

## CASE COMMENTARIES

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### ANTITRUST

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**An agreement that deprives the marketplace of “independent centers of decisionmaking” may be an unlawful restraint of trade under section 1 of the Sherman Act.** *Am. Needle, Inc. v. Nat’l Football League*, 130 S. Ct. 2201 (2010).

By N. Adam Dietrich II

Since being organized in 1920, the National Football League (the “NFL”) has become the nation’s most successful professional sports league and a lucrative multi-billion dollar business. The NFL is comprised of thirty-two separately owned teams, each controlling the use of its name, colors, logo, and related intellectual property. While these teams are fierce competitors on the field, some cooperation is necessary off the field for things like promoting the game and competing with other professional sports leagues. This interplay of competition and cooperation presents some interesting issues in light of section 1 of the Sherman Act and was addressed by the United States Supreme Court in *American Needle, Inc. v. National Football League*. Specifically, the Court considered whether the NFL and its thirty-two teams were considered a single entity for antitrust purposes or whether they were “separate economic actors pursuing separate economic interests.” In the end, the Court held that the teams could not be considered a single entity and that their arrangement to collectively license their intellectual property rights constituted concerted action in violation of section 1 of the Sherman Act.

Prior to 1963, each team in the NFL managed its own intellectual property rights. In 1963, however, the teams formed National Football League Properties (“NFLP”) to develop and license their intellectual property as well as market their trademarked items, such as caps and jerseys. Most of the revenue from this arrangement was shared equally among the teams. For nearly forty years, NFLP granted nonexclusive licenses to many vendors, including petitioner, American Needle, Inc. (“American Needle”), permitting them to manufacture and sell apparel bearing team names and logos. In December 2000, however, the teams authorized NFLP to grant exclusive licenses. Thereafter, NFLP granted an exclusive ten-year license to Reebok International (“Reebok”) for the manufacture and sale of trademarked headwear for all thirty-two teams.

After NFLP declined to renew American Needle’s nonexclusive license, American Needle filed suit in federal district court alleging that the agreements between the NFL, its teams, NFLP, and Reebok violated sections 1 and 2 of the Sherman Act. Finding for the defendants, the district court concluded that in regards to licensing the teams’ intellectual property, “they have so integrated their operations that they should be deemed a single entity rather than joint ventures cooperating for a common purpose.” The court of appeals affirmed, focusing on the fact that football itself can only be carried out jointly. The court noted that the teams “share a vital economic interest in collectively promoting NFL football.” As a result, the court concluded that the teams function as one source of economic power and are not subject to section 1 of the Sherman Act.

On appeal, the United States Supreme Court first looked at the language of section 1 of the Sherman Act, which makes illegal “[e]very contract, combination in the form of a trust or otherwise, or, conspiracy, in restraint of trade.” The Court noted that not every

instance of cooperation between individuals is illegal under the Sherman Act; rather, section 1 only applies to *concerted* action that restrains trade. The Court explained that, unlike independent action, Congress was weary of concerted activity because it “deprives the marketplace of independent centers of decisionmaking that competition assumes and demands.” In determining what qualifies as concerted action, the Court stated that the parties involved do not have to be legally distinct entities. On the other hand, just because there is more than one legally distinct entity involved does not imply that there is concerted action. The Court proffered that the key is whether the alleged “contract, combination . . . , or conspiracy” joins together “separate economic actors pursuing separate economic interests.” Moreover, the Court determined that where two legally distinct entities have organized themselves under a single umbrella or into a structured joint venture, courts will look to substance over form to determine whether the agreement joins together “independent centers of decisionmaking.”

Applying these rules to the facts in *American Needle*, the Court reversed and remanded the decision of the court of appeals, concluding that the NFL teams “do not possess either the unitary decisionmaking quality or the single aggregation of economic power characteristic of independent action.” The Court noted that each of the thirty-two teams are independently owned and managed, their objectives are distinct, and they compete with one another not just on the playing field, but in attracting fans, obtaining ticket sales, and signing players to contracts. Furthermore, the Court indicated that the teams are competing suppliers of their valuable trademarks, so when they decide to collectively license these marks to a single vendor, they “deprive the marketplace of independent centers of decisionmaking.” In regards to NFLP, the Court held that its decisions also constitute concerted action under section 1 because it acts on interests separate from the interests of the thirty-two teams, which actually own the share of jointly managed assets. Again, looking to substance over form, the Court found that NFLP was simply a “formalistic shell” or vehicle for ongoing concerted activity.

Additionally, the Court was not persuaded by the NFL teams’ argument that they constitute a single entity because, without their cooperation, there would be no NFL football. The Court recognized that some degree of cooperation is necessary for the economic survival of all professional sports leagues; however, this necessity of cooperation does not change concerted action into independent action. As the Court noted, “a nut and a bolt can only operate together, but an agreement between nut and bolt manufacturers is still subject to [section] 1 analysis.”

Finally, while the Court held that the NFL teams could not be treated as a single entity “when it comes to the marketing of the teams’ individually owned intellectual property[,]” it stated that the special characteristics of the industry would make many agreements between the teams exempt from section 1 scrutiny. Specifically, the Court cited the “Rule of Reason,” which states that certain joint ventures and other cooperative arrangements are “not usually unlawful . . . where the agreement . . . is necessary to market the product at all.” As an example, the Court stated that agreements for the production and scheduling of games would be an acceptable type of concerted action in which the “Rule of Reason” would apply.

In practice, the Court’s unanimous decision in *American Needle* will have the largest impact on sports agents and corporate attorneys representing players and professional sports leagues, such as the NFL, NBA, and MLB. In regards to the ongoing NFL labor dispute, the Court’s decision should give the NFL players more leverage in dealing with the owners,

who may face additional scrutiny when trying to implement league-wide policies such as salary ceilings and an eighteen game season. Furthermore, intellectual property attorneys, in general, should benefit as more vendors are permitted to manufacture and sell merchandise bearing professional sports logos, resulting in a new source of revenue for the vendors, while lowering the price of these goods on the market. Exclusive licensing deals for apparel, television, and video games will face extensive antitrust scrutiny, and entities such as NFLP, set up to manage the licensing rights of the teams, may become totally obsolete. Furthermore, in the future, individual teams will likely make their own arrangements for licensing their intellectual property and marketing trademarked goods. This result is good for large market teams, like the Dallas Cowboys, but could harm small market teams, like the Jacksonville Jaguars, who benefitted from the revenue sharing set up by NFLP.

In conclusion, while the effect of *American Needle* outside the professional sports realm is uncertain, it is clear that any corporate attorney should be wary of agreements between their client and rival corporations. Even for industries where cooperation between competitors is necessary, so long as the agreement joins together two “independent centers of decisionmaking,” courts may strike the deal for being an illegal restraint on trade. In sum, corporate attorneys should always consider substance over form when determining whether an agreement violates section 1 of the Sherman Act.

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### ARBITRATION

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**An arbitration agreement binds contractual parties to arbitration, even for threshold issues, unless the challenging party specifically contests the provision within the arbitration agreement that grants the arbitrator authority to determine the agreement’s validity.** *Rent-A-Center, West, Inc. v. Jackson*, 130 S. Ct. 2772 (2010).

By Keshia L. Williams

Under the Federal Arbitration Act, the law of contracts applies to written agreements to arbitrate matters of controversy. Hence, arbitration agreements are subject to general contract principles relating not only to formation and terms but also to defenses against validity. Typically, courts have authority to determine the validity of a contract’s arbitration provision if the challenging party contests the arbitration provision specifically, rather than the contract as a whole. In *Rent-A-Center, West, Inc. v. Jackson*, however, the United States Supreme Court addressed whether this same rule applies if the contract itself is an arbitration agreement. Following precedent, the Court held that, absent a specific challenge to the provision within the arbitration agreement that grants an arbitrator authority to determine the agreement’s validity, the arbitrator, rather than the court, has authority to decide the validity of the arbitration agreement.

In 2003, Antonio Jackson signed a “Mutual Agreement to Arbitrate Claims” (the “Agreement”) as a condition of his employment with Rent-A-Center, West, Inc. (“Rent-A-Center”). Two of the Agreement’s arbitration provisions were relevant. The first, “Claims Covered By The Agreement,” required arbitration for all “past, present or future” matters related to Jackson’s employment. The second, the “Delegation Clause,” gave the arbitrator exclusive authority over “any claim that all or any part of [the Agreement] is void or voidable.”

On February 1, 2007, Jackson filed an employment discrimination claim against Rent-A-Center in the United States District Court for the District of Nevada. Thereafter,

Rent-A-Center filed a motion to dismiss and to compel arbitration under the Federal Arbitration Act (the “FAA”). Rent-A-Center claimed that under the Agreement, Jackson was required to pursue his claim in arbitration rather than in court. In response, Jackson argued that the Agreement was unconscionable under Nevada state law. Rent-A-Center not only questioned whether the court even had authority over the unconscionability issue but also challenged the merits of Jackson’s argument.

The district court found that Jackson’s unconscionability claim referenced the Agreement in its entirety and that the Agreement clearly gave the arbitrator exclusive authority over enforceability. Therefore, the district court concluded that Jackson’s challenge was an issue for the arbitrator and, thus, granted Rent-A-Center’s motion. On appeal, the Ninth Circuit reversed the lower court on the issue of authority. Though the Agreement delegated questions of validity to the arbitrator, the court of appeals found that Jackson’s claim of unconscionability negated his consent to that part of the Agreement. Therefore, the Ninth Circuit held that unconscionability was logically a threshold issue for the court to decide.

On appeal, in a 5-4 decision, the United States Supreme Court held that unconscionability is an issue for the arbitrator if the challenging party fails to contest the specific provision within the arbitration agreement that grants the arbitrator authority to determine the agreement’s validity (the “delegation provision”). The Court glossed over any consideration of the parties’ intent and instead focused on which part of the agreement Jackson challenged. The Court determined that the decision is for the arbitrator when the question of unconscionability is based on the whole agreement and that the decision is for the courts when the question is specific to the delegation provision.

In its analysis, the Court first looked to the FAA, which establishes both substantive and procedural rules regarding arbitration agreements. Under the substantive rule of section 2 of the FAA, arbitration is a matter of contract law. According to the FAA, a written agreement “to settle by arbitration a controversy . . . shall be valid, irrevocable, and enforceable.” The Court noted that just like all contracts, arbitration agreements are subject to invalidation by traditional contract defenses such as fraud or unconscionability. Citing procedural rules established in sections 3 and 4 of the FAA, the Court explained that when a written agreement requires that a certain issue be handled in arbitration, a party may request a stay of federal litigation and may petition the court for an order requiring arbitration of the matter.

The Court then explained that in the past, it had followed two rules regarding who decides validity issues of arbitration agreements. First, gateway issues are decided by an arbitrator when the delegation provision “clear[ly] and unmistakabl[y]” requires so. The Court noted that courts decide this issue by looking at the parties’ intent. Second, when a party challenges the entire contract or a provision separate from the agreement to arbitrate, the arbitrator decides validity.

The Court noted that as a matter of federal law, an arbitration provision is severable from the rest of a contract; therefore, under the FAA, a contract’s arbitration provision remains enforceable if the challenging party contests another provision of the contract or even the contract as a whole. In that case, the arbitration provision applies and the arbitrator decides the validity of the questioned contract provisions. However, the Court found that when the party specifically challenges the arbitration provision, the court, not the arbitrator, determines the agreement’s enforceability. Under these circumstances, the court decides the validity before ordering compliance with the written agreement. Applying these

principles to situations where the contract itself is an arbitration agreement, the Court held that in order for courts to have authority to decide the validity of an arbitration agreement, the challenging party must specifically contest the agreement's delegation provision.

Turning to the facts of the case, the Court found that Jackson only contested the validity of the Agreement as a whole. In both his response to Rent-A-Center's motion to dismiss and his appeal to the Ninth Circuit, Jackson failed to contest the validity of the Delegation Clause in particular. Instead, he made repeated references to the Agreement in its entirety. Furthermore, in his claim of unconscionability under Nevada state law, the Court determined that Jackson failed to identify substantive challenges related to the Delegation Clause. The Court concluded that Jackson argued for the invalidation of the entire agreement without specifically identifying why the Delegation Clause should be void.

The dissenting opinion criticized the majority for failing to realize that an arbitration agreement alone, rather than just an arbitration provision in a broader contract, should be treated differently under the FAA. In particular, the dissent identified the oxymoron of requiring an arbitrator to decide the threshold validity of the agreement to arbitrate. To require the party to submit to arbitration is to enforce the agreement. In particular, the dissent cited the first rule for arbitration validity by looking to the parties' intent. Like the Ninth Circuit, the dissent found that Jackson's claim of unconscionability countered any possible "clear and unmistakable" evidence validating the agreement.

The Supreme Court's decision to send issues of enforceability to arbitrators serves as a learning tool to attorneys drafting arbitration agreements. For clients who want to ensure arbitration, such as corporations and organizations, attorneys should include delegation provisions when drafting arbitration agreements. The provision should explicitly and clearly state that the arbitrator will resolve even gateway issues, such as enforcement or validity. By requiring a challenge to the specific provision, parties who challenge arbitration agreements in court will have a hard time making a case when a delegation provision is present. However, for clients who want to challenge the validity of an existing arbitration agreement, attorneys can overcome this hurdle and get into court by specifically challenging the delegation provision rather than the agreement as a whole. Overall, the Court's decision presents a very pro-arbitration stance, as it will lead to more cases being decided by arbitrators than by courts. While the Supreme Court chose to follow its own precedent, the close vote is a warning that attorneys should watch this issue in the future. Until then, the success of arbitration agreements will depend on both the careful drafting of all-inclusive delegation provisions and the specificity of challenges against such provisions.

**In Tennessee, parties to an arbitration agreement may not agree to modify the scope of judicial review beyond that imposed by statute, and the inclusion of such a provision constitutes mutual mistake requiring rescission of the agreement.** *Pugh's Lawn Landscape Co. v. Jaycon Dev. Corp.*, 320 S.W.3d 252 (Tenn. 2010).

By Joshua S. McCord

In the state of Tennessee, as in many other states, the General Assembly has enacted legislation to govern arbitration agreements between conflicting parties. By limiting the scope of judicial review available to arbitration agreements, such statutes limit a trial court's ability to retry issues decided in arbitration and reinforce the utility of arbitration as a final resolution, thereby giving conflicting parties confidence and encouraging private settlement through arbitration. Despite the existence of statutes governing arbitration

agreements, the rule regarding whether parties can agree to modifications of these provisions has been ambiguous. In *Pugh's Lawn Landscape Co. v. Jaycon Development Corp.*, the Tennessee Supreme Court addressed whether parties to an arbitration proceeding can agree to a scope of judicial review different from that imposed by statute, ultimately holding that they cannot and that the inclusion of such a provision constitutes mutual mistake requiring rescission of the arbitration agreement.

The facts leading to *Pugh's Lawn Landscape* began in March 2006, when Pugh's Lawn Landscape Company, Inc. ("Pugh's") filed a breach of contract suit against Jaycon Development Corporation ("Jaycon"). Jaycon subsequently asserted a counterclaim for breach of contract, and although the contract did not require the parties to submit to arbitration, it did stipulate that Tennessee law would govern any arbitration or litigation arising from that transaction. Early in the discovery process, the parties agreed to submit their dispute to arbitration, and the trial court entered a consent order stipulating that the arbitrator's judgment would be appealable under the same standards of review applied to a judgment issued by a trial court. Thus, each party believed that they would have the right to appeal the arbitrator's award. In arbitration, the arbitrator awarded Jaycon damages plus reasonable attorney fees, court costs, and arbitration costs, and the trial court confirmed the award upon Jaycon's motion after Pugh's failed to respond. Citing language in the consent order that allowed either party to seek an appeal, Pugh's appealed, but the Tennessee Court of Appeals held that the Tennessee Uniform Arbitration Act (the "TUAA") limits the scope of judicial review of an arbitrator's decision, and therefore, the parties could not simply consent to expand the scope of this review. The court of appeals thus affirmed the trial court's confirmation of Jaycon's award and subsequently denied Pugh's petition for rehearing because Pugh's did not object to Jaycon's motion to confirm the award on the basis of mutual mistake. The Tennessee Supreme Court, however, granted Pugh's application for permission to appeal because neither party challenged the validity of the provision expanding judicial review at trial court; rather, the court of appeals raised this issue *sua sponte* during oral argument.

The TUAA, found in sections 29-5-301 through 29-5-320 of the Tennessee Code, governs arbitration agreements, including the scope of judicial review to be applied to such agreements. Specifically, section 29-5-312 prescribes that a court must confirm an arbitrator's award except in two very specific instances, codified in sections 29-5-313 and 29-5-314. Under section 29-5-313, the court must vacate an award where the arbitration was conducted fraudulently or unfairly, while section 29-5-314 provides that the court must modify or correct an award in specific instances of mistake. Thus, in order to obtain judicial review of an arbitrator's award under the TUAA, a party to the arbitration must move the court to vacate, modify, or correct the award on the basis of one of these narrowly tailored scenarios. In the absence of one of these scenarios, no judicial review is available, as the court is bound to confirm the award and enter the judgment reached by the arbitrator. Additionally, Tennessee law allows courts to rescind a contract for mistake when the mistake is innocent, mutual, and material to the transaction and when the complaining party is injured.

On appeal, the Tennessee Supreme Court held that parties to an arbitration agreement cannot simply agree to expand the scope of judicial review beyond that set forth by the TUAA. Thus, provisions that purport to achieve such a modification are unenforceable. Because the arbitration agreement between Pugh's and Jaycon included this failed provision, and because both parties mistakenly believed that they were entitled to judicial review of the arbitrator's award, the court also held that mutual mistake necessitated

rescission of the agreement. Although the court of appeals also held that the parties could not agree to expand the scope of judicial review, the Tennessee Supreme Court disagreed that Pugh's had waived its right to challenge the validity of the provision. Thus, the Tennessee Supreme Court reversed the judgment of the court of appeals, vacating the trial court's confirmation of the arbitrator's award and remanding the case to the trial court for further proceedings.

For Tennessee practitioners, *Pugh's Lawn Landscape Co. v. Jaycon Development Corp.* clarifies the scope of judicial review available to parties to arbitration agreements. Although parties may attempt to agree to a more expansive scope of judicial review than that prescribed by the TUAA, such provisions will not be enforced, and the statute will dictate the applicable scope of judicial review. Furthermore, the inclusion of such a provision that attempts to expand the scope of judicial review will constitute mutual mistake and require rescission of the arbitration agreement. While practitioners may utilize this standard to reinforce the finality of a favorable arbitration award by preventing frivolous appeals from opponents, they must also be careful not to rely on such an agreement to the detriment of a client. Finally, practitioners must also remain cognizant of the possibility of forum shopping, as some states explicitly allow parties to agree to expanded judicial review.

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## BANKRUPTCY

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**In a chapter 7 bankruptcy proceeding, the perfected status of a security interest in collateral is not waived if the secured party surrenders such collateral after the bankruptcy's petition date.** *In re Cumberland Molded Prods., LLC*, 431 B.R. 718 (B.A.P. 6th Cir. 2010).

By Byron Pugh

Typically, if a secured party has a perfected security interest in a debtor's collateral, the security interest survives a bankruptcy filing by the debtor, and the bankruptcy court makes a determination regarding the priority of the security interest and the appropriate relief owed to the secured party. In some situations, after bankruptcy proceedings have commenced, a secured party in possession of collateral may, upon request from the bankruptcy trustee, voluntarily surrender such collateral to the trustee. In *In re Cumberland Molded Products, LLC*, the United States Bankruptcy Appellate Panel of the Sixth Circuit examined whether such a voluntary relinquishment of collateral waives the secured party's perfected security interest in the collateral. The court found that in a chapter 7 bankruptcy proceeding, a voluntary relinquishment of collateral does not waive the secured party's perfected security interest in the relinquished collateral.

The relevant facts of this case began in October 2007 when Cumberland Molded Products, LLC ("Cumberland") consolidated its loan obligations into a single \$1 million promissory note in favor of First National Bank of Woodbury ("Woodbury"). In the course of issuing the promissory note, Cumberland entered into a security agreement granting Woodbury a security interest in collateral, which, according to the security agreement, was defined as "all equipment, machinery, inventory, tools, accounts receivable and all general intangibles of [Cumberland] whether now owned or hereafter acquired, together with substitutes and replacements thereof, all accessions, and accessories added to or used in connection with such equipment." Soon after, Woodbury perfected its security interest by filing a proper financing statement.

Cumberland also held a standard checking account at Woodbury, which it used to deposit payments from various customers. On August 29, 2008 (the “petition date”), Cumberland filed a voluntary petition for relief under chapter 7 of the United States Bankruptcy Code. The balance of Cumberland’s checking account on the petition date was \$455,655.66. Also on the petition date, Cumberland listed Woodbury as a secured party in its schedules, and Cumberland had not defaulted on its obligations to Woodbury. Subsequent to the petition date, the court appointed bankruptcy trustee (the “trustee”) asked Woodbury to turn over the funds contained in Cumberland’s checking account. On September 12, 2008, Woodbury complied and deposited a check for \$455,655.66 into the trustee’s account. Woodbury was aware that Cumberland was contemplating bankruptcy but did not take any steps to freeze the checking account or set-off Cumberland’s indebtedness to Woodbury.

Instead, in November 2008, Woodbury filed a motion for relief from stay and abandonment, seeking an order directing the trustee to return the funds contained in Cumberland’s checking account and any interest earned on the account. The trustee responded by filing a complaint, seeking to determine the validity and priority of Woodbury’s alleged interests. Woodbury then filed an answer and a counterclaim, again asking for relief from stay and abandonment. In response, the trustee filed an amended complaint alleging (1) that Cumberland did not grant Woodbury a security interest in the checking account; (2) that Woodbury’s security interest was unperfected because Woodbury did not maintain control of the collateral; and (3) that, as a transferee, the trustee took the funds from Cumberland’s checking account free and clear of any competing interests. On May 29, 2009, the trustee filed a motion for summary judgment, seeking a determination that the funds transferred were the property of the estate and not subject to any perfected security interest. A day later, Woodbury filed a motion for summary judgment, seeking a judgment in its favor on all three allegations made in the trustee’s amended complaint.

On July 21, 2009, the bankruptcy court issued a memorandum opinion in favor of the trustee, finding that the checking account funds held by the trustee were property of the estate, free and clear of Woodbury’s unperfected security interest. On appeal by Woodbury, the issue presented to the Bankruptcy Appellate Panel was whether Woodbury lost its perfected security interest in Cumberland’s checking account funds by transferring the funds to the trustee after bankruptcy proceedings had commenced.

In response to this issue, the court explained that a trustee may only exercise its authority over property in the bankruptcy estate and that the determination of which claims are perfected and secured by property in the bankruptcy estate is made as of the petition date. Accordingly, if a secured party were to turn over, to a trustee, collateral subject to a security interest, the secured party would not lose its perfected security interest in the collateral simply because the secured party no longer possessed the collateral. The court warned that ignoring this principle would elevate the trustee’s interest against those who properly perfected their security interests prior to the bankruptcy proceeding. Although section 544 of the United States Bankruptcy Code provides trustees with powers similar to that of judicial lien holders, the court noted that such powers are only conferred to trustees after the “commencement of the case” and that section 544 does not “provide the trustee with an interest superior to that of [secured parties] whose interests were perfected prior to the commencement of bankruptcy proceedings.”

The court next rejected the trustee’s argument that it was a transferee of the collateral under section 9-332 of the Uniform Commercial Code. The court again noted that

when a debtor files a bankruptcy petition, an estate is created in all of the debtor's property as of the petition date. Therefore, in this case, because Woodbury transferred the checking account funds to the trustee after the petition date, the court found that the funds were included in Cumberland's estate and that the trustee could not be considered a transferee of the collateral who took free and clear of any perfected security interests. The court also found that the trustee's argument did not conform with the function of the free and clear policy provided to transferees. As the court explained, the purpose for such a policy is to prevent secured parties from extending their security interests to anything the transferee purchases. Given the fact that the trustee gave no consideration for the transfer and had no authority to purchase anything with the funds, the court determined that the post-petition date check was nothing more than a delivery of funds already owned by Cumberland's estate.

The court also found the trustee's statutory interpretation to be inconsistent with public policy. For example, if a secured party faces the prospect of losing its perfected security interest as a result of surrendering collateral, the secured party will be less willing to surrender such collateral. This system would also create a strong distrust among trustees and secured parties. Finally, the court determined that the policy interests concerning secured and perfected claims are best resolved, not by waiving the perfected status of a security interest, but through proper bankruptcy proceedings. Basing its decision on statutory law, case law, and public policy, the court concluded that Woodbury did not surrender its perfected security interest when it voluntarily turned over Cumberland's checking account funds to the trustee.

With this decision in mind, secured parties can rest assured that when deposit account funds or other collateral are voluntarily surrendered to a bankruptcy trustee after the petition date, the secured party does not risk losing its perfected security interest. The court's decision also protects the integrity of current relationships that exist between bankruptcy trustees and secured parties. Preserving the integrity between secured parties and trustees strengthens the ability of trustees to perform their primary purpose: "marshal[ing] assets for the benefit of . . . [secured parties]." Also, the decision benefits current and potential debtors alike; secured parties will be less averse to extending credit knowing that their interest remains perfected following a turnover request from the bankruptcy trustee.

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## BUSINESS ASSOCIATIONS

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**In Delaware limited partnerships, general partners may not utilize federal privacy regulations or partnership privacy notices to prevent the disclosure of certain information to limited partners.** *Parkcentral Global, L.P. v. Brown Inv. Mgmt., L.P.*, 1 A.3d 291 (Del. 2010).

By Michael Franz

When hedge funds or other investment companies lose extensive amounts of investor capital or fail altogether, investors may turn to litigation against the investment company as a way to recoup those losses. The process of proving mismanagement or a breach of fiduciary duty may require vast amounts of research and investigation. Not surprisingly, investors entering this type of litigation often contact other investors in the same fund in an effort to gather information or to propose a pooling of resources. In *Parkcentral Global, L.P. v. Brown Investment Management, L.P.*, the Delaware Supreme Court

considered whether a limited partner in a Delaware limited partnership could demand, from the general partner, a list of the names and addresses of all other limited partners. The court ultimately held that a general partner may not use federal privacy regulations or unilaterally-issued partnership privacy notices to avoid the requirement to disclose under Delaware law.

In *Parkcentral*, the hedge fund Parkcentral Global, L.P. (“Parkcentral”) was structured as a Delaware limited partnership. Investors in the fund served as limited partners, while the manager, Parkcentral Capital Management, L.P., served as the general partner. In August 2008, Brown Investment Management, L.P. (“Brown”) signed a partnership agreement with Parkcentral and became a limited partner. Sections 9.1(b) and 9.1(c) of the signed partnership agreement were substantially identical to language from parts of title 6, section 17-305 of the Delaware Code, which grants each partner in a Delaware limited partnership the right to obtain certain information from the general partner, including the names and addresses of each other partner. However, the partnership agreement also incorporated language from section 17-305, which places limitations on the right to obtain information, including a requirement that the partner demanding information must state the purpose for making the demand, the general partner’s power to refuse disclosure if doing so would prevent damage to the partnership, and other reasonable standards established by the general partner.

In November 2008, Parkcentral suffered losses of capital so great that all limited partners, including Brown, lost their entire investments. As a result, Parkcentral stopped doing business, was liquidated, and continued to operate only as was necessary to defend against lawsuits. In early 2009, alleging mismanagement and breach of fiduciary duty, several Parkcentral investors brought a class action claim against entities affiliated with Parkcentral, including its general partner, Parkcentral Capital Management, L.P., in Texas federal court (the “Texas litigation”). Although Brown was not directly involved in the Texas litigation, later that year, Brown wrote to Parkcentral requesting the names and addresses of each of Parkcentral’s limited partners. Parkcentral first denied the request because Brown had failed to provide a purpose for demanding the information. When Brown reiterated the demand and explained in writing that it sought the names of other partners in order to investigate claims made by Parkcentral limited partners in the Texas litigation, Parkcentral again refused the request, claiming this time that privacy obligations prevented such a disclosure.

In February 2010, Brown filed suit in the Delaware Court of Chancery to compel Parkcentral to turn over the names and addresses of the other partners. After a trial, the vice chancellor found that based on the language in the partnership agreement, Brown had met all requirements set forth for access to the information. The vice chancellor then ordered Parkcentral to surrender the list. In May 2010, Parkcentral appealed.

On appeal, the Delaware Supreme Court affirmed the vice chancellor’s decision, holding that Parkcentral’s refusal to grant Brown’s request for the names and addresses of other investors could not be justified by the partnership’s privacy notices, federal privacy regulations, or the language of the partnership agreement. Parkcentral first argued that its annual privacy notices to investors, which stated that Parkcentral would generally not disclose non-public information about current or former investors, were “reasonable standards governing access to information” as allowed by the partnership agreement. The court held, however, that the privacy notices went beyond reasonably governing access to information and instead completely denied a right granted in the partnership agreement. Additionally, the court pointed out that the privacy notices were unilaterally issued and could

not supersede the rights granted in the partnership agreement, a legally binding document signed by all parties.

Second, Parkcentral argued that federal privacy regulations, including rules adopted by the Federal Trade Commission and the Securities and Exchange Commission, prevented Parkcentral from disclosing nonpublic information about investors. The court noted that these regulations typically require that an investment company provide each partner with adequate notice and an opportunity to opt-out before it discloses any non-public information. Parkcentral also alleged that these federal regulations pre-empt state law, including the section of the Delaware Code that had been incorporated into Parkcentral's partnership agreement. The court, however, rejected Parkcentral's argument for two reasons. First, the court highlighted language in the federal regulations that provided an exception to the opt-out requirements when disclosure is necessary to comply with federal, state, or local laws. Here, the court held that the Delaware Code provisions that require general partners to comply with limited partners' information requests fall within the exception. Second, the court noted that each federal privacy regulation applied only to disclosures to "unaffiliated third parties." Because limited partners are in no way "unaffiliated" with the partnership, the federal privacy regulations did not even apply.

Lastly, Parkcentral alleged that under the language of the partnership agreement, it could deny Brown's request for the names of all limited partners because revealing that information would damage the partnership. Acknowledging that the relevant provisions in the partnership agreement applied only to disclosures to "third parties," Parkcentral also claimed that every limited partner was functionally a third party in relation to each other limited partner and the general partner. The court rejected this characterization, insisting that because each limited partner and the general partner had signed the partnership agreement, they must all be principal parties to the partnership, and none could be "third parties." Furthermore, the court pointed out that Parkcentral, as a liquidated partnership, no longer had any business that could possibly be damaged by the disclosure. Even if disclosure might damage the reputation of the general partner, the court found that Parkcentral had failed to adequately show the potential for harm. Rejecting all three of Parkcentral's principal arguments on appeal, the Delaware Supreme Court affirmed the vice chancellor's judgment in favor of Brown.

Although the court's holding in *Parkcentral* only applies to limited partnerships established in Delaware, the decision will likely have a significant impact on the establishment of similarly structured business entities. Transactional attorneys who are working to create Delaware limited partnerships should note the court's insistence that Delaware law and the partnership agreement will be the primary legal authorities used to assess the limited partners' rights to information. In its decision, the court points out that had Parkcentral barred directly in the partnership agreement any disclosure of the other partners' names and addresses, Parkcentral would have been justified in refusing Brown's requests. Under the court's analysis, neither the privacy notices nor the application of federal securities regulations could overcome the partnership agreement's legal force.

The *Parkcentral* decision also serves as a powerful reminder for all attorneys representing investors to pay close attention to language in partnership agreements. In order to preserve the right to demand information from the general partner, investors should ensure that such rights, which might normally be accessible under state law, are not revoked by the language of the partnership agreement. Attorneys representing investors in Delaware and in states with similar partnership disclosure laws should also be wary of situations in

which the general partner could legitimately claim that a disclosure would harm the partnership. Had Parkcentral not already been liquidated, it might have been able to claim that the disclosure of limited partners' identities would damage its still-ongoing business operations. Ultimately, both sides in the negotiation of a partnership agreement should recognize the primacy of the agreement's language and negotiate accordingly.

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### CIVIL PROCEDURE

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**Forum selection clauses in Tennessee are voidable if an associated lawsuit is determined to be a local action that concerns injury to the value of the plaintiff's land, rather than injury to the value of the plaintiff's business.** *Kampert v. Valley Farmers Coop.*, No. M2009-02360-COA-R10-CV, 2010 Tenn. App. LEXIS 657, 2010 WL 4117146 (Tenn. Ct. App. Oct. 19, 2010).

By Scott M. McLeod

Although forum selection clauses in construction contracts increase the likelihood litigation will occur in the stipulated forum, forum selection clauses can be invalidated in Tennessee if the litigation is a local action. However, few suits qualify as local actions, and generally, only certain actions alleging injury to land are local actions. In *Kampert v. Valley Farmers Cooperative*, the Tennessee Court of Appeals determined what constitutes a local action in Tennessee. In its holding, the court emphasized that not all suits involving tracts of land whose values have allegedly been reduced because of the defendant's conduct are local actions. If a plaintiff has essentially suffered harm to his business rather than to his land, the court declared that the suit must be tried in the venue specified in the contract's forum selection clause, unless the party opposing enforcement demonstrates that it would be unfair and inequitable to do so.

In May 2008, Theo and Ruth Kampert (the "Kamperts") entered into a contract with Valley Farmers Cooperative ("VFC") in which VFC was to build an operational dairy facility on the Kamperts' farmland. The contract specified that VFC would construct new barns, sheds, and milking facilities. The contract between the Kamperts and VFC contained a forum selection clause stating that the contract "shall be construed and interpreted under Tennessee Law and venue for any litigation shall lie in the Circuit or Chancery Court for McMinn County, Tennessee."

On April 9, 2009, the Kamperts filed suit against VFC and two of its officers (the "defendants") in the circuit court of Giles County, Tennessee. The Kamperts alleged that the defendants had breached the contract by exercising poor workmanship, incurring cost overruns, and using substandard materials. Accordingly, the Kamperts claimed that the defendants were liable for breach of contract, negligence, civil fraud, intentional infliction of emotional distress, and violating the Tennessee Consumer Protection Act.

Relying upon the forum selection clause contained in the contract between the parties, the defendants subsequently filed a motion to dismiss for improper venue. In response, the Kamperts asserted that the contract's forum selection clause was unenforceable under the Tennessee Supreme Court's decision in *Hall v. Southball Brothers & Carl*, 240 S.W. 298 (Tenn. 1921), in which the court declared that under Tennessee law, any action involving injury to real estate must be treated as a local action which may only be brought in the county in which the real estate is located.

Siding with the Kamperts, the trial court ruled that because the Kamperts were asserting that their land had lost some of its value as a result of the defendants' actions, the suit was a local action and could be brought in Giles County. Accordingly, the trial court rejected the defendants' motion to dismiss for improper venue. The trial court then denied the defendants' subsequent motion for interlocutory appeal. However, the Tennessee Court of Appeals granted the defendants' motion for extraordinary appeal and agreed to hear their interlocutory appeal.

On appeal, the Tennessee Court of Appeals overturned the trial court's ruling and held that the Kamperts' suit was a transitory action rather than a local action and thus could be brought in the county specified in the forum selection clause. Reviewing the suit *de novo*, the court began its assessment by analyzing the proper venue for the Kamperts' claims. The court explained that when determining proper venue, it is important to differentiate causes of action that are transitory from those that are local. Transitory actions, such as personal injury claims arising from torts or actions for recovery of personal property, are based on causes of action that can arise anywhere. In contrast, local actions, which generally involve land disputes such as actions to quiet title or actions for injuries to real estate, are based on causes of action that can only arise in a particular locality. Importantly, the court noted that not every action involving land is a local action, and in actions involving land in which the plaintiff has sustained injury to his business rather than to his land, the action is certainly not a local action.

The court then explained that parties can stipulate to a particular venue for resolution of transitory actions through contract under Tennessee law. The court stated that it is well established that Tennessee courts should enforce forum selection clauses in contracts "unless other considerations, like fairness to the parties, preclude enforcement." The court noted, however, that although transitory actions can be brought in a particular stipulated venue, a local action may only be brought in the county where the subject matter of the dispute is located. Thus, venue implicates jurisdiction in local actions, and a court has no jurisdiction to hear a local action when that court is not a proper venue for the action.

The court next addressed the Kamperts' contention that their suit was a local action. Citing two previous rulings, in which actions for injuries to two barns and an orchard were deemed local actions that could only be brought in the county in which the injured land was located, the Kamperts argued that their action should similarly be classified as a local action. The court rejected this argument on two grounds. First, the Kamperts failed to state in their pleadings that the defendants' actions resulted in injury to the land. Second, the Kamperts did not even suggest that the value of their land had declined because of the defendants' negligence. In fact, the Kamperts claimed that the injury they suffered as a result of the defendants' negligence was the loss of earnings and profits, which were lost because the defendants' alleged negligence had interfered with the Kamperts' ability to operate their dairy business. This claim weakened the Kamperts' argument that their suit should be deemed a local action because, as the court had previously explained, a suit alleging injury to one's business is traditionally a transitory action.

Addressing *Hall* and distinguishing it from the instant case, the court noted that, in *Hall*, the plaintiff alleged that the defendant had negligently damaged two barns, which had been affixed to the land for some time. The damage to the barns caused the value of the realty to decrease. However, in the instant case, the alleged negligence involved the construction of new buildings on the Kamperts' land, which had presumably increased the value of the land. More importantly, the court also recognized that if it were to rule that the

instant action was a local action, such a ruling “would effectively make all actions on construction contracts local, and it would render void any forum selection clause in a construction contract that designates venue in a county other than the one where the construction takes place.”

In support of its position, the court asserted that the language in section 66-11-208 of the Tennessee Code implies that forum selection clauses in construction contracts can be enforceable. The court then emphasized that because the Kamperts’ claims were “of a type that could arise anywhere,” the Kamperts’ action was transitory in nature, and accordingly, the trial court erred in holding that the forum selection clause in the contract was unenforceable without evidence that it would be unfair and inequitable to enforce it. In the interests of justice and judicial economy, the court then directed the trial court to transfer the case to an appropriate court in McMinn County, Tennessee.

The Tennessee Court of Appeals’ ruling in *Kampert* affirms the enforceability of forum selection clauses in construction contracts involving real property located in the state of Tennessee. In light of the current economic downturn and the profoundly negative effects it has had on the construction industry, this ruling preserves the ability of construction companies and contractors to use forum selection clauses to their advantage when drafting construction contracts. Attorneys representing construction companies and contractors should encourage their clients to utilize carefully worded forum selection clauses to ensure that litigation will take place in a favorable and convenient forum, should it become necessary. Attorneys should also advise these clients that if they engage in actions that directly affect the value of land and a subsequent lawsuit is determined to be a local action, the forum selection clause may be circumvented. Attorneys representing people hiring construction companies and contractors should inform their clients that courts will determine that a lawsuit is a local action if the defendant’s actions caused injury to the value of the plaintiff’s land rather than to the value of the plaintiff’s business. Finally, in order to increase the likelihood that a court will deem a suit a local action, attorneys representing individuals such as the Kamperts should be careful to state in their pleadings that their clients have been injured because the value of their clients’ land, rather than their business, has decreased as a direct result of the defendant’s actions.

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## CONTRACTS

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**In Tennessee, a contractor performing remodeling or repair work owes a non-delegable duty to ensure that all work that he is contractually obligated to perform is completed in a careful and workmanlike manner.** *Fed. Ins. Co. v. Winters*, No. E2009-02065-COA-R3-CV, 2010 Tenn. App. LEXIS 652, 2010 WL 4065609 (Tenn. Ct. App. Oct. 18, 2010), *cert. granted* (Feb. 16, 2011).

By William T. Smith

In *Bowling v. Jones*, 300 S.W.3d 288, 295 (Tenn. Ct. App. 2008), the Tennessee Court of Appeals found that under a contract for the construction of a residence, a general contractor owed an implied contractual duty to perform all contracted-for work in a workmanlike manner. Consequently, the *Bowling* court found that assigning specific tasks to subcontractors did not absolve the general contractor of liability for breach of his contractual obligations. The court’s ruling provided homebuilders with a useful contractual

remedy but did not define the scope of a contractor's duty to perform in a workmanlike manner.

In *Federal Insurance Co. v. Winters*, the court of appeals applied *Bowling* and expanded the duty to perform in a workmanlike manner to cover instances in which a contractor delegates remodeling or repair work to a subcontractor. The case presented the issue of whether a plaintiff could recover from a defendant roofer whose subcontractor caused a fire that destroyed the plaintiff's home. The trial court awarded the defendant summary judgment after it found that, under the facts of the case, the defendant could not be held liable in tort for the negligent acts of its subcontractor and could not be held liable under contract because the plaintiff's damages were unforeseeable. The court of appeals reversed the trial court and remanded the case. It found that the trial court failed to consider the defendant contractor's non-delegable duty to ensure that the contracted-for work was performed in a workmanlike manner.

In *Winters*, Federal Insurance Company (the "plaintiff"), as subrogee of Robert and Joanie Emerson (the "Emersons"), brought suit against Martin Winters, owner and sole employee of Winters Roofing Company. In 2007, the Emersons contracted with defendant Winters for the installation of a new roof on their residence. The Emersons, who claimed that they decided to hire Winters based upon representations on Winters' website that the roofing company was covered by general liability insurance, orally agreed to pay Winters \$17,832 for the work. At no time were the Emersons informed that Winters would use subcontractors for the work or that Winters' insurance was lapsed.

Winters initially hired subcontractor Monk to replace the Emersons' roof. Monk replaced the entire roof in a matter of two weeks and returned to fix three leaks discovered approximately one month thereafter. However, a few weeks after Monk's repairs, the Emersons informed Winters that the roof continued to leak at the drain. On September 26, 2007, Winters sent subcontractor Jacobs to fix the leak. While repairing the tar roof with a propane torch, Jacobs sparked a fire that caused substantial damage to the Emersons' home.

At trial, the plaintiff alleged (1) that Winters was negligent and failed to use reasonable care when replacing the roof and (2) that Winters breached the contract to provide a new roof by failing to complete the roof carefully and to perform the work with liability insurance. Plaintiff sought to recover over \$800,000 in claims paid to the Emersons. Winters moved for summary judgment, claiming that he had sublet the work to an unsupervised subcontractor and that he had not participated in any of the work itself. Winters testified that Jacobs had signed a subcontract agreement stating that Jacobs would be liable for any damages resulting from his work. Winters also contended that the Emersons had never inquired about insurance. Winters admitted that the fire occurred while his insurance was lapsed but stated that he had purchased insurance a few days after the accident.

The trial court granted summary judgment to defendant Winters. The trial court found that the plaintiff's tort claim failed because the plaintiff failed to show that Winters negligently hired subcontractor Jacobs and failed to demonstrate that Winters supervised or otherwise exerted control over Jacobs' work; similarly, the trial court found that the plaintiff's contract claim failed because the plaintiff failed to show that the fire was caused by the contracted-for service and that the resulting damages were foreseeable.

On appeal, viewing the facts in a light most favorable to the plaintiff, the Tennessee Court of Appeals reversed the trial court and held that the plaintiff should be able to

proceed with its breach of contract claim. The court found that Winters, though guaranteeing his work by warranty, did not deliver a functional roof but, rather, installed one riddled with leaks. Likewise, the court of appeals also reversed the trial court's finding that the damages caused by the fire were unforeseeable. The court of appeals found that the trial court failed to consider Winters' non-delegable duty to ensure that all the work that he was contractually obligated to complete was performed in a workmanlike manner. Finally, the court of appeals noted that the trial court should have considered Winters' potential liability for misrepresenting the status of his insurance. Though his website represented that he was covered by general liability insurance, Winters admitted that his insurance was lapsed at the time of the accident. Consequently, the court of appeals reversed the trial court's grant of summary judgment and remanded the case for further proceedings.

In reaching these conclusions, the court of appeals relied upon the "general rule" that under every contract, there exists an implied, non-delegable duty to perform the contracted-for services in a workmanlike fashion. The court cited the following language from *Bowling*, 300 S.W.3d at 295, as precedent applying the implied duty to a construction case: "The [defendants] had a contractual duty to construct the house to completion and to perform the construction in a workmanlike manner. Their unilateral delegation of work to third parties did not absolve them of this duty." Though *Bowling* applied to the construction of a new house, the court noted the case's applicability to the remodeling or repair task at hand. The court reasoned that, like the general contractors in *Bowling*, Winters should not be able to escape the duty of workmanlike performance that he assumed through contract merely by passing off the task to a subcontractor. It relied upon the principle that performance, though it may be entrusted to another, may not be estranged from liability. As the one who contracted to provide the service, the contractor is impliedly obligated to ensure that the work is performed with due workmanlike care.

The court buttressed its position with several cases from other jurisdictions—namely Delaware, Kansas, Minnesota, New Mexico, Washington, and Wisconsin. As explained in *Brooks v. Hayes*, 395 N.W.2d 167, 169 (Wis. 1986), the cases stand for the proposition that "the delegation of the performance of a contract does not, unless the obligee agrees otherwise, discharge the liability of the delegating obligor to the obligee for breach of contract." In particular, the court cited a case strikingly similar to the one at hand: *White Pass Co. v. St. John*, 427 P.2d 398 (Wash. 1967). In *White Pass*, a general contractor subcontracted out work during the enlargement of a ski lodge to an independent contractor. The Washington Supreme Court held that the ski lodge owner could recover from the general contractor despite the fact that the independent contractor's negligence caused the fire damages. *White Pass* and the many other cases cited by the court emphasize a central theme: barring express agreement to the contrary, the duty of workmanlike performance—whether performance of construction, renovation, or repair—is not delegable. The contractor is contractually obligated to provide full and workmanlike performance. Until performance is complete, the subcontractor's acts are considered to be the contractor's own.

Thus, until the Tennessee Supreme Court addresses the case, *Winters* puts contractors on notice. *Winters* expands the duty of workmanlike performance announced in *Bowling* to cover contracts for remodeling or repair. In remanding the case to the trial court with instructions to consider the contractor's duty of workmanlike performance, the court of appeals displayed its commitment to the concept. Regardless of how the Tennessee Supreme Court ultimately rules, attorneys on both sides of the table should advise their clients to discuss the use of subcontractors on their projects and should inform clients of the duty of workmanlike performance. Moreover, agreements between contractors and

subcontractors should explicitly provide for whether the subcontractor assumes the duty of workmanlike performance. Finally, in contrast to defendant Winters, contractors should ensure that their insurance never lapses. As *Winters* illustrates, though performance may be delegated, liability generally may not. Unless the parties otherwise agree, the risk falls upon the contractor. As implied in the very contract, the duty of workmanlike performance is his.

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## INSURANCE

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**In Tennessee, insurers have the burden of specifying when the insured will be required to notify it of changes in material information arising after an insurance policy has been issued.** *Adams v. Tenn. Farmers Mut. Ins. Co.*, No. W2009-00931-COA-R3-CV, 2010 Tenn. App. LEXIS 262, 2010 WL 1444477 (Tenn. Ct. App. Apr. 13, 2010).

By David Otten

*Adams v. Tennessee Farmers Mutual Insurance Co.* presents several important issues for attorneys dealing with insurance contracts. First, the court addressed whether a consumer must have an ownership interest in property to have an insurable interest. Second, the court addressed whether an insured has a duty to notify the insurance company of changes in information material to the risk of the contract. Finally, the court addressed whether an insured may recover damages up to the limit of the policy, even though he does not have an ownership interest. The court held that it is not necessary for an interest in property to be an ownership interest for that interest to be insurable; that absent an express term in the insurance contract, the insured has no duty to inform the insurer of changes in information material to the risk of the contract arising after the policy has been issued; and that the insured may recover the full amount of the policy, even if his interest in the property is not an ownership interest. This case was decided by the Tennessee Court of Appeals and not only solidified existing Tennessee law but also created new law based on the law of other jurisdictions.

In 1992, Joseph Adams bought a house and land in Chester County, Tennessee. Adams had the name of his son, Shane, placed on the deed instead of his own, to ensure that the property would pass to his sons if something happened to him. When Adams applied for homeowner's insurance with Tennessee Farmers Mutual Insurance Company ("Tennessee Farmers"), he also listed his son as the name of the insured on the insurance application and explained to his agent that the deed to the property was in his son's name instead of his own. Tennessee Farmers subsequently issued the policy. When Adams's youngest son, Dustin, turned eighteen, Shane gave Dustin a one-half interest in the property and recorded the new deed. Adams then instructed his insurance agent to add Dustin as an additional insured to his homeowner's insurance policy, which the agent did.

In 2000, Adams moved to California, and his sons executed a warranty deed conveying the property back to him. After the deed was recorded, Adams applied to Tennessee Farmers for a homeowner's insurance policy, naming himself as the insured, and the policy was issued. Adams moved back to Tennessee in 2002 and again submitted a new application for homeowner's insurance with Tennessee Farmers. The new application required that the applicant have an ownership or insurable interest in the property. Adams listed himself as the applicant, and Tennessee Farmers issued the homeowners policy in December 2002.

In 2005, Adams conveyed the property back to his sons by warranty deed and the deed was recorded. Throughout the years, Adams lived in the house and maintained the property. He paid all the taxes, insurance premiums, utility bills, improvement costs, and other expenses associated with the property. Adams's sons never claimed any ownership interest in the property, and they considered it their father's.

In October of 2006, the house and outbuildings on the property were destroyed by fire. Adams made a claim under his homeowner's policy, but Tennessee Farmers denied the claim because Adams had conveyed the property to his sons. Tennessee Farmers also asserted that Adams had no insurable interest in the property at the time of the fire. However, Tennessee Farmers paid Adams's claim for the loss of his personal property in the house because the deed had no effect on the personal property he owned.

In response, Adams filed a complaint against Tennessee Farmers for breach of contract. Both parties moved for summary judgment. Tennessee Farmers argued that Adams had no insurable interest in the property, that he breached a duty to Tennessee Farmers to notify it of matters material to the risk arising after the policy had been issued, and that Adams should not have been awarded the full policy proceeds because he did not legally own the property at the time of the casualty. The trial court held that Adams had an insurable interest in the property, that Adams had not breached a duty to notify Tennessee Farmers of changes in information relating to the risk of the policy, and that Adams was entitled to the entire amount of the policy proceeds.

The first issue the court of appeals addressed was whether an insured must have an ownership interest in property in order to have an insurable interest. In Tennessee, an insured must have an insurable interest in the property they wish to insure in order for an insurance contract to be valid. One has an insurable interest in property if he will gain an advantage by its continued existence or will suffer a loss by its destruction, whether or not he has any title in or possession of the property. Thus, the court held that the insured does not need to have an absolute legal ownership in the property—i.e. by deed—in order to have an insurable interest; instead, the insured needs only to derive a benefit from the existence of the property or suffer loss from its destruction. The court noted that a benefit is sufficient whether it is a legal, unqualified ownership interest or merely a right to use the property with or without payment of rent.

In this case, Adams paid every expense relating to the property, including taxes, utilities, and improvement expenses, and used the property as his residence every year. Accordingly, the court determined that Adams did have an interest in the property sufficient to be an insurable interest. In fact, the court stated that Adams "certainly benefitted from [the property's] continued existence and suffered a loss by its destruction." Because any interest in property, even a mere right to use the property, is enough for a finding that an insured has an insurable interest in the property, the court found that Adams's use of the property as his primary residence was enough to show that he had an insurable interest in the property. Accordingly, the court concluded that Tennessee Farmers' argument was without merit.

The second issue that the court addressed was whether an insured has a duty to inform the insurance provider of changes in information material to the risk of the policy arising after the policy has been issued. The court explained that, in Tennessee, representations made in an insurance application are continuing affirmations of the truthfulness of such representations, but only *until* the policy is issued; thus, absent an obligation to disclose in the policy agreement or by request from the insurer, no duty exists

for the insured to notify the insurer of new information arising after the policy has been issued. The court also found that the failure of the insured to inform the insurer of acts or conditions occurring after the issuance or renewal of the policy would not void the policy. Rather, citing persuasive authority from Maine and Massachusetts, the court held that the burden is placed on the insurer to specify when the insured will be required to notify it of changes in circumstances arising after the policy is issued.

In this case, Adams's insurance policy required that the insured disclose information that was material to the risk involved. The court noted that if Adams had misrepresented his interest in the property on his application, he would have been unable to recover on the policy. However, while the application required Adams to warrant that the information on the application was "true, correct and complete," it made no mention of a requirement that Adams update the information during the policy period. As a result, the court found that Adams had no duty to disclose the change in legal ownership subsequent to the issuance of the policy.

Finally, the court determined whether the award of proceeds from Tennessee Farmers was appropriate, holding that the award of the entire proceeds from the insurance contract was proper, even though Adams did not have a legal ownership interest in the property. Citing authority from Oklahoma and Alabama, the court explained that the policy limits did not exceed the loss that Adams actually suffered. In fact, Tennessee Farmers ceded that the fire resulted in a total loss and that if Adams had legal title to the property, the proper measure of damages would have been the policy limit. Further, the court reasoned that Tennessee Farmers assumed the risk that there would be a total loss of the property and that it intended to enter into a contract of indemnity for the full value of the home with Adams. According to the court, to deny recovery of the policy limits in this case would frustrate the legitimate expectations of the insured and would allow the insurer to avoid the risk that it intended to insure.

The findings of this case not only solidify existing Tennessee law but also add new facets to accepted insurance principals. By allowing any interest in property to be an insurable interest, the court effectively allows consumers to insure property that is important to them or that provides economic benefit, even though the consumer may not have an ownership interest in the property. Further, by adopting new laws that shift the burden of updating records to insurers and that allow insureds to recover the full amount of a policy, despite the status of their interest, the court makes insurance less daunting for non-owners and requires more diligence from insurance companies. Following this case, attorneys representing both insureds and insurers must be careful to specifically include in insurance agreements the obligations they wish to require of the other party. By failing to do so, insurance attorneys, especially those working with insurance companies, may find the litigation of an insurance contract tipped in favor of the insureds.

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#### INTELLECTUAL PROPERTY

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**In trademark infringement cases, a likelihood of dilution by tarnishment is presumed if there is a clear semantic association between a junior and senior trademark, and the junior trademark is associated with sexually oriented products.** *V Secret Catalogue, Inc. v. Moseley*, 605 F.3d 382 (6th Cir. 2010).

By Mary Lauren Walden

In *V Secret Catalogue, Inc. v. Moseley*, the United States Court of Appeals for the Sixth Circuit addressed the issue of whether Victor's Little Secret, a small retail store that sold sex toys and other sexually oriented products, created a "likelihood of dilution by tarnishment" of the Victoria's Secret trademark. Specifically, the issue in *V Secret* was whether the semantic association of Victor's Little Secret with Victoria's Secret amounted to a liability-creating mental association that constituted dilution by tarnishment when the trademark of Victor's Little Secret was used to sell sexually oriented products. The Sixth Circuit held that there was a rebuttable presumption that the semantic association between Victor's Little Secret and Victoria's Secret created dilution by tarnishment and that Victor's Little Secret failed to overcome the "inference of tarnishment" caused by its trademarks.

The relevant facts of *V Secret* began when a Fort Knox Army Colonel saw an advertisement for Victor's Secret in a local publication. The advertisement reported that Victor's Secret sold adult videos, lingerie, and other adult novelties. Although the Army Colonel was not confused by the similarity between the trademarks of Victor's Secret and Victoria's Secret, he was offended that Victor's Secret was semantically associating itself with the famous store brand in its attempt to promote the sale of "unwholesome, tawdry merchandise." The Army Colonel subsequently sent a copy of the advertisement to Victoria's Secret. Counsel for Victoria's Secret then wrote to Victor and Cathy Moseley (the "Moseleys"), the owners of Victor's Secret, stating that their store name was likely to cause confusion with the well-known Victoria's Secret trademark. In response, the Moseleys changed the name of their store from Victor's Secret to Victor's Little Secret. Because this change did not satisfy Victoria's Secret, it promptly filed suit for trademark infringement and "dilution by tarnishment" in the United States District Court for the Western District of Kentucky.

The district court issued an injunction against Victor's Little Secret, and the Sixth Circuit affirmed. In 2003, based on its interpretation of language contained in the Federal Trademark Dilution Act of 1995 (the "Old Act"), the Supreme Court reversed and remanded the injunction to district court. On remand, the district court reconsidered the case based on language in a newly legislated act, the Trademark Dilution Revision Act of 2006 (the "New Act"). The passage of and amended language contained in the New Act was a direct response to the Supreme Court's earlier interpretation of the Old Act in this very case. In specific, the New Act defined "dilution by tarnishment" as an "association arising from the similarity between a mark or trade name and a famous mark that harms the reputation of the famous mark." The New Act also changed the standard for proving a "dilution by tarnishment" claim from "actual dilution" of the senior trademark's reputation to only a "likelihood of dilution." Congress termed this new standard the "*Moseley* standard" and asserted that such a revision was necessary because the Old Act's standard created an undue burden for trademark holders, requiring "actual dilution" rather than a "likelihood of dilution." Thus, under the New Act, the question for the district court became whether Victor's Little Secret created a "likelihood of dilution by tarnishment" of the Victoria's Secret trademark.

Based on the language of the New Act, the district court granted summary judgment in favor of Victoria's Secret, and Victor's Little Secret again appealed. On appeal, the Sixth Circuit affirmed the district court's ruling, holding that Victor's Little Secret failed to overcome the "inference of tarnishment" caused by its trademarks. Citing eight federal cases, the Sixth Circuit noted that there was a consensus emerging in case law that the creation of an association between a senior trademark and "lewd or bawdy sexual activity" disparaged the senior trademark and reduced its commercial value. The court further

interpreted the language of the New Act to create a rebuttable presumption or strong inference that a junior trademark used to sell sexually oriented products was likely to tarnish a senior trademark if there was a clear semantic association between the two marks. The court then determined that this rebuttable presumption placed, on the owner of the junior trademark, the burden of presenting evidence that there was no likelihood of tarnishment. Observing that the Moseleys had two opportunities in the district court to offer this type of evidence but failed to do so, the court found that Victor's Little Secret created a likelihood of tarnishment to the Victoria's Secret trademark.

Next, the court addressed three other issues raised by the Moseleys: first, whether the "Law of the Case Doctrine" meant that the Supreme Court's decision in the Moseleys' favor remained in effect; second, whether the New Act was retroactive; and third, whether, pursuant to 15 U.S.C. § 1125(c)(5), Victoria's Secret qualified for injunctive relief and certain other remedies. For the first issue, the court found that the "Law of the Case Doctrine" did not apply to this case because Congress changed the law while the case was pending. For the second issue, the court stated that new statutes may be applied to pending cases where, as was the situation in this case, prospective relief is sought for ongoing conduct. The court resolved the third issue by finding that § 1125(c)(5) merely referred to "additional remedies" not included in 15 U.S.C. § 1125(c)(1), which allows for an injunction anytime after a trademark becomes famous. Because Victoria's Secret had satisfied each of the requirements under § 1125(c)(1) for injunctive relief, the court concluded that the district court did not err in its decision in favor of Victoria's Secret.

In her dissent, Circuit Judge Karen Nelson Moore brought up a crucial point that the New Act contains two requirements: that there be an association between the two marks and that there be a likelihood of harm to the senior mark. Judge Moore also noted that, although courts have concluded that "dilution by tarnishment" is likely when a trademark's likeness is associated with sexual activity, courts cannot ignore the statutory requirement of reputational harm. Judge Moore pointed out that the *V Secret* case was unlike the cases cited by the majority because both Victoria's Secret and Victor's Little Secret sold sexually oriented products. Thus, the involvement of Victor's Little Secret with sexually oriented products was less likely to tarnish the reputation of the Victoria's Secret trademark. She concluded that when dealing with a junior trademark of sexual character, the bright-line rule of presuming a likelihood of harm to the reputation of a senior trademark was not what Congress intended when enacting the New Act.

The Sixth Circuit's decision in favor of Victoria's Secret in this case demonstrates the court's desire to stand by the bright-line rule in emerging case law that where a senior trademark is semantically associated with a sexually oriented junior trademark, there is a rebuttable presumption that the senior trademark is likely to be tarnished. As a result of this decision, businesses with famous trademarks will no longer be required to show actual dilution in order to prove "dilution by tarnishment." Instead, by simply demonstrating that the junior trademark was associated with sexually oriented products, a likelihood of dilution will already be presumed. In these situations, the owner of the junior trademark will then have the burden of disproving such a presumption.

However, it is also important to note that the majority did not consider the issue raised by the dissent that both trademarks in this case were associated with sexually oriented products. Based on the dissent's logical argument, future courts may consider whether a senior trademark is sexually related before determining whether the sexual character of a junior trademark likely tarnishes the senior trademark. It is possible that the dissent may

cause future courts to apply the bright-line rule only where a junior trademark is of sexual character and the senior trademark is not. Finally, while the Sixth Circuit applied the emerging rule in case law to this particular case, Sixth Circuit attorneys should not overlook the New Act's two requirements for dilution by tarnishment: an association between two trademarks and a likelihood of harm to the senior trademark.

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### MISREPRESENTATION

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**In Tennessee, real estate appraisals, while an opinion of value, can form the basis of an intentional misrepresentation claim and do not by their opinion-nature compel summary judgment.** *Davis v. McGuigan*, 325 S.W.3d 149 (Tenn. 2010).

By Greer Lynch

When considering the purchase of real property, most homebuyers finance their purchase with a residential bank loan. To determine the amount of the loan, banks generally rely on third-party appraisers to evaluate the necessary costs of buying or building the home. The bank then makes an internal determination as to how much money to make available for the homebuyer. Although the appraisal typically contains no guarantees to the homebuyer and is designed only for use by the bank, homebuyers sometimes use the appraisal to gauge the future value of their home. In *Davis v. McGuigan*, the Tennessee Supreme Court addressed whether a third-party appraiser, by issuing an overvalued appraisal, could be liable to a homebuyer for fraudulent misrepresentation or for causes of action under the Tennessee Consumer Protection Act (the "TCPA"). The court held that an opinion could form the basis of a fraudulent misrepresentation claim and, with genuine issues of material fact remaining, determined that summary judgment was precluded as to both the intentional misrepresentation and the TCPA claims.

The relevant facts leading to *McGuigan* began when Joseph and Kimberli Davis (the "Davises") purchased a corner lot in the Horseshoe Bend subdivision near Nashville, Tennessee, for \$135,500. They planned to design and build a custom home on the lot and were given an estimate of nearly \$600,000 by a contractor for the cost of building the home to specifications. The total cost for the lot and construction would be over \$730,000. The Davises submitted a Uniform Residential Loan Application to SunTrust Bank ("SunTrust") for \$580,000, and SunTrust sent an appraisal request to Patrick McGuigan ("McGuigan"), an appraiser regularly used by SunTrust. McGuigan produced an appraisal report using two methods to appraise the property. Using the "cost approach," he estimated the cost per square foot with various references and appraised the Davises' property value at \$731,000. Using the "comparison approach," he evaluated the recent sale of comparable properties, choosing three properties in the LaurelBrooke subdivision "deemed the best and/or the most similar sales available" and appraised the Davises' property at a value of \$735,000. McGuigan forwarded his appraisal report to SunTrust, estimating the property's market value at \$735,000 and including a disclaimer stating that the report "is not to be relied upon by third parties for any purpose, whatsoever." SunTrust subsequently informed the Davises that their proposed loan application for \$580,000 was approved. By the loan's closing on July 2, 2002, the Davises had not read the appraisal report provided by McGuigan to SunTrust.

Over a year later, Mr. Davis returned to SunTrust for a home equity loan. SunTrust ordered a second appraisal, and a value of \$510,000 was stated for the Davises' property.

The loan request was denied. The Davises later decided to sell their home, and six separate real estate agencies estimated the home's sale price between \$590,000 and \$625,000. The Davises eventually listed their home for \$679,000, closing with the first prospective buyer for \$660,000 on April 13, 2005. Soon thereafter, the Davises filed a complaint against McGuigan claiming that he intentionally or negligently misrepresented the market value of their home and also that he violated the TCPA. The trial court granted summary judgment to McGuigan with regard to the intentional misrepresentation claim and the TCPA claim, and the Davises voluntarily dismissed their negligent misrepresentation claim. On appeal, the intermediate appellate court affirmed the trial court's granting of summary judgment, holding that an appraisal cannot provide the basis for an intentional misrepresentation claim as it is an estimate or opinion and is not considered a fact. The Tennessee Supreme Court granted permission to appeal.

The Tennessee Supreme Court reversed the summary judgment and remanded the case to the trial court for further proceedings. Using a six-element test, the court reasoned that McGuigan had the burden to either affirmatively negate an essential element of the intentional misrepresentation claim or to show that the Davises could not prove an essential element of their claim. In so doing, McGuigan challenged the first, fourth, fifth, and sixth elements of the claim: (1) that McGuigan made a representation of an existing or past fact; (4) that McGuigan made the representation recklessly, with knowledge that it was false; (5) that the Davises reasonably relied on the representation; and (6) that the Davises were damaged by relying on the representation. Each element was analyzed in turn.

First and most significantly, the court held that an opinion of value is a material fact and may provide the basis for a fraudulent misrepresentation claim. McGuigan contended that his appraisal was an opinion and could not provide a basis for the Davises to claim he made a representation of fact. However, the court referenced section 62-39-102(3) of the Tennessee Code, Tennessee case law, and the Restatement (Second) of Torts, in determining that an appraisal "develop[s] an *opinion* of [market] *value*," which is an exception to the general rule that opinions do not constitute a basis of fraud. Thus, the court determined that opinions "may give rise to an intentional misrepresentation claim" where the opinion is of a form that "leaves no room for [doubt][,]" the speaker's relationship to the recipient is that of a disinterested expert, and "the fact that such person holds the opinion is material."

As for the remaining elements, the court next determined that evidence of McGuigan's deviation from the Uniform Standards of Professional Appraisal Practice (the "USPAP") allowed a reasonable person to question whether the appraisal was made recklessly with knowledge of its falsity. Third, the court found that the Davises did not rely on the appraisal report at all but, instead, relied on the figure conveyed to them by SunTrust and that any recovery should be based, not on how the representation was relayed, but on the representation alone. Coupled with an expert witness's testimony that "[a]ppraisers know . . . buyers . . . are likely to rely upon their conclusions in making decisions[,]" the court found that a reasonable person could reach separate conclusions also as to whether the Davises' reasonably relied on the appraisal. Finally, the court concluded that McGuigan was unable to introduce undisputed facts showing that the Davises were exceptionally motivated to sell their property at a reduced value without relying on the appraisal. By establishing genuine issues of material fact for all disputed elements, the Davises persuaded the court that summary judgment was not warranted.

Alternatively, McGuigan also moved for summary judgment on the TCPA claim. The TCPA offers a broad cause of action for losses resulting from an "unfair or deceptive

act or practice declared to be unlawful” under the Act. Without proof of any specific unlawful act by McGuigan, the court found that the Davises had the burden to prove that McGuigan was otherwise engaged in deceptive practices or omissions likely to mislead a reasonable consumer. Again, the court determined that McGuigan’s deviation from the USPAP provided a question of fact for which a reasonable person could reach different conclusions. The Tennessee Supreme Court, therefore, reasoned that summary judgment was not appropriate and remanded the case to the trial court for further proceedings.

The court’s decision in *Davis v. McGuigan* gives caution to appraisers and demonstrates a trend in favor of individual homebuyers, opposite their loaning counterparts. In this case, the Davises purchased and sold their home while a continual rise in the housing market climbed to its historic apex. However, the case arrived at the Tennessee Supreme Court following one of the greatest housing market declines in the history of the United States. Considering *McGuigan* in the shadow of the housing bubble burst, the court placed an additional burden on appraisers to arguably insure their appraisals against a falling market. Reiterating a previous decision, the court even hints that the case against McGuigan is not particularly strong but still requires deliberation. Appraisers and the financial institutions that they support must be aware of this potential liability, and their attorneys should take specific action to inform loan applicants that the appraisal they receive should not be relied upon for determining the potential worth of the appraised property.

Acknowledging that the court’s remand allows further factual discovery for the trier of fact, it still must be recognized that the court’s findings likely provide homebuyers with additional security, shielding the homebuyer from the full risk of his purchase and providing a means to charge someone else with his poor bargain. From a policy standpoint, it may seem appropriate to increase the liability of appraisers, but it is arguably of equal importance to require that a homebuyer make himself acquainted with the fundamental facts surrounding the purchase of a property. In light of the Tennessee Supreme Court’s decision in *McGuigan*, an appraiser should be thoroughly cautioned against inadvertently overvaluing a property’s worth. If not careful, he may face the consequence of legal costs associated with defending himself against dissatisfied homebuyers caught in a bad deal.

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## PROPERTY

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**In Tennessee, unless a tenant’s assignee personally assumes the tenant’s obligations under a lease, the tenant remains liable for damages caused by the assignee during both the lease’s initial term and any subsequent periods for which the lease is extended, even if such extensions result from the assignee’s holdover tenancy.** *Patton v. Massey*, No. E2009-00408-COA-R3-CV, 2010 Tenn. App. LEXIS 499, 2010 WL 3025551 (Tenn. Ct. App. Aug. 4, 2010).

By Dan Calvert

Under Tennessee law, tenants’ liability for damages caused by third parties to whom they assign their leasehold interests takes on added significance in light of the multiple means by which a lease may be extended beyond its initial term. While past Tennessee decisions clarified the means by which a tenant may effectively exercise an option to extend a lease, ambiguity remained regarding an assigning tenant’s liability for damages incurred by an assignee after the expiration of the lease’s initial term. In *Patton v. Massey*, the Tennessee Court of Appeals addressed this issue, holding that if a lease’s initial term is extended,

whether by the tenant's exercise of an option or by the assignee's holdover tenancy, the tenant is liable for damages caused by the assignee during the subsequent term.

In *Patton*, Larry Massey entered into a residential lease with an option to purchase the leased property (the "Lease") with Randall Patton. The Lease required monthly rental payments for a period of 24 months, a term that could be extended "for a period of 12 months" upon the mutual agreement of Patton and Massey. Soon after executing the Lease, Massey assigned his interest therein to Patricia McCormick and entered into a separate purchase option lease with McCormick (the "McCormick Lease") that would expire on the same date as the Lease, December 31, 2006.

As this date approached, Patton and Massey discussed extending the Lease. When Patton refused to offer an extension in writing, Massey tendered his final rental payment and informed Patton that he would allow the Lease to expire by its own terms. McCormick remained on the property after the Lease's expiration, however, and in January 2007, Patton sent Massey an eviction notice demanding he surrender the property. At trial, Patton claimed that after sending this notice, he and Massey orally agreed to extend the Lease an additional two months to give Massey and McCormick time to obtain financing to purchase the property. McCormick remained on the property until April 2007, four months after the Lease had expired, during which time neither McCormick nor Massey paid rent. Patton thereafter attempted but was unable to collect the unpaid amounts from McCormick.

As a result, Patton filed suit against Massey to recover these unpaid balances as well as additional amounts to compensate him for damage to the property and attorney's fees. After a bench trial, the court found that Patton and Massey had orally agreed to extend the Lease and that Massey was liable for the additional four months of rent and for property damage caused by McCormick.

On appeal, the Tennessee Court of Appeals affirmed the trial court's judgment and further clarified the extent to which tenants who assign their leasehold interests to third parties are liable for damages caused by such third-party assignees. Considering first whether the Lease was renewed by oral agreement, the court examined Tennessee precedent regarding when a tenant may be deemed to have exercised an option to extend a lease's term. The court explained that, to renew or extend a lease, parties do not have to execute a new agreement if the lease grants the tenant an option to extend the lease's term; where a tenant exercises such an option, a new contract is formed for the new period, subject to the conditions and covenants contained in the original lease. The court also clarified that if the lease does not stipulate the time or method by which the option must be exercised, the tenant may exercise it by remaining in possession of the property after the lease's initial term expires and paying the required rent.

Turning to the facts therein, the *Patton* court held that the evidence on record was insufficient to warrant overturning the trial court's finding that Patton and Massey had orally agreed to extend the Lease. While Massey refuted Patton's claim that they had reached an oral agreement, this assertion, supported only by Massey's own testimony, was insufficient to preponderate against the trial court's adoption of Patton's factual account. In addition, the court concluded that Patton's claim was supported by the fact that McCormick remained on the property for four months after the Lease's expiration and that no evidence existed that she did so knowingly or in bad faith.

Having thus affirmed the trial court's finding that Patton and Massey had orally agreed to extend the Lease, the court clarified that a contrary holding in this regard would

not have led to a different result. According to the Lease's terms, any holding over after the Lease's expiration created a month-to-month tenancy, subject to the conditions and covenants of the original Lease. In light of this clause, the court declared that, even if the Lease had not been extended by oral agreement, McCormick's holdover tenancy effectively extended the Lease to encompass the subsequent months during which she remained on the property.

Because of the lack of evidence that McCormick had assumed Massey's obligations under the Lease, the court held Massey liable for unpaid rent resulting from McCormick's holdover tenancy. Citing a well-established principle of property law, the court declared that an assignment alone does not terminate the original tenant's privity of contract with and resulting liability to the landlord; the original tenant's contractual responsibilities are relieved only if the assignee expressly assumes them. Because no such assumption accompanied the assignment therein, the *Patton* court held that Massey remained responsible for ensuring that possession of the property was returned to Patton upon the Lease's expiration. The court thus concluded that, even if Patton and Massey had not agreed to extend the Lease and McCormick's continued residence on the property was merely a holdover tenancy, Massey was nevertheless liable for unpaid rental payments incurred during this period. In addition, the court concluded that the lack of an assumption by McCormick also meant that Massey was not relieved of his obligation to return the property undamaged. Therefore, the court held that Massey was liable for physical damage to the property, including damage caused by McCormick.

The Tennessee Court of Appeals' decision in *Patton v. Massey* illustrates the multiple means by which a tenant's liability may be extended beyond the initial term of the tenant's lease. However, the simplicity of the facts in *Patton* enabled the court to reach its conclusion while conflating the multiple, distinct inquiries likely most relevant to practitioners. In light of the *Patton* opinion and the cases cited therein, an attorney assessing the possibility of a tenant's continuing liability after a lease's expiration should consider the following three issues.

First, the attorney should determine whether the lease contains an option to extend its term. Second, if such an option exists, the attorney should determine whether the timing of the alleged exercise thereof accords with applicable conditions in the lease. If the lease requires the option to be exercised "at the lease's end," an alleged exercise thereafter is insufficient. In cases such as *Patton* where the lease contains no such limitation, the option may be exercised within a reasonable time after the lease's expiration. Third, the attorney should examine whether the tenant's conduct constitutes an effective exercise of the option. If the lease requires the tenant to give notice of its election to exercise the option, the option cannot be exercised absent such notice. If not, the tenant's holdover tenancy and continued payment of agreed-upon rent creates the presumption that the tenant exercised the option. Conversely, this presumption cannot arise where the lease requires increased rent during the extension period but the tenant continues to pay the lesser amount due under the initial term.

Because *Patton* did not require the court to distinguish whether the continued possession therein amounted to a holdover tenancy or an exercise of the extension option, practitioners should be careful not to interpret *Patton* as permitting the above presumption where a tenant merely remains in possession of the property and does *not* pay the required rent. Because the court affirmed that the parties therein had agreed to extend the Lease, this

presumption, which applies in the absence of such an agreement, could not have been relevant to the trial court's decision.

However, attorneys should note the ramifications that the *Patton* court's dicta may have on future trial court opinions. Having already affirmed the trial court's finding that Patton and Massey had agreed to extend the Lease, the *Patton* court went on to provide a detailed illustration of why its decision would not have differed had the trial court not made this finding of fact but had merely construed the continued possession therein as a holdover tenancy. Given this indication by the court of appeals, trial courts faced with similar circumstances may be more receptive to holdover-tenancy treatment; accordingly, plaintiffs may be more likely to focus their arguments on such treatment rather than undertake the more difficult task of proving the existence of an oral extension agreement. However, the facts in *Patton* fall within a very narrow range of circumstances in which holdover-tenancy treatment and option-exercise treatment necessarily come to the same ends. Thus, a clearer designation regarding the nature of McCormick's continued residence might have benefitted practitioners. For example, such a determination will be necessary in similar circumstances where a lease's extension provision requires the tenant to pay increased rent or extends the tenant's obligations beyond those created by holdover tenancy.

Even if the oral extension argued by Patton did occur, practitioners should note the additional issues that would have arisen had holdover-tenancy treatment and option-exercise treatment not functioned identically herein. The trial court's decision in *Patton* appeared to allow holdover tenancy to effectively extend an exercised option beyond the time period agreed upon by the parties. As Patton testified, he and Massey had agreed to extend the Lease for an additional two months, yet the trial court appeared to treat this extension as covering the entire four months during which McCormick remained on the property. Such flexible treatment of the option's length would have prevented Patton from evicting McCormick after the two-month period since the subsequent months would have been considered extended periods pursuant to the option rather than holdover tenancy. Although the *Patton* court did not expressly reject this treatment, its focus on holdover tenancy suggests that the circumstances therein were more properly characterized as an initial two-month extension followed by a two-month holdover tenancy. This implicit distinction, while not relevant in *Patton*, will be crucial where such characterization affects the amount of rent for which a tenant is liable or where a landlord does not consent to a tenant's holdover tenancy.

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### SECURED TRANSACTIONS

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**When determining whether a duty to dispose of collateral in a commercially reasonable manner exists between two or more secured parties, Tennessee courts look to the disposing party's degree of participation and control in the disposition.** *Regions Bank v. Trailer Source*, No. M2008-01167-COA-R3-CV, 2010 Tenn. App. LEXIS 351, 2010 WL 2074590 (Tenn. Ct. App. May 21, 2010).

By Crystal L. Lucas

According to section 47-9-610 of the Tennessee Code, after a debtor defaults, a secured party may take action to dispose of the collateral, provided that it does so in a commercially reasonable manner. Typically, where the secured party takes physical possession of the collateral, the debtor may assert that the disposition was commercially

unreasonable. Applying the rule becomes less clear, however, when a junior secured party makes a “commercially unreasonable” allegation against a senior secured party that lacked actual possession of the collateral, and it was the debtor, not the senior secured party, that conducted the sale. The Tennessee Court of Appeals addressed this issue in *Regions Bank v. Trailer Source*. The court held that the duty to dispose of collateral in a commercially reasonable manner arises between a junior and senior secured party if the evidence shows that the disposing party possessed enough control to approve or disapprove the disposition. Where such a duty arises, the court concluded that low proceeds resulting from the senior secured party’s failure to appraise the collateral before the sale does not alone prove a commercially unreasonable disposition.

In *Trailer Source*, Regions Bank (“Regions”) loaned \$640,000 to Trailer Source, Inc. (“Trailer Source”), a retailer of new and used semi truck trailers. The loan was secured by Trailer Source’s accounts, inventory, and general intangibles, and Regions perfected its security interest in July 1999. Trailer Source acquired its used trailers from customer trade-ins and purchased its new trailers from Southern Trailer (“Southern”), which purchased the trailers directly from the manufacturer, Hyundai Translead (“Hyundai”).

In 2002, Hyundai sued both Trailer Source and Southern to recover payment for new trailers. To settle the lawsuit, the parties negotiated the “Hyundai Agreement,” which secured the \$20 million debt owed to Hyundai. The Hyundai Agreement also granted Hyundai a security interest in 1,431 used trailers that Trailer Source and Southern owned. Under the Hyundai Agreement, the certificates of title for the trailers were held in a lockbox account at First Bank, Hyundai approved all sales of the used trailers, and Hyundai received 75% of any proceeds from the sales. Although the Hyundai Agreement did not specify who owned which trailers, Hyundai was aware that its interest in the trailers owned by Trailer Source was subordinate to Regions’ perfected security interest. Because Hyundai initially failed to describe the collateral in its filed financing statement, its security interest was not perfected until September 23, 2003.

Also in September 2003, with \$381,969 outstanding on its loan from Regions, Trailer Source defaulted on its payments, and Regions sued Trailer Source to obtain possession of the collateral. Pursuant to writs of possession granted by the trial court, on September 18, 2003, Regions took possession of the certificates of title and cash proceeds held at First Bank. At this time, Trailer Source still owed Hyundai \$16 million. Upon receiving the titles, Regions consented to a sale of 241 of the used trailers that Trailer Source had previously negotiated to sell to a third party four days earlier (the “September sale”). In exchange for the certificates of title, Trailer Source gave Regions \$120,500 in proceeds from the sale of the trailers.

On October 7, 2003, Hyundai intervened in the lawsuit between Trailer Source and Regions and asserted a counterclaim against Regions. Hyundai sought damages and alleged that Regions violated section 47-9-610 of the Tennessee Code by disposing of the used trailers in a commercially unreasonable manner. Between November and December of 2003, Regions authorized Trailer Source to sell another 38 trailers for \$53,052, and Trailer Source again released the titles in exchange for the proceeds.

Under section 47-9-611(c)(3)(B) of the Tennessee Code, unless a secured party’s security interest is perfected at least ten days before the date of the sale, it is not entitled to receive notice of the collateral’s sale. On that basis, the trial court determined that Hyundai lacked standing to challenge the September sale and dismissed the issues relating to that sale on summary judgment. Hyundai appealed the trial court’s ruling, and the Tennessee Court of

Appeals reversed, holding that Hyundai had standing to challenge the September sale despite the notice issue.

On remand, the trial court found that (1) by actually possessing the certificates of title and authorizing Trailer Source to proceed with the sale, Regions had constructive possession of the trailers sold; (2) Regions had a duty to dispose of the collateral in a commercially reasonable manner; and (3) the sales were commercially unreasonable. Based on expert testimony that the trailers were worth \$548,950, the trial court awarded Hyundai \$375,398 in damages.

On appeal, the Tennessee Court of Appeals held that Regions exercised control over the sales so that section 47-9-610 of the Tennessee Code applied; however, it reversed the lower court's holding that the disposition was unreasonable. First, the court explained that the commercially reasonable obligation applies to the interests of debtors and secured parties. The statute applies when "the debtor [is] in default, and . . . the [secured party] [has] take[n] some action to dispose of the collateral." Therefore, the court determined that the issue was not whether Regions had possession of the collateral, but whether its participation was necessary to dispose of the trailers. The court answered this question affirmatively, reasoning that (1) Regions obtained the collateral with an intent to sell it; (2) Regions considered possession of the certificates of title necessary to dispose of the trailers; (3) Regions consented to the sales and released the titles in exchange for the proceeds; and (4) the buyer acknowledged that it would not have purchased the trailers without the certificates of title.

After determining that the statute applied to the sales, the court then turned to the question of whether Region's failure to appraise the trailers before selling them for such low prices was commercially unreasonable. The court explained that according to section 47-9-627 of the Tennessee Code, a disposition is commercially reasonable if it is made (1) in the usual manner on any recognized market; (2) at the current market price at the time of the disposition; or (3) in another manner conforming to reasonable commercial practices for the type of property. After considering the circumstances facing Regions, the court concluded that the sales were commercially reasonable under the statute.

Applying section 47-9-627 to the facts of the case, the court first noted that neither Regions nor Hyundai knew where the trailers were located, making it difficult to have them appraised. Furthermore, even if located, the court found that appraising 279 trailers would have been expensive. Second, the court determined that Trailer Source's pre-negotiated sales shifted to the buyer the risk that some of the trailers would be worthless. The buyer was willing to purchase trailers that it had not seen and would have to locate. Third, through expert testimony on "ordinary liquidation" value and by comparing the trial court's estimation of the trailers' value to the price for which the buyers later sold the trailers, the court found that the trial court's valuation of the trailers was low. The court determined that the "ordinary liquidation" standard was too high because Regions "was not in a position to obtain . . . an orderly liquidation of the collateral."

This ruling sends a stark message to secured parties seeking to dispose of collateral after a debtor's default. First, it is not possession but control and participation that determine whether a secured party has an obligation to make a commercially reasonable disposition. Second, what constitutes a commercially reasonable disposition will vary according to the facts of each case. At the very least, attorneys representing clients in transactions involving multiple security interests in the same collateral should inform their clients of these distinctions.

Attorneys should also take note of the various concerns that arise in disputes between secured parties and debtors, as opposed to disputes between two or more secured parties. As the court noted, when a dispute involving the disposition of collateral arises between a debtor and a secured party, “possession is . . . key since the [secured party] cannot usually sell what the debtor possesses.” However, when the dispute is between two or more secured parties, the focus turns to control and participation. In these situations, the duty to dispose of collateral in a commercially reasonable manner arises if the disposition requires the secured party’s approval. If the secured party seeking to dispose of the collateral does not have actual physical possession and does not wish to be subject to the statutory duty of commercially reasonable disposition, it should take precautions to ensure that its actions do not amount to control of the disposition.

Finally, when the duty to dispose of collateral in a commercially reasonable manner does apply, the disposing party should look at the totality of the circumstances to determine how to avoid liability. When making this determination, practitioners should consider the following issues: (1) the nature of the parties involved in the dispute, (2) whether the debtor or a secured party has actual possession of the collateral, and (3) whether, under the circumstances, an orderly liquidation is reasonably possible.

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## SECURITIES

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**Section 10(b) of the Securities Exchange Act applies only to transactions involving securities traded on domestic exchanges or transactions where the sale of the securities occurred in the United States.** *Morrison v. Nat’l Australia Bank Ltd.*, 130 S. Ct. 2869 (2010).

By Luke Archer

In *Morrison v. National Australia Bank Ltd.*, the Supreme Court limited the reach of section 10(b) of the Securities Exchange Act, a major anti-securities fraud provision. For nearly forty years, federal district and circuit courts had interpreted the provision to apply to certain transactions in foreign securities made outside the United States. In *Morrison*, the Court decided whether section 10(b) applied to securities purchased abroad that were not listed on a domestic exchange. Relying on the presumption against extraterritorial application of federal law, the *Morrison* Court restricted the scope of section 10(b) to transactions involving securities traded on domestic exchanges or transactions where the sale of securities occurred within the United States.

The facts of *Morrison* are straightforward. In 1998, National Australia Bank Ltd. (“National”), the largest bank in Australia at the time, purchased HomeSide Lending, Inc. (“HomeSide”), a Florida-based mortgage-servicing company. Although it owned HomeSide, National’s common stock was not traded on any exchanges in the United States. From 1998 to 2001, National reported that HomeSide was thriving; however, in late 2001, National wrote down the value of HomeSide’s assets by \$2.2 billion. National’s stock value plummeted.

Three Australians (the “plaintiffs”), who had purchased National stock before the write-down, sued National in the Southern District of New York for securities fraud under section 10(b) of the Securities Exchange Act. National moved to dismiss the suit for lack of subject matter jurisdiction and for failing to state a claim upon which relief could be granted. The district court, finding that section 10(b) did not apply to National’s conduct, concluded

that it lacked jurisdiction to decide the case. The Second Circuit affirmed the district court's decision, concluding that the "heart of the alleged fraud" occurred outside the United States. The Supreme Court affirmed the Second Circuit's ruling but rejected two aspects of the circuit court's reasoning.

First, the Court held that the Second Circuit incorrectly dismissed the suit on jurisdictional grounds when the suit should have been dismissed on the merits. The Second Circuit dismissed the case after determining that section 10(b) did not apply to National's conduct. The Court held that such a determination was not a jurisdictional question, but a merits question. Therefore, the proper ground for dismissing the complaint was for failing to state a claim upon which relief could be granted. Nevertheless, because the technical error did not alter anything else about the case, the Court chose not to remand it.

Second, although the Court agreed with the Second Circuit that section 10(b) did not apply to National's conduct, the Court held that the circuit court had applied the incorrect legal test in coming to its conclusion. Section 10(b) of the Securities Exchange Act bans fraud "by the use of any means or instrumentality of interstate commerce . . . or of any facility of any national securities exchange . . . in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered." In interpreting section 10(b), the Second Circuit employed a line of reasoning that focused on the reasonableness of applying section 10(b) to the transaction in question. The majority of lower courts had used variations of the "reasonableness" analysis for over forty years. The Second Circuit crafted the parameters of its specific reasonableness analysis with two tests: "whether the wrongful conduct had a substantial effect in the United States or upon United States citizens" and "whether the wrongful conduct occurred in the United States." The ambiguous and broad nature of the two tests applied section 10(b) to some sales of foreign securities made outside of the United States but not to others. The Court observed that the tests' ambiguity stymied consistent application by leaving ample room for the policy preferences of individual courts.

The Court rejected the Second Circuit's standard by relying on the well-established presumption against extraterritorial application of federal law. The Court stated that federal law does not apply outside the United States absent an affirmative indication that Congress intended for the law to apply abroad.

To defeat the presumption against extraterritoriality, the plaintiffs argued that Congress in fact intended for section 10(b) to apply to certain foreign transactions, but the Court rejected their arguments. First, the plaintiffs argued that because section 10(b)'s definition of "interstate commerce" references foreign commerce, Congress intended for the section to apply abroad. The Court was not convinced, stating that the section's "general reference" to foreign commerce did not "defeat the presumption against extraterritoriality." Next, the plaintiffs highlighted Congress's observation from the Securities Exchange Act that "prices [of securities] . . . offered in . . . transactions . . . are generally . . . quoted throughout the United States and foreign countries." Again, the Court said that such a "fleeting reference" to price quotations did not overcome the presumption against extraterritoriality. Lastly, the plaintiffs relied on the following language in section 30(b) of the Securities Exchange Act: "The provisions [of the Securities Exchange Act] . . . shall not apply . . . insofar as [any person] transacts a business in securities without the jurisdiction of the United States," unless he does so in violation of SEC regulations "to prevent . . . evasion of [the Securities Exchange Act]." The Court acknowledged that it is possible to infer from the language that the Securities Exchange Act may apply overseas; however, the Court,

relying on the presumption against extraterritoriality, stated that it is more likely that the language penalizes those who attempt to cover up a domestic violation of the Securities Exchange Act by acts abroad. Although the Court rejected all the plaintiffs' arguments that Congress intended for section 10(b) to apply outside the United States, the Court asserted that it was not creating a "clear statement rule," meaning that its ruling did not necessarily require all statutes to include an explicit provision that it applied abroad before having extraterritorial effect.

The Court then applied the presumption against extraterritoriality to the language of section 10(b) and concluded that the provision reached only transactions involving securities traded on domestic exchanges or transactions where the sale of securities occurred in the United States. Section 10(b) bans fraud "in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered." The presumption, in part, led the Court to interpret "national securities exchange" to mean *domestic* national securities exchanges and to interpret "any security not so registered" to include only securities sold within the United States. The Court noted that the Securities Exchange Act focuses not on where the deception occurred but on "purchases and sales of securities in the United States." Because National's stock was not traded on a domestic exchange and because the plaintiffs had not bought National's stock in the United States, the Court dismissed the suit. The fact that the fraud stemmed from an alleged bolstering of a Florida company's success made no difference.

*Morrison* is important to transactional attorneys in three ways. First, the case clearly defines the scope of section 10(b) of the Securities Exchange Act. Before *Morrison*, federal circuit and district courts were inconsistent in applying section 10(b) to various foreign securities. Now, the Court has given a straightforward rule: section 10(b) simply does not cover transactions concerning securities absent from domestic exchanges when those securities were not sold within the United States. Second, *Morrison* further strengthened the presumption against extraterritoriality of federal law. Attorneys working for corporations who do business abroad should use the presumption to their clients' advantage. Before determining whether an international corporation's practices are following the letter of the law in the United States, a shrewd attorney should determine whether the letter of the law even governs the corporation's practices. If the regulation applies, the corporation benefits; if it does not apply, purchasers of foreign securities, like the plaintiffs in *Morrison*, have no recourse in the United States for securities fraud. Lastly, *Morrison* serves as a reminder that although the rules on securities fraud in the United States may now be clearly defined, attorneys must still be aware of the reach of any similar foreign securities regulation. Just because section 10(b) may not apply to certain conduct does not mean that a corporation escapes liability in other countries.

**The two-year limitations period for a private section 10(b) action begins to run when the plaintiff actually discovers "the facts constituting the violation" or when a "reasonably diligent plaintiff would have discovered" such facts.** *Merck & Co. v. Reynolds*, 130 S. Ct. 1784 (2010).

By Dora Misciagna

In *Merck & Co. v. Reynolds*, the United States Supreme Court addressed the timeliness of a private securities-fraud action under section 10(b) of the Securities Exchange Act of 1934. Under 28 U.S.C. § 1658(b)(1), a securities fraud complaint is timely if filed no

more than “[two] years after the discovery of the facts constituting the violation” or five years after the violation, whichever comes first. In *Merck*, the Supreme Court held that the two-year limitations period for a private section 10(b) action begins to run when the plaintiff actually discovers “the facts constituting the violation” or when a “reasonably diligent plaintiff would have discovered” such facts, whichever takes place first. The Supreme Court further held that the “facts constituting the violation” include those demonstrating scienter or fraudulent intent.

In *Merck*, a group of investors (the “plaintiffs”) brought a section 10(b) claim against Merck & Co. (“Merck”) alleging that Merck “knowingly misrepresented the risks of heart attacks” associated with the use of Merck’s painkiller, Vioxx, which lead to economic losses when the public discovered the risks associated with the drug. Merck developed Vioxx in the 1990s. After developing the drug, Merck conducted a study (the “VIGOR Study”) comparing Vioxx with naproxen, another pain-killing drug. The VIGOR Study revealed that Vioxx users were approximately four times more likely to suffer heart attacks. In March of 2000, Merck announced the results of the VIGOR Study, acknowledging the adverse cardiovascular data. However, Merck attributed the adverse findings “to the absence of a benefit conferred by naproxen rather than due to a harm caused by Vioxx.” This theory later became known as the “naproxen hypothesis” (the “Naproxen Hypothesis”).

Public debate regarding the Naproxen Hypothesis continued throughout 2001. Then, in May of 2001, a group of plaintiffs filed a products-liability lawsuit against Merck regarding the adverse cardiovascular risks associated with Vioxx. In September of 2001, the Food and Drug Administration (the “FDA”) released a warning letter to the public stating that Merck’s Vioxx marketing was “false, lacking in fair balance, or otherwise misleading.” While the warning letter acknowledged that the Naproxen Hypothesis was a “possible explanation” for the adverse results, the FDA determined that Merck had promoted the Naproxen Hypothesis without adequately acknowledging that Vioxx, the drug itself, could have caused the adverse cardiovascular effects and ordered Merck to send a corrective letter to healthcare providers. Merck ultimately withdrew Vioxx from the market in September of 2004, claiming that it did so based on the results of a new study. Shortly after, internal Merck emails were released to the public, demonstrating that Merck “fought forcefully for years to keep safety concerns from destroying the drug’s commercial prospects.”

The plaintiffs filed their complaint on November 6, 2003, alleging that Merck “had defrauded investors by promoting the naproxen hypothesis, knowing the hypothesis was false.” Merck moved to dismiss the complaint, asserting that the complaint did not fall within the applicable limitations period because, while the complaint was clearly filed within the five-year limitations period of § 1658(b)(1), the plaintiffs knew or should have known “the facts constituting the violation” more than two years earlier. The United States District Court for the District of New Jersey granted the motion, holding that the plaintiffs’ complaint was untimely because the FDA’s warning letter and Merck’s response put them on “inquiry notice”—i.e., they possessed information that would cause a reasonably diligent plaintiff to investigate further—more than two years prior to filing their complaint. The Third Circuit reversed, holding that the information available more than two years before the plaintiffs filed their complaint did not commence the running of the limitations period because it did not suggest scienter, a necessary element of a section 10(b) claim.

After granting Merck’s petition for certiorari, the Supreme Court affirmed the Third Circuit’s decision and held that the plaintiffs’ complaint was timely. The Supreme Court first addressed whether, under § 1658(b)(1), “discovery” encompassed not only when a plaintiff

*actually* discovered “the facts constituting the violation” but also when a reasonably diligent plaintiff would have discovered such facts. The Court noted that in the context of limitations periods, courts have long interpreted the term “discovery” to include the “reasonably diligent plaintiff” standard and concluded that in adopting § 1658, Congress intended “discovery” to be interpreted in the same manner.

The Court then addressed Merck’s argument that the plaintiffs’ claims accrued more than two years before they filed their complaint. First, the Court determined that the limitations period does not begin to run until facts related to scienter become discoverable. In support of this determination, the Court noted that scienter is an important and necessary element of a section 10(b) violation and that special heightened pleading requirements required a section 10(b) plaintiff to set forth facts in the complaint demonstrating that it is “at least as likely as” not that the defendant acted with scienter. As a result, the Court concluded that the limitations period cannot commence until such facts become discoverable.

Next, the Court dismissed Merck’s argument that, even if “discovery” required scienter-related facts, facts demonstrating a materially false or misleading statement were sufficient to demonstrate scienter as well. The Court acknowledged that facts demonstrating a materially false or misleading statement normally do show scienter but concluded that additional facts may be necessary in certain circumstances. The Court then addressed Merck’s argument that the claim was untimely because the plaintiffs were on “inquiry notice” more than two years before filing the complaint. As defined by Merck, “inquiry notice” refers to the point at which the facts would cause a reasonably diligent plaintiff “to conduct a further inquiry.” The Court reasoned that such a point does not necessarily occur after a plaintiff would have discovered “the facts constituting the violation” and that according to § 1658, private section 10(b) actions accrue “only after the ‘discovery’” of such facts. As a result, the Court concluded that “inquiry notice” does not commence the running of the limitations period for a private section 10(b) action.

Finally, the Court addressed Merck’s argument that the plaintiffs discovered or should have discovered facts relating to scienter more than two years before filing the complaint. Merck based its argument on the following incidences: (1) the FDA’s September 2001 warning letter stating that Merck had “minimized” the “potentially serious cardiovascular findings” of the VIGOR Study and (2) the products-liability complaints, filed in 2001, alleging that Merck “omitted, suppressed, or concealed material facts concerning the dangers and risks associated with Vioxx.” Noting that the FDA even described the Naproxen Hypothesis as a “possible explanation” for the VIGOR Study’s findings, the Court concluded that the FDA’s warning letter showed little or no evidence that Merck promoted the Naproxen Hypothesis with fraudulent intent. The Court further concluded that the products-liability complaints revealed little more with regard to scienter because they alleged only in general terms that Merck concealed information concerning Vioxx and “purposefully downplayed and/or understated the serious nature of the risks associated with Vioxx.” As a result, the Court concluded that prior to November 6, 2001—two years before the plaintiffs filed their complaint—the plaintiffs had not discovered and a reasonably diligent plaintiff would not have discovered “the facts constituting the violation.” Thus, the plaintiffs’ claim fell within the applicable limitations period.

The Court’s decision in *Merck* will likely increase the number of section 10(b) complaints that fall within the two-year limitations period of § 1658(b)(1). Prior to *Merck*, many jurisdictions applied a form of the “inquiry notice” standard applied by the district

court in this case. Under this standard, events occurring outside of the two-year limitations period that would cause a reasonably diligent plaintiff to investigate further but that did not necessarily demonstrate fraudulent intent could trigger the two-year statute of limitations. Now, defendants must establish that the plaintiff knew of facts demonstrating scienter or that such information was publicly available. As a result of this heightened standard, the two-year statute of limitations defense will not be as useful. On the other hand, in holding that the facts in *Mervk* did not demonstrate sufficient evidence of scienter to commence the running of the statute of limitations, the Supreme Court reaffirmed that a section 10(b) plaintiff must allege scienter with the requisite specificity and that facts demonstrating a materially false or misleading statement do not necessarily meet this burden.

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### SHAREHOLDER LITIGATION

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**When a shareholder receives shares of an acquiring corporation as consideration in a merger, the shareholder's derivative action against the acquired company may still exist as a double derivative action.** *Lambrecht v. O'Neal*, 3 A.3d 277 (Del. 2010).

By Mary Elizabeth Anderson

In *Lambrecht v. O'Neal*, the Supreme Court of Delaware was asked to clarify the procedural requirements for a shareholder plaintiff who lost standing to bring suit in a standard corporate derivative claim because of a merger; as a result of the merger, the plaintiff was a shareholder in the acquiring corporation, and the acquiring corporation was the parent and 100% owner of the target subsidiary corporation. The court held that shareholder plaintiffs are not required to show that, at the time of the wrongdoing, they owned stock in the acquiring corporation nor that the acquiring corporation owned stock in the target corporation. This decision overruled the Delaware Court of Chancery's holding in *Saito v. McCall*, No. Civ.A. 17132-NC, 2004 Del. Ch. LEXIS 205, 2004 WL 3029876 (Del. Ch. Dec. 20, 2004) and provides a different standing requirement for post-merger double derivative suits than for standard derivative suits.

*Lambrecht* was before the Delaware Supreme Court as a certified question from the Southern District of New York where the double derivative suits were initially filed. Originally, *Lambrecht* and Loveman (the "plaintiffs") filed separate standard derivative actions against Merrill Lynch's board of directors claiming breach of fiduciary duties for underwriting collateralized debt obligations, discarding the risks of mortgage investments, and paying \$3.6 billion in employee bonuses. In January 2009, Merrill Lynch and Bank of America ("BofA") (collectively, the "defendants") closed a reverse triangular merger where Merrill Lynch, the target corporation, became a wholly owned subsidiary of BofA, the acquiring corporation, and BofA became the parent corporation and 100% owner of Merrill Lynch. As consideration for the merger, Merrill Lynch shares were converted to BofA shares. Because the plaintiffs' shares were converted to BofA shares, the plaintiffs lost standing to bring standard derivative suits against Merrill Lynch under *Levis v. Anderson*, 477 A.2d 1040 (Del. 1984). As a result, the plaintiffs' cases were dismissed without prejudice. In response, the plaintiffs amended their cases to double derivative suits in order to force BofA's board of directors into action against Merrill Lynch's board of directors to correct the wrongdoing. Relying on *Saito v. McCall*, the defendants moved to dismiss the plaintiffs' actions for lack of standing and argued that the plaintiffs must show that, at the time of the wrongdoing, both BofA and the plaintiffs owned stock in Merrill Lynch and that the plaintiffs also owned stock in BofA.

In answering the certified question, the Delaware Supreme Court first analyzed the different types of derivative actions. The court noted that a standard derivative action occurs when a shareholder brings a claim on behalf of the corporation in which the shareholder owns stock, either because its board wrongfully refuses to act or is incapable of making an impartial decision. In a double derivative action, however, the shareholder of the parent corporation brings a lawsuit on behalf of its subsidiary because the subsidiary has harmed the parent corporation and thus the parent corporation's shareholders. The court went on to note that double derivative actions have an additional twist that relates to the parent-subsidiary relationship and the time of the wrongdoing. If the shareholder owns stock in the parent corporation, and the parent-subsidiary relationship was created before the time of the alleged wrongdoing, then the shareholder can only bring a double derivative lawsuit. But, if the shareholder has stock in the parent corporation only as a result of a merger, and the wrongdoing occurred before the merger, then the shareholder may be able to bring a standard derivative suit pre-merger and a double derivative suit post-merger, if the correct procedural requirements are met.

Second, the court discussed what standing requirement should apply to double derivative actions. In a standard derivative suit, plaintiffs must satisfy a contemporaneous and continuous ownership standing from the time of the wrongdoing and throughout the entire litigation. The court observed that title 8, section 327 of the Delaware Code sets the contemporaneous ownership condition and requires a shareholder plaintiff bringing a claim on behalf of a corporation to be a shareholder of that corporation at the time of the wrongdoing. The Delaware Supreme Court's decision in *Lewis v. Anderson* set the requirement that plaintiffs must hold the shares continuously throughout litigation (the "*Lewis* test").

The court next looked to *Blasband v. Rales*, 634 A.2d 927 (Del. 1993), a double derivative case where the United States District Court for the District of Delaware certified a question regarding demand excusal to the Delaware Supreme Court. In *Rales*, the Delaware Supreme Court held that for demand excusal of the parent board in a double derivative action, plaintiffs must follow the *Rales* test rather than the *Lewis* test. Unlike the *Lewis* test, which sets the requirements at the time of the wrongdoing, the *Rales* test is applied at the time the complaint is filed. The court also held that the plaintiff must satisfy the *Lewis* test for the subsidiary's board but that the *Rales* test applies to the parent board. In *Lambrecht*, the timing requirement between *Lewis* and *Rales* is an important distinction for the different types of derivative actions.

Next, the court turned to the defendants' proposed standing requirement for post-merger double derivative actions and found the defendants' argument fatally flawed. The defendants claimed that double derivative lawsuits are like two standard derivative lawsuits stacked on top of each other and that each action must satisfy the *Lewis* test. Thus, the defendants argued that the plaintiffs must show that they owned BofA stock before the merger and at the time of the Merrill Lynch wrongdoing and that BofA must have also owned Merrill Lynch stock at the time of the wrongdoing. The court rejected this argument for four reasons.

First, the court recognized that aside from the *Saito* decision, there was no other case law or statutory law in Delaware that proposed requirements for the standing of defendants in double derivative suits. If the court followed *Saito*, then double derivative suits would be "virtually impossible to bring except in bizarrely happenstance

circumstances.” The court declared that such an interpretation would negate old precedent that encouraged double derivative actions.

Second, the court rejected the defendants’ proposal that, in order to bring a claim, BofA had to be a shareholder of Merrill Lynch at the time of the wrongdoing. The court explained that, post-merger, BofA was the sole owner of Merrill Lynch including all claims; therefore, BofA had the ability to act directly and did not have to follow the derivative requirements.

Third, the court rejected the defendant’s application of the contemporaneous requirement in title 8, section 327 of the Delaware Code. The court asserted that the plaintiffs in this double derivative action were bringing a claim on behalf of BofA. Thus, the plaintiffs only had to show they were BofA shareholders at the time the claim was brought, not at the time of the wrongdoing. The court determined that this requirement was easily met because the plaintiffs acquired BofA shares in the merger and brought the claim post-merger.

Fourth, the court determined that a post-merger double derivative action is not a de facto continuation of the pre-merger derivative action. The court found that standing to bring a double derivative action instead rests on the fact that the acquiring corporation, BofA, failed to act and correct the original wrong. It was that failure to act, not the original failure, that allows shareholders to bring a double derivative action. The court concluded that if BofA’s board had corrected the wrongdoing, the plaintiffs could not have brought a double derivative action.

Finally, the court turned to the *Saito* decision and held that it misapplied Delaware law because it extended a standard derivative requirement to a double derivative action. In *Saito*, the court held that to have standing to sue in a double derivative action the plaintiff must follow the *Lewis* test rather than the *Rales* test. The *Lambrecht* court rejected the Delaware Court of Chancery’s holding in *Saito* and clarified that while a standard derivative action must follow the *Lewis* test, a double derivative action must follow the *Rales* test.

There are three reasons this case is significant to transactional lawyers. First, this case helps transactional lawyers representing shareholders by clarifying and lowering the requirements for standing to bring a post-merger double derivative action. Now, a shareholder is able to pursue a claim that was dismissed for lack of standing as a result of a merger. Second, this case warns the acquiring corporation’s transactional lawyers to structure the merger and consideration to prevent a double derivative action. Transactional lawyers must be aware that a merger with a share-for-share exchange will not terminate the target shareholder’s standing for a claim against the target corporation. The acquiring corporation needs to be prepared to shield itself from this potential litigation or avoid the acquisition until this litigation has been resolved. Third, this case is a reminder that all transactional lawyers must understand the different types of derivative actions and their standing requirements because each action’s rules are vastly different.