CASE COMMENTARIES

BANKRUPTCY

The United States Bankruptcy Appellate Panel for the Eighth Circuit extended the Supreme Court's ruling in *Clark v. Rameker*, 573 U.S. 122, 134 (2014), and held that in order for 401(k) and IRA assets to be considered exempt in a bankruptcy proceeding, they must be created for the retirement of the debtor and the debtor must contribute funds into the retirement account. *Lerbakken v. Sieloff & Assocs., P. A.* (*In re* Lerbakken), 590 B.R. 895 (B.A.P. 8th Cir. 2018).

Drew Hove

In *In re* Lerbakken, the United States Bankruptcy Appellate Panel for the Eighth Circuit addressed whether certain retirement accounts acquired by property settlement incident to a divorce may be exempt from creditor claims in a voluntary Chapter 7 bankruptcy proceeding. 11 U.S.C. § 522(d)(12) (2018) offers exemptions for "[r]etirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986." This provides a safety net to individuals filing for bankruptcy by allowing them to retain their tax-free retirement accounts, and directing creditors to collect from the remaining assets. Following a brief review of 11 U.S.C. § 522(d)(12) and *Clark v. Rameker*, 573 U.S. 122, 134 (2014), the United States Bankruptcy Appellate Panel for the Eighth Circuit concluded that retirement funds obtained or received by means other than self-creation and contribution do not qualify for this exemption.

In 2014, Brian Lerbakken ("Mr. Lerbakken") retained Sieloff & Associates, P.A. ("Sieloff") to represent him in a divorce proceeding. As part of the divorce settlement, Mr. Lerbakken was awarded one-half of the value in his ex-wife's Wells Fargo 401K and an entire IRA account ("Accounts"). Following the court proceedings, Mr. Lerbakken made no attempt to obtain title or possession of the accounts. Moreover, Mr. Lerbakken failed to pay his attorneys' fees that accrued in the divorce proceeding. A couple of years later, on January 23, 2018, Mr. Lerbakken filed a voluntary Chapter 7 petition.

Mr. Lerbakken's "Schedule C claimed the Accounts [received pursuant to the divorce settlement] as exempt retirement funds for the values agreed to under the property settlement." Mr. Lerbakken argued

that the Accounts met the statutory definition of a retirement fund, pursuant to 11 U.S.C. § 522(d)(12), because their non-taxable status to his ex-wife inured to his benefit. Sieloff, who was listed as a creditor for unpaid attorney fees, objected to Mr. Lerbakken's claim of exemption. Ultimately, the bankruptcy court rejected Mr. Lerbakken's claim on the basis that the Accounts were not retirement funds pursuant to the definition set forth in *Clark*. Thus, the Accounts did not qualify for the exemption. Mr. Lerbakken appealed.

The United States Bankruptcy Appellate Panel for the Eighth Circuit ultimately held that the "exemption is limited to individuals who create and contribute funds into the retirement account." The court first noted that the issue of whether the claimed exemption applies presents a question of law which is subject to *de novo* review. *Rucker v. Belew* (*In re* Belew), 588 B.R. 875, 876 (B.A.P. 8th Cir. 2018). The court then began its analysis by reviewing the language of 11 U.S.C. § 522(d)(12) to determine whether a claim of exemption would be proper in this instance. Specifically, the court recognized that 11 U.S.C. § 522(d)(12) contains two requirements: "(1) that the amount must be retirement funds; and (2) that the retirement funds must be in an account that is exempt from taxation under one of the provisions of the Internal Revenue Code set forth therein. In order for the Account to be exempt both of these elements must be established."

After acknowledging and rejecting both Mr. Lerbakken and Sieloff's arguments regarding potential tax consequences and penalties, in addition to ERISA provisions, the court turned to the Supreme Court's unanimous decision in *Clark*. In *Clark*, the Supreme Court "considered whether an inherited IRA qualified as a retirement fund for purposes of exemption under federal law." The Supreme Court defined the term "retirement funds" as "sums of money set aside for the day an individual stops working." Although the funds in *Clark* were acquired by a different method, the United States Bankruptcy Appellate Panel for the Eighth Circuit viewed the case as determinative, noting that "[t]he opinion clearly suggests that the exemption is limited to individuals who create and contribute funds into the retirement account. Retirement funds obtained or received by any other means do not meet this definition."

Lastly, the court addressed Lerbakken's argument that the Accounts were saved for the joint retirement of him and his ex-wife. The court responded by explaining that "[c]ourts are not required to address these subjective, [fact-intensive] considerations in determining the

exemption issue." Rather, the court is to ask "whether, as an objective matter, the account is one set aside for the day when an individual stops working." (quoting *Clark*). Notwithstanding the fact that the case arose in a different context, the court relied on *Clark* in determining that retirement accounts acquired by way of property settlement are not retirement funds which qualify as exempt under federal bankruptcy law.

Ultimately, the United States Bankruptcy Appellate Panel for the Eighth Circuit affirmed the bankruptcy court's holding that the bankruptcy exemption for retirement funds does not extend to accounts received in the name of another party. The court explained that retirement funds obtained or received by any other means, including, but not limited to, property settlements, do not meet the *Clark* definition of "retirement funds." Therefore, they are not exempt from the claims of creditors.

In light of this decision, practitioners should be cognizant of their client's financial condition and likelihood of filing for bankruptcy. The court does not directly address whether or not Mr. Lerbakken could have shielded the retirement funds from the creditors. As such, practitioners should advise their clients not to comingle retirement funds awarded in a divorce settlement with their own personal retirement accounts. Such actions could potentially expose a client's retirement funds, which would otherwise be exempt from bankruptcy proceedings, to creditors in the event of a bankruptcy.

BUSINESS ASSOCIATIONS

The Tennessee Court of Appeals held that a plaintiff shareholder may pierce the corporate veil of her own corporation in order to hold the other shareholder personally liable for a judgment she obtained against the corporation when the other shareholder disregards the corporate structure to his benefit and the plaintiff shareholder's detriment. *Judd v. Guye*, No. M2017-01791-COA-R3-CV, 2018 Tenn. App. LEXIS 400, 2018 WL 3460435 (Tenn. Ct. App. July 17, 2018).

Tyler Munger

In *Judd v. Guye*, the Tennessee Court of Appeals addressed whether a plaintiff shareholder may pierce the corporate veil of her own corporation to hold the other shareholder personally liable for the unpaid judgment she obtained against the corporation, despite both parties being

equal shareholders in the corporation. Prior to the case, Tennessee courts had not yet addressed whether the state recognized an insider reverse piercing of the corporate veil as an equitable remedy. However, upon review, the Tennessee Court of Appeals found that the trial court's action in the present case did not constitute an insider reverse piercing and held that, where a defendant disregards the corporation's structure to his benefit and the plaintiff's detriment, the plaintiff may pierce the corporate veil in order to recover an award for a previous judgment rendered against her own corporation.

This is the second action that arose from a financial dispute between two siblings: Carlene Guye Judd ("Carlene") and her brother, Carlton Guye ("Carlton"), who were equal shareholders in the West Mead Decorating Company, Inc. ("WMDC" or the "Company"). During the economic recession beginning in 2007-2008, WMDC's business experienced a dramatic drop in profits. Around the same time, Carlene noticed that Carlton was using the company's financial resources for his own benefit, including: living rent-free in an apartment on real estate owned by WMDC, and using WMDC funds to pay for his utilities, car insurance on four personal vehicles, personal cell phone bills, groceries, and personal vacations and related expenses. Additionally,, Carlton had sold company property—one tractor—in order to pay off the outstanding obligation of a personal promissory note, among other things.

To protect the company's assets, Carlene requested that Carlton stop using WMDC's credit cards, as well as provide her with invoices for the work he had done for customers and any payments received from the customers to deposit in WMDC's account. When Carlton ignored these requests, Carlene removed Carlton's privileges from the company credit cards, changed the company's P.O. Box, and opened new bank accounts on behalf of WMDC. Carlton, in response, opened two new credit cards on behalf of WMDC, deposited checks from previous customers into a new bank account, locked Carlene out of the WMDC building, stopped paying her salary, and completely took control of the Company. Carlton also refused to turn over any of the requested payments or information regarding WMDC's finances to Carlene.

In February 2013, Carlene brought her first action against WMDC and Carlton, in her individual capacity, as well as derivatively as a WMDC shareholder. Carlene requested that the court dissolve WMDC, appoint a receiver to wind up the company, and allow the her to recover misappropriated funds and converted property of WMDC from Carlton.

Following a trial, the court ruled, *inter alia*, that Carlton abused the corporate structure of WMDC for his own benefit, and had acted to the detriment of WMDC and Carlene. The court awarded Carlene $266, 246.70 in her individual capacity against WMDC and $239, 102.79 in her derivative capacity, for the benefit of WMDC, against Carlton.

Carlton fully satisfied the judgment against him to WMDC. However, WMDC was unable to fully satisfy the judgment owed to Carlene, leaving an outstanding balance of $161,147.56. As a result, Carlene bought this action seeking to pierce the corporate veil of WMDC and hold Carlton liable for the remaining balance owed by WMDC. At trial, Carlene moved for summary judgment, relying heavily on findings from the previous action. Carlton opposed the motion, arguing that Carlene was requesting a "reverse piercing" of the corporate veil (i.e. "when a creditor seeks to hold the corporation accountable for the actions of its shareholders."), a remedy Tennessee courts have not recognized.

In deciding this issue of first impression, the trial court considered two cases from other jurisdictions: *Hibbs v. Berger*, 430 S.W.3d 296, 309 (Miss. Ct. App. 2014) and *Walensky v. Jonathan Royce Int'l Inc.*, 624 A.2d 613 (N.J. Super. 1993). In *Hibbs*, the Missouri Court of Appeals held that, under appropriate circumstances, minority shareholders may attempt to pierce the corporate veil in order to hold a majority shareholder liable. "After all, if majority shareholders desire to be protected via the equitable doctrine of corporate veil piercing, then we should also require majority shareholders to operate under the same equitable principles by which they seek protection." *Hibbs*, 430 S.W.3d at 309. In *Walensky*, a case where minority shareholders in a closely held corporation were defrauded by a majority stockholder's disregard of the corporate structure, the New Jersey Superior Court held that a controlling stockholder can be liable for debts of a corporation where he misuses the corporation's funds for personal expenses.

Acknowledging that those cases differ from the present case, where two shareholders own equal shares in the company, the trial court held that the same logic nonetheless applies in a situation where a dominant shareholder acts in a way that harms another shareholder. Thus, "the Chancellor found that the claim at issue was not one of reverse veil piercing, but instead it was more akin to when one shareholder, who is a creditor of the corporation, is seeking to hold another shareholder liable by piercing the corporate veil." The Chancellor also held that a shareholder may pierce the corporate veil of a company and hold a

defendant shareholder liable when (1) the plaintiff shareholder has an unfulfilled judgment against the company and (2) the defendant shareholder acted in a controlling capacity of the company to the detriment of the company and its shareholders. Accordingly, the Chancellor granted summary judgment to Carlene and Carlton appealed.

On appeal, the Tennessee Court of Appeals affirmed the trial court's grant of summary judgment for Carlene, allowing her to pierce WMDC's corporate veil and hold Carlton personally liable for the judgments against WMDC. However, the court stated that the decision to pierce the corporate veil of a company is a fact-based determination, under which courts must consider a variety of factors, and that courts should presumptively treat a corporation as a separate entity from its shareholders. Regardless, given the record from the previous action, the court determined that the trial court's decision to grant summary judgment to the plaintiff, allowing Carlene to pierce the corporate veil, was an appropriate one.

To ensure that a client is aware of the potential personal liability that may attach to majority shareholders of a corporation from a judgment against the corporation, practitioners should notify clients that a majority shareholder's disregard of the corporate formalities may allow a piercing of the corporate veil in a way that holds an individual majority shareholder personally liable. Furthermore, practitioners should advise clients that this holding allows a piercing of the corporate veil where two individuals are equal shareholders of a corporation. However, from the holding in this case, it remains unclear how frequently Tennessee courts will utilize this remedy, given that the facts of the case represent a clear and blatant example of abuse of the corporate structure by the defendant.

CONTRACTS

The Tennessee Court of Appeals held that the simple inclusion of the word "individually" cannot, by itself, designate personal liability upon the signatories of a lease when the body of the agreement is silent as to any assumption of personal liability. *Teal Properties v. Dog House Investments, LLC*, No. M2018-00257-COA-R3-CV, 2018 WL 3912299, 2018 Tenn. App. LEXIS 470, 2018 WL 3912299 (Tenn. Ct. App. Aug. 15, 2018).

Wade Blair

In *Teal Properties v. Dog House Investments, LLC*, the Tennessee Court of Appeals addressed whether co-owners of a limited liability

company became personally liable for the obligations of the entity when they signed a lease agreement twice: once on behalf of the entity in a representative capacity, and once more on a line followed by the word "individually", when the LLC was the sole party to the lease agreement and the lease was otherwise devoid of any provision or language conveying personal liability to the co-owners.

Teal Properties, Inc. ("Teal"), owner of office and warehouse space in Nashville, Tennessee, and Dog House Investments, LLC ("Dog House"), owned jointly by Steve Lassiter and Nancy Purvis (collectively, "Lassiter and Purvis"), entered into a commercial lease agreement (the "Lease"). The Lease provided that Teal would lease one of its properties to Dog House for a four-year term beginning on June 1, 2009 and ending on May 31, 2013, with two additional five-year option periods after the expiration of the original lease term. Teal and Dog House were the only named parties to the Lease, and all obligations set forth in the Lease were imposed upon Teal and Dog House. Furthermore, there was no language in the Lease that indicated that Lassiter and Purvis were personally liable for any obligation under the Lease. However, the Lease contained two signature lines. The first line was preceded by the word "By" and followed by Lassiter and Purvis's signatures. Underneath that line, both Lassiter and Purvis handwrote the word "co-owner" next to the word "Title". These two lines combined show Lassiter and Purvis signing in their representative capacity on behalf of Dog House as joint co-owners. The second line contained both Lassiter and Purvis's full names, but was followed by the word "Individually". Lassiter and Purvis both signed.

In October of 2017, during the first option period, Teal filed suit for breach of contract against Dog House and Lassiter and Purvis for failure to perform obligations under the Lease. Lassiter and Purvis responded by filing an answer in which they denied all of Teal's breach of contract claims. They also jointly filed a motion to dismiss all claims against them individually, as they were not named parties to the Lease. They argued that since Dog House was the only party to the lease, Dog House was the only party bound to its provisions. In its response, Teal relied on the second signature line, which appeared above the word "Individually", to argue that when Lassiter and Purvis signed their names on those lines it bound them in their individual capacities in addition to their representative capacities as co-owners of Dog House.

The trial court dismissed all claims against Lassiter and Purvis individually. Specifically, the trial court held that the Lease "while signed

by both Lassiter and Purvis, does not provide for any liability of Lassiter or Purvis, whether individually or as a guarantor…" Additionally, the court did not attach personal liability to Lassiter and Purvis because the lessee to the Lease was Dog House and not Lassiter and Purvis, making Dog House the only party bound to its terms.

Teal appealed, maintaining that by signing the lease twice Lassiter and Purvis bound themselves individually. Teal argued that the trial court incorrectly interpreted the Tennessee Supreme Court's decisions in *84 Lumber Co. v. Smith*, 356 S.W.3d 380 (Tenn. 2011) and *MLG Enters. LLC v. Johnson*, 507 S.W.3d 183 (Tenn. 2016). In *84 Lumber*, the Tennessee Supreme Court held that "[a] representative who signs a contract may be personally bound…when the clear intent of the contract is to bind the representative." 356 S.W.3d at 382–383. Utilizing this language, Teal argued that the second signature line, in the Lease, that was followed by the word "Individually" demonstrated "clear and unambiguous" language to bind Lassiter and Purvis in both a representative capacity and as personal guarantors.

In *MLG Enterprises*, the Tennessee Supreme Court held that an initial signature made in a representative capacity on behalf of an entity does not indicate that the second signature line should be disregarded as a nullity for purposes of personal liability. Teal used this language to argue in its brief that the Supreme Court held "that a second signature on a lease agreement was sufficient to bind one individually as a guarantor of the tenant's obligation under the lease." The Tennessee Court of Appeals notes, however, that Teal is imprecise in its analysis of the court's prior holdings.

The Tennessee Court of Appeals points out a crucial distinction between the Lease and the contracts in *84 Lumber* and *MLG Enterprises*. In both *84 Lumber* and *MLG Enterprises*, the relevant contracts contained separate provisions with "explicit and unambiguous language stating that the signatories were personally assuming the liabilities of their respective entities. Here, there is no [such] language…" As a result, the Tennessee Court of Appeals clarified the law by stating that a second signature, alone, is not enough to personally bind a signatory. It is the combined effect of the second signature with the explicit and unambiguous additional language in separate provisions of the document that convey personal liability upon a signatory.

Accordingly, the court held that "the formal inclusion of the single word 'individually' cannot by itself convey personal liability upon [Lassiter

and Purvis] when the body of the lease is otherwise devoid of any assumption of personal obligation or guarantor status." Thus, Dog House is the only party liable in the Lease.

The Tennessee Court of Appeals noted that the holding here is consistent with its earlier decision in *Brooks v. Networks of Chattanooga*, 946 S.W.2d 321 (Tenn. Ct. App. 1996). There, inclusion of the word "individually" after a signature was deemed insufficient to establish personal liability of the signatory, because the lease did not explicitly indicate that the parties intended to be personally bound.

This decision clarifies the analytical framework Tennessee courts apply to contract disputes. In particular, the holding gives clear guidance that the intent of the parties and the entire body of the contract are more important than words such as "individually", which are arbitrary in relation to what was bargained for. Transactional attorneys should be cognizant of the fact that in the contract drafting stage, if personal liability is to be enforced, it must be negotiated, drafted, and have a strong visual presence within the contract terms. This way, the contract can properly distinguish between the corporate entity and the individual signatory regarding responsibilities in the event of breach. Taking the proper steps in the drafting stage of the contract will help clients avoid costly disputes if a breach occurs.

CORPORATE FINANCE

The Chancery Court for the State of Tennessee, on remand from the Tennessee Supreme Court, reconsidered the fair valuation determination of dissenting shareholder's shares following the Supreme Court's adoption of the *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) valuation approach as opposed to the *Blasingame v. American Materials, Inc.*, 654 S.W.2d 659 (Ten. 1983) by evaluating the findings and opinion of each party's expert. Athlon Sports Commc'ns, Inc. v. Duggan, No. 12-187-III (Tenn. Ch. Nov. 9, 2018).

Andrew Cox

In *Athlon Sports Commc'ns, Inc. v. Duggan*, the Chancery Court for the State of Tennessee, on remand from the Tennessee Supreme Court, reconsidered its fair value determination of dissenting shareholders' shares following the Supreme Court's adoption of the *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) valuation approach, an approach that allows courts

to use "any technique or method generally acceptable in the financial community and admissible in court."

Athlon Sports Communications, Inc. was founded in 1967, as "a Nashville-based media business engaged in publishing and sports marketing" (the "Company"). The Company maintained steady sales until 2008, when profits began to decline. By 2009, the Company's profits had declined by 35%. In 2010, the Company hired Stephen Duggan ("Duggan") in hopes that he would turn the tide for the flagging company. Duggan, "a sophisticated, experienced and knowledgeable investor and analyst of companies and their operations and finances[,]" convinced the Company that he would save them via a new stream of advertising revenue: a monthly sports magazine inserted into local newspapers.

"At a March 12, 2010 meeting of the Company's Board, Defendant Duggan presented two cases for his initiative: a base case and a worse case." Following that, Duggan was named president of the Company's newspaper magazine division and given a voting seat on the Company's board after purchasing 15% of Series A Preferred Company stock. Ultimately, however, the promised revenue never materialized and the Company lost $9.5 million between 2010 and 2012: "losses significantly greater than the worse case presented by Defendant Duggan."

In 2011, the company had a dismissal year. Apart from Duggan, all Board of Director employees took permanent salary cuts. The Company was also forced to sell its building and Keyman insurance for Spencer Hays. "In November 2011, Defendant Duggan was terminated as President of the Newspaper Magazine Division of the Company." Additionally, the Company's request for a line of credit was rejected by the bank. The Company was on the verge of insolvency, and it became clear that a change was needed.

After firing Dugan, the Company considered several solutions. They consulted a bankruptcy attorney. They looked for, but could not locate, third party investment. Finally, in the spring of 2012, the Company devised a plan of merger. After negotiations, in March 2012, the Company approved Mr. Hays proposition that "he and his co-investors would provide 2 million of additional capital to the Company with a Plan of Merger and proposed payment of $.10 per share." It is this plan to which the Defendants dissented.

In Tennessee, the procedure for shareholders to dissent from a share value dictated by a plan of merger is outlined in Tennessee Code

Annotated sections 48-21-101 through 302. Specifically, when the parties cannot agree, such as the parties in this case, Tennessee Code Annotated sections 48-28-301 through 303 provide the parties with a judicial proceeding to "determine the fair value of the dissenter's shares." As the parties were unable to agree within 2 months of receiving demand for payment on the fair value of the shares, the Company filed suit. A trial was held in September 2015 where parties provided exhibits and expert opinions in support of their valuations. The Company's expert asserted that the value of the shares was zero. Defendants' expert claimed, however, that each share was worth $6.40.

Tennessee valuation law, with respect to determining fair value, is a hybrid of statute and case law. Tennessee Code Annotated section 48-21-101(4) says that the fair value of the shares must be based on the value of the shares "immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action . . . ." In October 2015, following Tennessee valuation law, the trial court valued the shares at no more than $0.10 per share. Defendants appealed and the Tennessee Supreme Court granted review.

Upon review, the Supreme Court overruled its previous holding in *Blasingame v. Am. Materials, Inc.*, 654 S.W.2d 659, 661 (Tenn. 1983), to the extent that it prevented trial courts from using valuation methods other than the Delaware Block Method. Instead, the Court adopted the approach presented in *Weinberger v. UOP*, Inc., 457 A.2d 701, 712-13 (Del. 1983), which provides that "any technique or method generally acceptable in the financial community and admissible in court" can be used to value the stock. Because the Court was unable to determine to what extent the trial court had relied solely on the Delaware Block Method, the Court vacated the judgement and remanded the case to the trial court for an opinion consistent with its updated jurisprudence.

On remand, Defendant's argued that the Delaware Block method was a particularly poor method for valuation, as the Company had "recently implemented [a] transformative business plan." Instead of relying on a backwards looking valuation, like the Delaware Block Method, Defendants petitioned the court to use the discounted-cash-flow ("DCF") method, "which focuses on the company's projected cash flows."

Using the newly adopted *Weinberger* standard, the court reexamined the complete record, paying particular attention to each party's expert. Looking at the record for a second time, the court sided

with the Company's expert's opinion, with one exception—share value. Instead of finding a $NIL value for the shares, like the Company's expert, the court valued the shares at $0.10 per share. The court based its valuation on "the recognition of the Athlon name or brand and the $9 million in circulation. . . ." The court then turned to Defendants' expert.

Unfortunately for Defendants, the court denied their request to apply the DCF method and summarily rejected Defendants' expert's opinion. While the court recognized that it had the power to use the DCF method of valuation in some cases, it concluded that the bases used by Defendants' expert was "the product of speculation and d[id] not provide a reliable basis for valuation." The court paid particular attention to Defendants' use of a Confidential Information Memorandum ("CIM") and Defendants' expert's lack of supported evidence.

One of the primary bases used by Defendants in applying the DCF method was a confidential information memorandum ("CIM"). The CIM, composed by Defendant Duggan, was used to entice potential investors once Defendant Duggan's new project proved it would not bear any fruit. The court declined to use the CIM as it contained "projections [that] were not used to manage the business." The court found that the CIM was "aspirational" and written "to attract the attention of potential investors." Furthermore, the court agreed with the Company's CFO's testimony that the CIM was speculative and unreliable.

Additionally, the court declined to use Defendants' DCF method based on the testimony of their expert. The court found the expert failed to make comparisons and analyze projections against actual performance with information actually provided in discovery. Moreover, the expert failed to consider company specific risk factors and used a long-term growth rate twice that of the growth rate for the print media industry.

In light of the court's decision, transactional attorneys should be aware that they are no longer limited to the Delaware Block Method of evaluation when determining share value in dissenter's rights cases. It is important, however, that to the extent a company uses a forward-looking method, the company must refrain from including speculative measures.

EMPLOYMENT

The Tennessee Court of Appeals held that an employee is not prohibited, per se, from preparing to compete with his current employer absent any intentional sabotage by the employee, or any agreements that barred such actions. *Leslie's Poolmart, Inc. v. Blue Wave Pool Supply of Memphis, LLC*, No. W2017-01894-COA-R3-CV, 2018 WL 3738666, 2018 Tenn. App. LEXIS 448 (Tenn. Ct. App. Aug. 6, 2018).

Jordan Ferrell

In *Leslie's Poolmart, Inc. v. Blue Wave Pool Supply of Memphis, LLC*, the Tennessee Court of Appeals addressed whether the trial court erred in holding that the defendants did not breach their employment agreement, maliciously or illegally misappropriate the plaintiff's trade secrets, or induce the plaintiff to suffer damages due to the defendants' conduct. The court also addressed whether the defendants were entitled to an award of attorney's fees, under T.C.A. § 47-25-1705, due to the plaintiff's alleged bad faith claim of misappropriation of trade secrets.

This case arose after Todd Heins ("Heins"), manager of Leslie's Poolmart, Inc.'s ("Leslie's") Bartlett Hills location in Memphis, created a pool supply business, Blue Wave Pool Supply ("Blue Wave"), that would become a de facto competitor to Leslie's. Heins' decision to create his own store stemmed from a conversation he had with Jay Karcher ("Karcher") in April 2015. The Court discussed the circumstances of how Heins and Karcher agreed (while Heins was still an employee) to form a new business in competition with Leslie's post-employment; exactly when Heins offered Karcher a job; how and why Heins was in possession of Leslie's proprietary information, such as Blue Wave's selection of its physical premises, Leslie's 2015 Productivity Book, and numerous shop tags containing customer information, and what Heins did with that intellectual properties. While under Leslie's employment, Karcher entered Leslie's as a customer, and he and Heins engaged in a spontaneous conversation regarding the possibility of going into business together. That day's conversation was abstract but led to future communications that ultimately resulted in the formation and opening of Blue Wave in 2016, following Heins' resignation from Leslie's.

While under Leslie's employment, Heins was ordered by a superior to take possession of the company's 2015 Productivity Book, which contained supply and demand statistics, and through forgetfulness, Heins maintained possession of the book until the eve of trial. Upon his

departure from Leslie's, Heins also took possession of several shop tags, which contained personal contact information of Leslie's customers. Additionally, Heins' former Leslie's colleague, Chad Pitcock ("Pitcock"), left Leslie's to join Heins at Blue Wave. Shortly after Blue Wave officially opened for business, " Leslie's sued Blue Wave, Heins, Karcher, and Pitcock, seeking damages and injunctive relief, asserting among other things breach of contract, breach of fiduciary duty, misappropriation of trade secrets, and inducement to breach contract."

The Chancery Court for Shelby County, Tennessee, dismissed all of Leslie's claims with prejudice based on its determination that the defendants' actions were all proper and lawful, except Heins' taking possession of the shop tags. Despite the court finding this specific deed actionable, the court held that no damages resulted, so the claim was similarly rejected. Additionally, the court noted that the actions taken by Heins and Karcher were all based on their desire to own their own business and not intended to cause harm to Leslie's. Leslie's appealed.

On appeal, the Tennessee Court of Appeals affirmed the trial courts findings that the defendants were blameless in all of their actions, except taking possession of the shop tags, and that even those ill-considered actions failed to result in damages to Leslie's. Thus, the trial court was correct in dismissing all claims with prejudice. The court also ruled that the defendant's counter-claim for attorney fees to penalize the plaintiff for an alleged misappropriation claim in bad faith was groundless.

First, the court addressed whether the trial court erred in finding that Heins and Pitcock breached their employment agreement. Both Heins and Pitcock executed a non-competition and non-solicitation agreement while employed at Leslie's. The non-compete provision provided, in part, that neither employee would compete with Leslie's while they were still employed, without written consent from Leslie's. The appellate court relied heavily on its previous decision in *Dominion Enterprises v. Dataium*, No. M2012-02385-COA-R3-CV, 2013 Tenn. App. LEXIS 840, 2013 WL 6858266, (Tenn. Ct. App. Dec. 27, 2013) in deciding whether Heins and Pitcock bread their fiduciary duty to Leslie's. The court noted that "relevant case law reflects that an employee is not prohibited, per se, from preparing to compete post-employment. Competition is, obviously, a key element of the free enterprise system." Additionally, the court recognized that the non-compete agreements at issue did not directly provide that an individual could not compete post-employment.

Leslie's also claimed that Heins wrongfully enticed Pitcock to resign from his position at Leslies and also breached his employment agreement by creating a company that directly competes with Leslie's. The court reiterates once more that the mere act of planning a future economic venture, or preparing to compete, only serves to foster the prevailing society's interest in protecting the freedoms of employment and competition. Additionally, the underlying facts provide that Heins in no way intended to undermine Leslie's. The court points to the fact that the initial conversation with Karcher was a completely spontaneous exchange and that Karcher initiated the topic, that Heins undertook no action that directly competed with Leslie's until post-resignation, and that Heins did not improperly solicit Pitcock away from Leslie's. The only improper action was Heins' taking of the shop tags, but the Court found that the Leslie's suffered no harm.

Regarding the alleged misappropriation of Leslie's trade secrets, the Court acknowledged the standard for the trial court's finding on testimony credibility was clear and convincing evidence; as opposed to ruling of law that are reviewed with no such evidence. The Court was forced to yield to the trial court's determination that Heins did not misappropriate any of the plaintiff's trade secrets without clear and convincing evidence to the contrary. As such, the trial court determined that the defendants' testimony regarding the site selection for the Blue Wave store and the possession of the 2015 Productivity Book was more logical than the plaintiff's testimony, therefore, this Court upheld those findings of fact.

Third, the court addressed the trial court's finding that Leslie's suffered no damages due to the defendants' alleged behavior. The Court previously addressed that Heins' inappropriate possession of the shop tags resulted in zero damages. In addition, the court concluded that neither defendant breached any contractual/fiduciary duty to the plaintiff, and that any negative change in the plaintiff's revenue, due to the existence of the new Blue Wave store, resulted from normal competition and does not serve as a justifiable basis for awarding of damages.

Finally, the Court attended to the defendants' counter-claim that they were entitled to an award of attorney's fees based on the plaintiff's alleged bad faith claim of trade secret misappropriation. The court quickly dismissed this claim because Heins was not completely innocent in his taking of the shop tags. This act was determined to be misappropriation, however, no damages resulted; so an allegation of a bad faith claim failed.

As such, the Tennessee Court of Appeals held that the defendants did not breach any employment agreement or fiduciary duty to their employers, that employees can prepare to compete while still employed, and that none of the defendants' actions resulted in any substantive damages.

In light of this decision, transactional attorneys in Tennessee representing employers should advise their clients to be more specific in drafting employment agreements. Attorneys should also advise employers to keep information they desire to remain confidential under closer supervision and to be wary of leaving important company documents with employees. *Leslie's Poolmart v. Blue Wave* illuminates how courts favor employees' rights to freedom of competition in these claims, while still ensuring that individuals are not in breach of contractual or fiduciary duties. As such, attorneys representing employees should advise their clients on how to toe the line of preparing to compete while not crossing over into true competition.

TAX

The United States Supreme Court overturned both its decisions in *Quill Corp. v. North Dakota, 504 U.S. 298 (1992)* and *National Bellas Hess, Inc. v. Ill. Dep't of Revenue, 386 U.S. 753 (1967)* and held a state may collect sales tax from remote-sellers, regardless of whether the sellers have a physical presence within a state. South Dakota v. Wayfair, Inc., 138 S. Ct. 2080 (2018).

Andrew Harrison

In *South Dakota v. Wayfair, Inc.*, the United States Supreme Court overruled its holdings in *National Bellas Hess, Inc. v. Ill. Dep't of Revenue*, 386 U.S. 753 (1967) and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) (hereinafter collectively referred to as "*Quill and Bellas Hess*") and resolved the fifty-year-old dormant Commerce Clause issue which allowed remote-sellers without a physical presence within a state to avoid use tax collection.

The case at bar arose when South Dakota enacted S.B. 106, which "provide[d] for the collection of sales taxes from certain remote sellers"—sellers who "deliver[ed] more than $100,000 of goods or services into the State or engage[ed] in 200 or more separate transactions for the delivery of goods or services into the State" on an annual basis (hereinafter referred to as the "Act"), in order to "confront the serious inequality *Quill* imposes." S.B. 106, 91st Leg. (S.D. 2006).

The controversial holdings in both *Quill and Bellas Hess* provided that remote-sellers—those sellers who lack a physical presence in a state—may not be required to collect sales tax. Instead, the burden to report the tax was placed squarely on individual South Dakota citizens when they purchased goods and services from out-of-state sellers.

Unsurprisingly, the impracticality of collection and noncompliance from citizens led to a substantial reduction in state use tax collection. South Dakota, as a result of *Quill and Bella Hess*, lost between $48 and $58 million annually due to no state income tax and the substantial reliance on sales and use taxes to fund state expenditures.

"The legislature found that the inability to collect sales tax from remote sellers was 'seriously eroding the sales tax base' and 'causing revenue losses and imminent harm . . . through the loss of critical funding for state and local services" and provided an unfair advantage to remote-sellers in contrast to in-state brick-and-mortar sellers. In response, South Dakota issued a state of emergency and enacted the Act in an attempt to require out-of-state sellers to collect and remit sales tax on items sold within the state—in direct opposition to the holdings in *Quill and Bellas Hess*.

In a concerted effort to enforce the Act, South Dakota filed a declaratory judgment against three online retailers: Wayfair, Inc., Overstock.com, Inc., and Newegg (hereinafter collectively referred to as the "Retailers"), who regularly shipped goods into South Dakota, did not have a physical presence or collect sales tax there, and certainly met the minimum requirements of the Act.

The Retailers moved for summary judgment and argued that the Act was unconstitutional under *Quill and Bellas Hess*. "South Dakota conceded that the Act [could not] survive under *Bellas Hess* and *Quill* but asserted the importance, indeed the necessity, of . . . review[ing] those earlier decisions in light of current economic realities." Ultimately, "the trial court granted summary judgment " in favor of the Retailers.

South Dakota appealed to the South Dakota Supreme Court, who affirmed, and held that Act invalid because *Quill and Bellas Hess* were indeed the controlling precedents on Commerce Clause issues relating to the collection of sale and use taxes from remote-sellers. The United States Supreme Court granted certiorari.

Justice Kennedy delivered the 5-4 majority decision of the Court which overruled the physical presence rule in *Quill and Bellas Hess*. In the

decision, Justice Kennedy outlined the historical development of the Commerce Clause through a review of its application in prior cases and determined that the physical presence rule had been repeatedly criticized and challenged. The Court elucidated that "[e]ach year, the physical presence rule becomes further removed from economic reality and results in significant revenue losses to the [s]tates." Therefore, the decisions in *Quill and Bellas Hess* should be overruled due to the emergence and prominence of high-volume online retail which has "create[ed] an inefficient 'online sales tax loophole' that gives out-of-state businesses an advantage" and has created an ever-inflating tax revenue loss for state governments.

The Court further examined additional flaws in *Quill and Bellas Hess*'s holdings. First, the Court identified that the Due Process and Commerce Clause standards are similar insofar as they require "some definite link, some minimum connection between a state and a person, property or transaction it seeks to tax." The physical presence rule is not a "necessary interpretation" of this requirement. Additionally, the physical presence rule creates market distortions and imposes an "arbitrary [and] formalistic distinction that the Court's modern Commerce Clause precedents disavow."

Citing *McGoldrick v. Berwind-White Coal Mining Co.*, 309 U.S. 33, 50, n.9 (1940), the Court found that "[t]he imposition on the seller of the duty to ensure collection of the tax from the purchaser does not violate the [C]ommerce [C]lause." When viewed in conjunction with *Quill and Bellas Hess*, the Court determined the physical presence rule to be an outmoded version of a retailer's "substantial nexus" and is an unnecessary requirement when the Commerce Clause is interpreted.

In addition, *Quill and Bellas Hess* placed in-state retailers at a competitive disadvantage through the required collection of sales and use taxes. This allowed out-of-state sellers to avoid and even advertise the non-collection of tax which created a substantial market distortion. The consequence of this was a non-uniform "judicially created tax shelter for [out-of-state] businesses." Because of this market distortion, the Court found it necessary to "reject the physical presence rule."

Last, the Court found the arbitrary and formalistic distinction "artificial in its entirety" and determined it violated the Commerce Clause through the "intru[sion] on [s]tates' reasonable choices in enacting their tax systems." In effect, an upholding of the physical presence tradition—

substantial nexus—encourages tax evasion and harms both "federalism and free markets."

The Court vacated the Supreme Court of South Dakota's judgment, "remanded for further proceedings," and recognized that *stare decisis* was no longer appropriate where the rapid expansion of Internet sales, the increase in "revenue shortfall faced by [s]tates seeking to collect their sales and use taxes," and the failure of consumers "to comply with lawful use taxes" has made the physical presence rule impractical.

Justice Thomas, in a concurrence, stated he should have joined Justice White's dissent in *Quill* and agreed that *Quill and Bellas Hess* "can no longer be rationally justified" due to the nature of modern commerce. In a second concurrence, Justice Gorsuch criticized the dormant Commerce Clause—prohibiting state legislation that discriminates against interstate commerce—due to the tax avoidance available under *Quill and Bellas Hess*. Further, Justice Gorsuch argued *Quill and Bella Hess* discriminates against brick-and-mortar retailers and unfairly created a tax break for out-of-state sellers.

Chief Justice Roberts, joined by Justices Breyer, Sotomayor, and Kagan, filed a dissent—affirmatively recognizing the tax collection issue created by *Quill and Bellas Hess*—that emphasized the necessity of *stare decisis* for the issue at bar. Chief Justice Roberts recognized that "the [I]nternet's prevalence and power have changed the dynamics of the national economy," but opined that it is not the Court's place to discard of the physical presence rule when "any alteration to those rules [may have] the potential to disrupt such a critical segment of the economy . . . ." Instead, the *Wayfair* decision is one that should be undertaken solely by Congress.

In response to the *Wayfair* decision, practitioners should advise a retail client who acts as a remote-seller that the client is likely to be subject to the burden of sales tax collection, even when a physical presence is not apparent. However, this does not apply to all remote-sellers, as some states have adopted statutes that protect small businesses from the tax collection burden. South Dakota's Act, for example, "applies only to sellers that, on an annual basis, deliver more than $100,000 of goods or services into the [s]tate or engage in 200 or more separate transactions for the delivery of goods or services into the [s]tate."

Similarly, the Tennessee Department of Revenue issued Rule 1320-05-01-.129(2) in 2016 which provides a safe harbor for remote-

sellers who deliver less than $500,000 of goods or services into the state and provides no separate transactions threshold. *See* TENN. COMP. R. & REGS. § 1320-05-01-.129(2). (2016). Although this is similar to the South Dakota Act and may be deemed constitutional if litigated, practitioners should warn their clients that potential litigation issues may arise if they elect to avoid use tax collection. Furthermore, practitioners should advise smaller clients, who do not currently have an out-of-state tax collection system implemented, to use an existing e-commerce platform, find an existing tax-collection software system, or reduce their sales in that specific state.