to transfer ownership of the property to the City, thus passing color of title, previous case law dealing with similar facts only restricted the ability of property owners to succeed in an ejectment action. Where, as in *Willowmet*, the property owner is seeking compensation for the property interest rather than a return of the property itself, an inverse condemnation action is an available and appropriate avenue for recovery. In addition, the court of appeals explained that the Developers' contractual obligation to transfer the open space to the Association, as recorded in the Declaration, acted to pass equitable title to the Association, thus creating a compensable property interest in the open space.

In support of its determination that the Association's property interest was compensable, the court of appeals explained that "once the Declaration was recorded and the Association was incorporated, the Developers were under an affirmative, executory duty to deed the [open space] to the Association." Even though the Developers were in breach of their duty following the sale of the first lot in 2002, the executory duty was not discharged, and thus, the Developers were still obligated to convey the property to the Association. Citing the general rule of equitable rights arising from executory contracts, the court of appeals explained that a valid contract for the purchase and sale of property acts as an equitable conversion resulting in the purchaser being seen as the equitable owner of the property. The court of appeals then concluded that, in *Willowmet*, the Association was such a "purchaser" of the open space based on the Declaration, and therefore, the Association was the equitable owner when the City purchased the property from the Developers.

After establishing that the Association was the equitable owner of the property, the court of appeals moved on to explain why such an interest was compensable under the inverse condemnation statute. Despite the City's arguments that the Developers had the authority to extinguish the Association's interest by unilateral sale, the court of appeals found that where the City had knowledge of the Association's ownership interest, the City could not "bury its head in the sand, ostrich like, and ignore the real outstanding interest." Because the Association was determined to be the equitable owner, and also because the City had knowledge of the Association's property interest due to the earlier title search, the court found that the City was required to compensate the Association for the value of its lost property interest.

Based on the ruling in *Willowmet Homeowners Association, Inc. v. City of Brentwood*, attorneys representing a municipality in a condemnation proceeding or a transaction in lieu of condemnation must ensure that all parties with a

compensable interest in the property are included in the process in order to avoid a later inverse condemnation lawsuit. Following *Willowmet*, such attorneys need to be aware that the “list of parties with a compensable interest” clearly includes parties that hold equitable title in the property, even if those parties do not yet have legal title, if the municipality has actual or constructive knowledge of the equitable interest.

For attorneys representing property owners in condemnation proceedings, the clear takeaway from *Willowmet* is that legal title is not required to succeed in an inverse condemnation proceeding against the government in Tennessee. However, because *Willowmet* and previous cases have focused on whether the government had knowledge of the equitable interest in the property, attorneys representing property owners need to ensure that, if possible, the interest is recorded before any condemnation proceeding is initiated or, in the alternative, that the government is made aware of the interest at the earliest juncture. In addition, it is also important for attorneys on the property owner’s side to remember that the inverse condemnation statute provides for an award of the costs of the proceeding, including attorney’s fees, which could serve as a point of leverage.

SECURED TRANSACTIONS

Under Tennessee law, a creditor perfects a security interest in insurance premiums when the debtor executes a valid security agreement covering the premiums, even if it does not file a financing statement. *Am. Bank v. Cornerstone Cmty. Bank*, 733 F.3d 609 (6th Cir. 2013).

By Michael Cottone

A secured creditor must take the steps required by law to perfect its security interest to obtain an interest that is effective against other secured creditors. In contests between creditors, several statutes—and the cases interpreting them—provide rules for determining each creditor’s priority. Tennessee law provides a carve-out from the general rules on perfection and priority for security interests in financed insurance premiums, implicating, among other things, notice concerns and the priority of banks holding security interests in deposit accounts that may contain financed premiums. The United States Court of Appeals for the Sixth Circuit, in *American Bank v. Cornerstone Community Bank*, considered these issues and strengthened the position of creditors with a security interest in financed insurance premiums.

In *American Bank v. Cornerstone Community Bank*, American Bank (“American”) provided a \$429,991 loan to Saberline Transportation (“Saberline”) as financing for an insurance premium. Saberline executed a security agreement giving American a security interest in “all unearned premiums.” The insurance contract with Praetorian Insurance Company (“Praetorian”) required Saberline to pay premiums for an entire year in advance, with premiums for each month becoming “earned” once Praetorian provided coverage for that month. In the event of default, American was entitled to cancel the policy and obtain all unearned premiums from Praetorian. The funds for the premiums were to be held in an account owned by U.S. Insurance Group (“U.S. Insurance”), the broker, at Cornerstone Bank (“Cornerstone”), and then forwarded to Praetorian as they were earned.

U.S. Insurance, however, directed American to deposit the funds in its general operating account rather than a trust account. U.S. Insurance owed money to Cornerstone “and authorized [it] to conduct daily sweeps of the operating account and apply anything over \$50,000 to the debt.” Therefore, upon American depositing the funds in the account, Cornerstone “cleared the account of Saberline’s money and reduced [U.S. Insurance’s] debt.”

Saberline immediately defaulted, and American terminated the policy with Praetorian. When U.S. Insurance returned the unearned premiums, however, it did so not from its operating account at Cornerstone, but rather from an account at a different bank. U.S. Insurance then filed for bankruptcy, “turning this last transfer into a preference payment.” After settling with the bankruptcy trustee, American brought suit against Cornerstone, asserting that it “had a superior security interest in the disputed funds and that Cornerstone was liable for conversion.”

Appearing in a separate title from Tennessee’s version of the Uniform Commercial Code, sections 56-37-101 through 56-37-115 of the Tennessee Code Annotated contain the perfection and priority rules for security interests in financed insurance premiums under Tennessee state law. Section 56-37-112 provides that such security interests are perfected “if the buyer or borrower signs a written security agreement assigning a security interest to the seller, seller’s assignee, or lender” and that “[n]o filing . . . shall be necessary to perfect the validity of such agreement as a secured transaction.” As the *American Bank* court noted, “perfection of the security interest [occurs] upon execution of [a] written premium financing agreement and payment of the insurance premium.” Section 56-37-112 further provides that perfected security interests in financed insurance premiums have priority over “creditors, subsequent purchasers, pledgees,

encumbrances, trustees in bankruptcy or any other insolvency proceeding under any law[,] or anyone having the status or power of the aforementioned or their successors or assigns.”

On appeal, the United States Court of Appeals for the Sixth Circuit affirmed the district court and held that American had a perfected security interest under section 56-37-112, that this interest took priority over Cornerstone’s interest as a “creditor” or “subsequent purchaser,” and that Cornerstone was liable to American for conversion. The Sixth Circuit also rejected Cornerstone’s waiver and laches defenses.

As an initial matter, the court held that American’s interest fell within section 56-37-112. Because Saberline executed a written agreement giving American “a security interest in . . . any and all unearned premiums and dividends which may be payable under the insurance policies,” the court found that Saberline “sign[ed] a written agreement assigning a security interest to the . . . lender.” Therefore, American held a perfected security interest under section 56-37-112.

Next, the court held that American’s interest took priority over Cornerstone’s. Interests perfected under section 56-37-112 have priority over a variety of other interests, and the court found that “Cornerstone [fell] into at least two lower-priority categories.” First, Cornerstone was a “creditor” for purposes of section 56-37-112. In making this determination, the court looked to the general definition of “creditor” in section 47-1-201(3) of the Tennessee Code Annotated, which includes “a general creditor, a secured creditor, a lien creditor, and any representative of creditors.” The court concluded that this “definition . . . cover[ed] Cornerstone.” Second, the court determined that Cornerstone was also a “subsequent purchaser” under section 56-37-112 because secured creditors are included in the definition of “subsequent purchaser” under section 47-9-401 of the Tennessee Code Annotated. Therefore, American’s interest had priority.

In determining that American had priority over Cornerstone, the court specifically rejected Cornerstone’s argument that its security interest in U.S. Insurance’s operating account had priority by virtue of being “held by the bank with which the deposit account is maintained” under section 47-9-327(3) of the Tennessee Code Annotated. Noting that when two statutes conflict, “courts customarily seek to honor as much of the competing laws as they can by giving priority to the more specific piece of legislation,” the court found that section 56-37-112 was more specific than section 47-9-327(3) because the former dealt with interests related to insurance premium financing while the latter covered deposit accounts generally.

The court ultimately found that Cornerstone was liable for conversion of the funds American deposited in U.S. Insurance's operating account. The court found that, under Tennessee law, conversion occurs when a party "appropriat[es] . . . another's property to [its] own use and benefit, by the exercise of dominion over the property, in defiance of the owner's right to the property," whether or not it acted in good faith. Here, Cornerstone "exercised dominion and control" by applying American's deposited funds to U.S. Insurance's debt and Cornerstone benefitted because its risk of non-payment of the debt was reduced. Therefore, because the sweeps "defied . . . American's senior security interest in the contested funds," Cornerstone was liable for conversion.

American Bank demonstrates two main points. First, this case illustrates the need for secured lenders of all stripes to insist on separate, isolated trust accounts for depositing funds covered by a security interest. Although American ultimately prevailed against Cornerstone, this was only after having its initial payment taken back by a bankruptcy trustee as a preference, incurring what were likely substantial litigation costs in bringing an action against Cornerstone and defending an appeal, and losing the time-value of its money. Much of this expense and inconvenience could have been avoided had American insisted on depositing the funds into a separate account that it could monitor.

Second, and more specifically, this case demonstrates the risk of hidden liens to banks that take security interests in their customers' deposit accounts. As illustrated by this case, banks must be aware of all statutory exceptions to the general filing or possession requirement for perfecting security interests, not just those contained in Tennessee's version of the Uniform Commercial Code. Because of these statutory exceptions, a bank performing sweeps of a customer's account risks conversion liability if it does not ensure that no hidden liens exist on funds in the account. However, by their very nature, hidden liens can be hard to uncover, so the best solution is likely for creditors to perform due diligence in determining where account funds come from, especially for particularly large deposits.

SECURED TRANSACTIONS

Under Chapter 9 of Tennessee's Uniform Commercial Code, the inclusion of "proceeds" of collateral in a financing statement is not adequate to perfect a security interest in accounts receivable arising from the debtor's use of the collateral. *1st Source Bank v. Wilson Bank & Trust*, 735 F.3d 500 (6th Cir. 2013).

By Will Hooper

When leveraged businesses fail, secured creditors frequently become entangled in disputes over who has priority over the various assets that the failed business has pledged as collateral. These disputes often turn on which creditor was the first to perfect its security interest by filing a financing statement that adequately describes the collateral, regardless of which creditor actually first obtained a security interest in the assets. In *1st Source Bank v. Wilson Bank & Trust*, the Court of Appeals for the Sixth Circuit held that, under Tennessee law, a financing statement describing collateral as certain assets and “all proceeds thereof, including rental and/or lease receipts,” did not perfect a security interest in accounts receivable arising from the debtor’s use of the collateral.

In *1st Source Bank v. Wilson Bank & Trust*, 1st Source Bank (“1st Source”) entered into a series of transactions with K&K Trucking and J.E.A. Leasing (collectively, the “Debtors”) in which 1st Source financed the Debtors’ acquisition of tractors, trailers, and other equipment. In each transaction, the Debtors executed security agreements granting 1st Source a security interest in the Debtors’ tractors and/or trailers, accounts, and proceeds from the collateral. Further, 1st Source filed a financing statement in accordance with Tennessee law for each transaction, each of which listed the specified tractors and/or trailers serving as collateral for the transaction along with “all proceeds thereof, including rental and/or lease receipts.” These financing statements did not, however, include the term “accounts.”

Sometime after 1st Source filed its financing statements, several other creditors (collectively, the “Defendants”) entered into subsequent secured transactions with the Debtors in which the Debtors pledged their accounts as collateral. In each subsequent transaction, the Debtors and the Defendants executed valid security agreements and the Defendants filed financing statements in accordance with Tennessee law that specifically provided that each of the Defendants had a security interest in “all accounts receivable now outstanding or hereafter arising.”

The Debtors eventually defaulted on their obligations, and 1st Source repossessed the physical collateral covered by its security agreements while the Defendants took possession of the Debtors’ accounts receivable. 1st Source then filed suit against the Defendants, seeking a declaratory judgment of its priority in the accounts receivable in accordance with its security agreements and financing statements. In response, the Defendants contended that, regardless of the inclusion of accounts in the security agreement between 1st Source and the Debtors, the financing statements filed by 1st Source did not name accounts, and such accounts could not properly be classified as proceeds of the specifically

listed collateral. Thus, the Defendants claimed that 1st Source's security interest in the accounts receivable was not perfected, and, therefore, the Defendants had priority. The District Court for the Middle District of Tennessee granted the Defendants' motion for summary judgment, and 1st Source appealed.

Pursuant to Chapter 9 of Tennessee's Uniform Commercial Code, codified at Tennessee Code Annotated sections 47-9-101 et seq., ("Chapter 9"), a perfected security interest prevails over an unperfected security interest, even where the unperfected security interest was obtained first. A security interest attaches to assets identified as collateral at the instant of the creation of an enforceable security interest, which occurs at the time a security agreement is executed between the creditor and the debtor. Such interests generally are not perfected, however, until a financing statement that adequately describes the covered collateral has been filed in accordance with the provisions of Chapter 9. The purpose of requiring such financing statements to be filed is to put third parties on notice that the creditor has a security interest in that collateral.

The Court of Appeals for the Sixth Circuit analyzed the financing statement filed by 1st Source to determine whether the statements adequately described the claimed collateral—the accounts receivable—so as to put the Defendants on notice that 1st Source had a security interest in those assets at the time the Defendants extended credit to the Debtors. Because the financing statements listed a number of specific types of collateral, but made no mention of "accounts" or "accounts receivable," the court applied the maxim *expressio unius est exclusio alterius*, meaning the expression of one or more things in a class implies the exclusion of others, to hold that the language in the financing statement limited the collateral to the assets actually identified, and therefore did not adequately describe the accounts receivable so as to perfect 1st Source's security interest.

The court then considered 1st Source's argument that the inclusion of the term "proceeds" in the financing statement should encompass the accounts receivable, because the accounts receivable were presumably derived from the rental and use of the listed collateral.

Pursuant to Chapter 9, "proceeds" includes "whatever is collected on, or distributed on account of, collateral" and "rights arising out of collateral." Tenn. Code Ann. § 47-9-102(a)(64) (2013). According to the official comments by the drafters of the Uniform Commercial Code, however, the term "proceeds" was not intended to refer to income generated from the debtor's own use and possession of the goods or to situations where there was not an actual dispossession of the debtor's interest in the collateral.

The Sixth Circuit, without mentioning the language in the financing statement modifying “proceeds” to specifically include rental and leasing receipts, reasoned that Chapter 9 specifically defined “accounts” separately from “proceeds,” and that classifying accounts receivable as proceeds would “render the [former] term . . . meaningless.” Furthermore, the court noted decisions from several other jurisdictions that uniformly support the proposition that revenues earned through the use of collateral are not proceeds, specifically citing *CLC Equipment Co. v. Brewer*, 139 F.3d 543, 546 (5th Cir. 1998), in which the Fifth Circuit expressed concern that treating the products and revenues from the use of collateral as proceeds would effectively give a creditor with a security interest in equipment a security interest in all items and revenues produced by the equipment. Thus, the court held that “proceeds” in this case could not include the Debtors’ accounts receivable, and affirmed the district court’s grant of summary judgment to the Defendants.

The Sixth Circuit’s decision in *1st Source Bank v. Wilson Bank & Trust* should serve as a warning to transactional attorneys to exercise great care in drafting financing statements to perfect their clients’ security interests. In this case, the drafting attorney may have believed that the inclusion of the language “all proceeds thereof, including rental and/or lease receipts” in the financing statement would be sufficient to include the Debtors’ accounts receivable, which were specifically listed on the security agreements, but as the case demonstrated, this was not enough. To protect their clients, transactional attorneys should ensure that the descriptions of collateral used in financing statements describe all of the assets covered by their clients’ security agreements with great specificity and accuracy. Further, even in the most routine transactions, transactional attorneys should carefully review the language used in financing statements, as the attorney in this case could have discovered and corrected his or her omission of the term “accounts” in one of the subsequent transactions.

WILLS & ESTATES

A contract to execute mutual wills is enforceable when the consideration for the contract is mutual promises not to amend or revoke the respective wills. Furthermore, a claim that a will violates such contractual obligations can be properly brought as a claim against the estate, as part of a will contest, or as an action for specific performance with the applicable procedural and jurisdictional requirements applying to each type of action. *In re Estate of Brown*, 402 S.W.3d 193 (Tenn. 2013).

By Jared Hagler

In the case of *In re Estate of Brown*, the Tennessee Supreme Court was faced with whether a will, executed in contravention of a contract between spouses to make mutual unalterable and irrevocable wills even after the death of the other spouse, is valid, or whether such a contract is unenforceable for lack of consideration leaving the surviving spouse with the full rights to alter, amend, or revoke her will. Furthermore, the court examined the procedural requirements for a claim challenging a will that contravenes such contractual obligations and concluded that such a claim can be brought in one of three types of actions.

Roy E. Brown Jr. (“Mr. Brown”) and Ina Ruth Brown (“Mrs. Brown”) were the two spouses whose joint estate plan was at issue in this case. Each had been married before their marriage to one another and each had children from the previous marriage. During the course of their marriage the two jointly owned property, including valuable real property, as tenants by the entireties. To ensure that neither spouse could disinherit the other’s children from the previous marriage, the couple executed a contract (the “Contract”) stating that after the death of one of them, the surviving spouse forfeits all rights to change his or her will that was executed on the same day as the Contract. Along with the Contract, dated June 13, 2002, both Mr. and Mrs. Brown executed wills giving the other a life estate in all real property owned separately or jointly with the other, and upon the death of the surviving spouse, all property would pass to the couple’s surviving children (the “Original Wills”). After Mr. Brown’s death on June 19, 2002, Mrs. Brown, in violation of the Contract, executed a new will on June 28, 2002 (the “New Will”). The New Will left Mrs. Brown’s entire estate to Mr. Rockford Estes (“Mr. Estes”), a son from her previous marriage. After Mrs. Brown died on February 1, 2003, Mr. Estes filed the New Will for probate without any of Mr. Brown’s children even being aware of the New Will’s existence. Mr. Brown’s children attempted to probate Mrs. Brown’s Old Will, but they quickly found that Mr. Estes was already attempting to probate the New Will. Mr. Brown’s children contested the New Will on grounds that it was executed under the undue influence of Mr. Estes and that the Contract was valid and enforceable, thereby making the New Will null and void. Mr. Estes denied exerting undue influence over his mother, Mrs. Brown, in connection to the New Will and argued that the Contract was unenforceable because it lacked the necessary contractual element of consideration.

The trial court found that Mr. Brown’s children failed to prove that the New Will was the product of undue influence by Mr. Estes. However, the trial court further found that the Contract did have the requisite consideration to be valid and enforceable. Therefore, the trial court held that the New Will, which was executed in violation of the Contract, was null and void. Mr. Estes appealed

the trial court's ruling, claiming that the trial court lacked subject matter jurisdiction over the dispute and that the trial court erred in finding adequate consideration for the Contract. However, the Tennessee Court of Appeals rejected Mr. Estes's arguments and upheld the ruling of the trial court. Mr. Estes then appealed to the Tennessee Supreme Court for review of the same issues and was granted certiorari.

Reviewing the case *de novo* with no presumption of correctness, the Tennessee Supreme Court upheld the judgments of the lower courts. On Mr. Estes's claim that the trial court lacked subject matter jurisdiction due to the late filing of Mr. Brown's children's claim, the court ruled that an assertion of untimely filing is a challenge to the sufficiency of a claim and not to the competency of the court to properly hear the claim. Moreover, the court held that the statute of limitations that Mr. Estes was seeking to apply to his opponent's claim was not necessarily applicable. The court noted that Mr. Estes's assertion that the claim was untimely rested on the notion that the only way to challenge a will on the grounds that it violates a contract to make mutual wills is to file a claim against the estate, which must be done within one year of the decedent's death. However, the court stated that such a claim can also be brought as a will contest or an action for specific performance of the contract. Under Tennessee law, the statute of limitations on will contests is two years after the order admitting the challenged will to probate. Because Mr. Brown's children brought this claim as a part of a will contest and the claim fell within the allowed statutory period of two years, the claim was timely and the court could adjudicate the dispute.

The court then turned to Mr. Estes's claim that the Contract should fail for lack of adequate consideration. After explaining the necessity of consideration to make any contract valid, the court quickly found the presence of adequate consideration in the Contract. The consideration needed to make the Contract lay in the forfeiture of each spouse's right to amend or revoke his or her will once the other spouse had died and each spouse's right to dispose of property by any other means than that specified in the Original Wills. The court found that these mutual promises not to alter the wills or the disposition of property were fairly contemplated and deliberate; thus, the Contract was enforceable, and the New Will was void.

The case of *In re Estate of Brown* presents two very important issues in regard to estate planning. First, the Tennessee Supreme Court ruled that a mutual promise to forfeit one's testamentary rights of amending or revoking one's own will is adequate consideration for a contract to make mutual wills. Transactional

attorneys utilizing contracts for mutual wills as an estate planning tool can rest assured that the mutual promises of the testators will be adequate consideration and that the contract will survive a challenge to its enforceability on this ground. Second, *In re Estate of Brown* addressed what type of claim is a challenge to a will based upon connection to a prior contract. In denying Mr. Estes's argument that the claim was not timely filed, the court noted that such a claim can be made as a claim against the estate, as part of a will contest, or as an action for specific performance of the contract; each of these claims may have different statutes of limitations, which may affect the timeliness of their filing. Thus, according to the rule in this case, a claimant lodging this type of claim has three options for the type of action being brought. Because the various options carry with them distinct procedural requirements that must be followed, an attorney who is arranging a contract for mutual wills should be mindful of the types of actions and their attendant requirements that can be brought if a will violates the contractual rights or obligations. Such awareness will support the estate planning process for clients seeking mutual wills.