

CASE COMMENTARIES

BANKRUPTCY

Creditors cannot revive discharged claim in a subsequent Chapter 12 case. *In re Myers*, 284 B.R. 478 (B.A.P. 10th Cir. 2002).

By C. Mark Anderson

The Tenth Circuit Bankruptcy Appeals Panel held that a creditor holding a claim discharged in a prior Chapter 7 case cannot assert that claim for purposes of setoff in a subsequent Chapter 12 case.

In *In re Myers*, the debtors owed the United States Department of Agriculture (the “USDA”) a sizeable sum of money. The loan was secured by liens on the debtors’ land and other assets. The loan went into default, and the USDA commenced foreclosure proceedings. The debtors filed a Chapter 12 petition, which was converted to a Chapter 7 petition. Pursuant to section 727 of the Bankruptcy Code, the debtors were granted a discharge. The USDA then proceeded to prosecute its foreclosure complaint in the United States District Court, receiving a judgment against the debtors.

The debtors then filed a second Chapter 12 petition. The debtors and the USDA agreed that the debtors were authorized to enroll in farm related payment programs. The USDA claimed that it had not waived its rights to setoff or to recoup its prior claims against any amounts that became payable to the debtors as a result of the programs. In order to setoff payments made to the debtors against the original claims that the USDA had in Chapter 7, the USDA moved to lift the automatic stay.

Both the trial court and the Appeals Panel agreed that this was an issue of interpretation of the Bankruptcy Code and that “when the debtors’ Chapter 7 discharge was entered, it discharged them from ‘all debts that arose before the date of the order for relief under this chapter.’” Once a debt is discharged, the creditor’s right to payment ceases to exist. The USDA argued that its right to setoff survived the discharge, because the discharge only acts to erase the debtors’ personal liability and not *in rem* liability. However, the court dismissed this contention by pointing out that an *in rem* claim was not at issue.

This decision should act to remind practitioners of the power of the Chapter 7 discharge and its so-called “Chapter 19” cases in which a debtor files a Chapter 7

case, receives its discharge, and then files a Chapter 12 case to address debts, such as secured claims with a Chapter 12 plan, not discharged in the Chapter 7 case. A Chapter 7 discharge effectively wipes out the creditors right to further payment for all discharged debts. Thus, the creditor's claim cannot be revived by the filing of a subsequent petition for bankruptcy by the debtor.

Debtor loses ownership in collateral upon repossession despite filing subsequent petition for relief. *In re Kalter*, 292 F.3d 1350 (11th Cir. 2002).

By Jason P. Jeffreys

Applying Florida statutory law, the Eleventh Circuit Court of Appeals held that upon repossession of collateral prior to a debtor's filing of bankruptcy, ownership of collateral passes to the repossessing creditor, even if the creditor has not obtained a certificate of title in its name.

In *In re Kalter*, the debtors sued the creditors seeking turnover under 11 U.S.C. § 542 of their respective vehicles, which the creditors had repossessed prior to the petition date. The bankruptcy court held for the debtors, reasoning along the lines of *U.S. v. Whiting Pools* that because a vehicle is "property of the debtor's estate," a third party creditor could be ordered to return the property to the debtor's possession.

On first appeal, the U.S. District Court of the Middle District of Florida focused its attention on whether the vehicles were actually part of the debtor's bankruptcy estate after repossession. Examining various Florida statutes, the court concluded that the vehicles were no longer property of the debtors' estates because ownership transferred to the respective creditors upon repossession. The Eleventh Circuit Court of Appeals affirmed.

In reaching its conclusion, the Eleventh Circuit looked to sources of Florida law that related to the rights and obligations of a secured creditor repossessing a vehicle, notably section 319.28 of the Florida Certificate of Title Statute. This statute expressly recognizes that ownership in a repossessed vehicle is transferred to a creditor upon repossession. Therefore, the debtors automatically lost their ownership interests the moment the repossession occurred. Further, the court noted that this statute also allows ownership to be retained by the creditor despite its failure to obtain either a certificate of title or certificate of repossession before the bankruptcy filings.

This case emphasizes the effects of the *Butner* principal: Questions of what constitutes property of the estate under 11 U.S.C. § 541, which property must be turned over to the debtor or the trustee upon bankruptcy, are governed by non-bankruptcy law. Just as that non-bankruptcy law may seem to provide the debtor with more leeway, however, that law may be drafted to reverse this result and protect secured creditors from the prospect of post-repossession loss of the collateral in a subsequent bankruptcy case.

COMMERCIAL

CD characterized as common law pledge instead of UCC certificate of deposit. *Nat'l City Bank v. Toffel*, 292 F.3d 1319 (11th Cir. 2002).

By Kimberly M. Jones

Applying Kentucky law, the Eleventh Circuit Court of Appeals held that funds deposited as a certificate of deposit (“CD”) and used to secure credit were a common law pledge rather than a negotiable instrument governed by Kentucky’s version of the Uniform Commercial Code (“UCC”) for failure to meet definitional requirements, and thus subject to the pledgee’s disposal.

National City Bank of Kentucky (“NCB”) issued a letter of credit to the Alabama Land & Mineral Corporation (“Alabama Land”) in favor of Van-American Insurance Company (“Van-American”) in the amount of \$1,000,000. NCB and Alabama Land then entered into a Reimbursement and Security Agreement (“Agreement”) whereby Alabama Land agreed to repay NCB should Van-American draw upon the line of credit. Meanwhile, Alabama Land and its parent company, Mid-South Resources Corporation (“Mid-south”), opened an escrow account with NCB to store the subject funds for the Agreement. The escrow account provided Alabama Land and Mid-South with the right to request investment of the subject funds in a CD. Mid-South subsequently requested investment of the subject funds in a CD, which was created by NCB. However, NCB never issued a certificate to represent the CD.

Three years later, Alabama Land and Mid-South petitioned for bankruptcy. Within two years of filing, Van-American drew upon the \$1,000,000 previously established line of credit. Based on the Agreement between NCB and Alabama Land, NCB requested the Trustee of Alabama Land’s bankruptcy estate (“Trustee”) to pay the \$1,000,000 Van-American drew from the line of credit plus a fee for drawing the funds. The Trustee refused to pay the requested amount, and as a result, NCB paid Van-American \$1,000,000 and retained the CD as payment.

Nevertheless, both a bankruptcy and district court placed an automatic stay over the CD, thus preventing NCB from retaining the fund as repayment. NCB then appealed to the Eleventh Circuit seeking relief from the automatic stay to apply the CD to the pre-petition obligations of Alabama Land and Mid-South set forth in the Agreement. The issue for determination was whether the funds in dispute could be characterized as a deposit account or as a CD.

Kentucky has long held the view that when determining the rights and liabilities of parties, it is the substance of a transaction rather than form that controls interpretation. Moreover, under Kentucky law, K.R.S. § 355.3-104(10), an adoption of Article 9 of the UCC, the only method of perfecting an interest in a negotiable instrument, such as a CD, is through possession.

In applying these principles, the Eleventh Circuit found that the substance of the transaction was the extension of a line of credit by NCB to Alabama Land in consideration for a security interest in the subject funds. Despite arguments by the Trustee that the substance of the transaction was altered when Alabama Land requested and NCB invested the subject funds in a CD, the court held that the substance of the transaction had not changed; that NCB did not relinquish its security interest in the subject funds by investing them in a CD.

Noting that a written certificate, which is required by the definition of a negotiable instrument, did not evidence the CD, the court could not characterize the subject funds as a CD under Kentucky's version of Article 9 of the UCC. Since this body of law did not apply, the court looked to the common law of Kentucky to characterize the funds. The court found that the funds would be more properly characterized as a pledge, meaning a "transfer of property as security for a debt."

The Eleventh Circuit then noted that in *Mechanics' & Traders' Ins. Co. v Kiger*, 103 U.S. 352, 356 (1880), the Supreme Court defined the elements required to make a pledge as "(1) debt; (2) the offer of property to secure the debt, and (3) the transfer of the property from the debtor (pledgor) to the creditor (pledgee)." Applying the facts of the case to the required definitions, the court found that (1) Alabama Land incurred debt when NCB extended the \$1,000,000 line of credit to Alabama Land in favor of Van-American; (2) Alabama Land (through Mid-South) offered the subject funds as security; and (3) Alabama Land (through Mid-South) transferred the subject funds to NCB.

Based on its findings, the Eleventh Circuit emphasized two points. First, the court noted that, conceptually and physically, Alabama Land's debt and Mid-South's

pledge were two different items. Second, the universal rule regarding pledges of personal property as security for debt is that to create a lien, possession of the item pledged, whether actually or symbolically, must be delivered by the pledgor to the pledgee. If however, the item pledged remains in the control of the pledgor, the item has not been delivered and cannot be in the pledgee's possession. Applying this rule, the court held that Alabama Land relinquished control over the subject funds when they were deposited to NCB under the terms of the escrow account. Alabama Land only could "request" that the subject funds be invested, but all other control of the funds rested solely with NCB. Thus, the court held that possession of the funds had been transferred to NCB, and therefore, the subject funds were pledged by Alabama Land as security for the letter of credit.

The lesson to transactional attorneys here is fundamental, but it obviously bears repeating. While the UCC applies to most commercial transactions, it only applies when transactions meet the requirements established by the UCC. If transactions, such as the funds in this case, do not meet the applicable requirements of the UCC, they may fall victim to common law interpretation.

Fast cash lending service bound by the requirements of the Truth in Lending Act. *Jump v. ACP Enters.*, 224 F. Supp 2d 1216 (N.D. Ind. Sept. 16, 2002).

By Mary L. Morris

Applying federal law, the United States District Court for the Northern District of Indiana held that a lender had violated the Truth in Lending Act, 15 U.S.C. § 1683, ("TILA") for failing to accurately convey a security interest it had taken and for failing to accurately portray the property in which the interest was taken.

ACP Enterprises ("ACP") specialized in making high interest loans with short-term payback periods to various customers throughout northern Indiana. The loan amounts were usually small in value but required that the customer pay a high annual percentage rate ("APR") to receive the money. As a result, the APRs on the loans were well beyond the allowable finance charges under Indiana law. In addition to the high finance charges, the loan customers were required to leave a post-dated check with ACP in exchange for the loan amount. At the end of the loan term, which was usually two weeks, ACP had the option to cash the checks if the customers had not paid the loan.

In *Jump v. ACP Enterprises, Inc.*, the court had to determine whether a post-dated check must be disclosed under TILA, whether ACP's disclosure of the APR in agreements violated TILA, and whether the consumer loan agreements between ACP and its customers were governed by TILA and Regulation Z (codified as 12 C.F.R. § 226.2(a)(25)).

The court held that the loan agreements between ACP and its customers fell under the regulations of TILA and Regulation Z. In reaching its conclusion, the court looked to the language of both TILA and Regulation Z, which state, in pertinent part, that a creditor is required to accurately convey a security interest taken by a lender and to accurately portray the property in which the interest is taken. Likewise, Regulation Z defines "security interest" as "an interest in property that secures performance of a consumer credit obligation and that is recognized by state or federal law."

The court held that the loan agreements between ACP and the customers fell under the regulations of TILA and Regulation Z based on the definitions and language found in the regulations. In its analysis, the court noted that the security interest created was not the *usual* security interest created in most transactions of this kind because the post-dated check did not impart an independent value separate from the amount already owed by customer. The court did, however, note that a post-dated check created additional extrinsic value to the transaction. Moreover, post-dated checks taken from customers by ACP represented an additional avenue by which ACP could secure payment, which is similar to usual Article 9 transactions. As a result, the court found that the criteria for attachment and enforceability of a security interest had been met and that the security interest should have been disclosed under TILA.

This decision highlights the importance of understanding the relevant laws and statutes regarding a business entity. While transactional attorneys should not offer clients advice regarding business decisions, they should be mindful of the laws that pertain to their clients' decisions and should advise clients to follow the applicable laws accordingly.

CONTRACTS

Party sophistication influences court’s analysis of disputed terms in recording agreement. *FurryRecords, Inc. v. RealNetworks, Inc.*, 01 Civ. 10998 (JSR), 2002 U.S. Dist. LEXIS 16272 (S.D.N.Y. 2002).

By Isaac Conner

When two sophisticated parties enter into a licensing agreement, courts will rely on the language of that agreement to interpret each party’s rights under the agreement. Such was the situation presented in *FurryRecords, Inc. v. RealNetworks, Inc.*

In *FurryRecords*, the plaintiff, Hanna Bentley, and her personal company, FurryRecords, Inc., entered into a licensing agreement with a music promotion company named, The Orchard, LLC (“Orchard”). Bentley is a graduate of Columbia Law School, and represented her company in this action. Her duties with the company included artist, President, and principal shareholder.

On September 3, 1999, both parties entered into a licensing agreement that stated that Orchard could nonexclusively

sell, distribute, and otherwise exploit any and all of the recordings by any means and media, including, without limitation, the non-exclusive rights to sell, distribute and otherwise exploit any and all of [Ms. Bentley’s] Recordings throughout E-stores including, but not limited to those via the Internet, as well as digital storage, download and transmission rights, whether now known or existing in the future.

Bentley later learned that Orchard was making MP3 copies of her recordings, and on July 24, 2001, she sent a letter to Orchard demanding that copying cease. Bentley then brought suit against Orchard arguing that: (1) Orchard’s MP3 copying constituted copyright infringement; (2) that the license agreement was unconscionable; and (3) that the license agreement was terminable at will. The district court interpreted parties’ licensing agreement based on New York law and the language expressed in the agreement.

Bentley’s primary argument was that the license agreement did not expressly provide for “copying” per se, therefore, any copying done by the defendant was copyright infringement. The court disagreed with this interpretation based on specific language expressed in the agreement. The agreement used phrases, such as, “rights to sell, distribute and otherwise exploit any and all of your Recordings by any

and all means and media,” and these means of exploitation included “[I]nternet, as well as digital storage, download and transmission rights, whether now known or existing in the future.” The court interpreted such language as an open-ended right for Orchard to exploit the recordings. The court also focused on the language “whether now known or existing in the future” as the overwhelming evidence as to why MP3 copying, a new technology, was valid under the agreement.

Bentley’s secondary argument was that the agreement was unconscionable. She claimed that the one-year period that the defendant would promote the recordings was inherently unreasonable because the defendant had a right in perpetuity to sell, distribute, and otherwise exploit the recordings. The court held that there was nothing inherently unreasonable about a promoter agreeing to promote an unknown artist for non-exclusive rights to exploit the works. Moreover, under 17 U.S.C. § 203(a)(3), Bentley has a statutory right to terminate the contract after 35 years; therefore, the agreement was conscionable. Additionally, the court considered both parties sophisticated. Bentley, a graduate from Columbia Law School, was not misled or coerced into agreeing to the terms at issue. She reviewed and voluntarily signed the agreement.

Finally, Bentley argued that the agreement was terminable-at-will. Under New York law, contracts are terminable-at-will if: (1) there is no fixed “or determinable” duration to the overall contract; and (2) there is no express agreement that the duration is perpetual. The court held that the agreement expressly provided the Orchard rights in perpetuity that were terminable only with mutual consent. Furthermore, since federal law establishes the right to terminate copyrights after 35 years, the contract was not terminable at will.

FurryRecords is a good lesson for any transactional attorney in closely reviewing contracts before endorsing. The court used the four-corners test to interpret the agreement. Here the plaintiff, who was not only the attorney, but also an artist, may have done herself a disservice by not using outside counsel. Her dreams of becoming a music sensation may have clouded her judgment as a legal practitioner.

Employment agreement providing judicial remedies for disputes supercedes asset purchase agreement's arbitration clause. *Frounfelker v. Identity Group, Inc.*, No. M2001-02542-COA-R3-CV, 2002 Tenn. App. LEXIS 390 (Tenn Ct. App. 2002).

By Patrick V. Fiel, Jr.

A Tennessee appellate court denied a company's motion to compel arbitration of a dispute arising out of an Employment Agreement. Though Tennessee courts generally construe any arbitration agreements in favor of compelling the arbitration of disputes, in *Frounfelker v. Identity Group, Inc.*, the appellate court found that the parties did not intend an arbitration clause to govern a claim for early termination.

Identity Group, Inc. ("Identity") motioned to compel David Frounfelker ("Frounfelker") to arbitrate his claim of early termination. The parties initially contracted for Frounfelker to sell his company to Identity. As part of the agreement, Frounfelker would transfer his company's assets to Identity while Identity would hire Frounfelker for a one-year term. The parties executed an Asset Purchase Agreement containing an arbitration clause providing that "any dispute, controversy, or claim arising out of, relating to, or in connection with, the Asset Purchase Agreement shall be finally settled by binding arbitration." Simultaneously, Identity and Frounfelker executed an Employment Agreement governing Frounfelker's term of employment. The Employment Agreement contained several provisions providing judicial remedies in the event of a breach by either party.

The Employment Agreement stated that Frounfelker's term of employment was to end on the twelve-month anniversary of the Commencement Date, listed as March 15, 2000. On March 14, 2001, Identity and Frounfelker mutually agreed to extend the employment term one (1) additional week. After failing to negotiate a renewal agreement, Frounfelker's employment ended on March 21, 2001. Frounfelker then filed a complaint claiming that he was terminated prior to the twelve-month anniversary of his Commencement Date. Frounfelker asserted that the agreed upon Commencement Date was April 1, 2000, his first day of employment with Identity following the close of the asset sale on March 31, 2000.

Identity moved the trial court to dismiss the complaint and to order Frounfelker to arbitrate his claim as mandated by the Asset Purchase Agreement. Despite Tennessee's strong presumption in favor of arbitration of disputes, the trial court denied Identity's motion. The appellate court affirmed under a *de novo* review (contract interpretation is a matter of law).

The appellate court applied Tennessee law in interpreting the contracts, stating that the key principle was to ascertain the intention of the parties and give effect to that intention. The appellate court held that the arbitration clause found in the Asset Purchase agreement failed to reach the parties' dispute in this case. The appellate court noted that the hiring date itself, derived from the Asset Purchase Agreement, was not in dispute, but that the dispute at hand was whether Identity had terminated Frounfelker's employment prematurely in violation of the Employment Agreement. The appellate court focused on the factual underpinnings of the claim holding that it was clear that the parties intended for disputes arising out of the Employment Agreement to be decided in a judicial forum.

It is well established that parties cannot be forced to arbitrate claims that they did not agree to arbitrate. A state's presumption in favor of arbitration will not supercede a part's right to judicial remedies. Contracting arbitration and judicial remedy clauses carefully is paramount to obtaining the appropriate forum desired for dispute resolution.

PROFESSIONAL RESPONSIBILITY

In-house counsel may bring retaliatory discharge suit when termination results from compliance with public policy provisions of the Code of Professional Responsibility. *Crews v. Buckman Labs. Int'l, Inc.*, 78 S.W.3d 852 (Tenn. 2002).

By Ennica Street

Deciding an issue of first impression, the Tennessee Supreme Court held that attorneys who are employed by a corporation may sue under the common law for retaliatory discharge resulting from the attorneys' compliance with ethical obligations that are rooted in public policy. Additionally, the Tennessee Supreme Court added a provision to Tennessee Disciplinary Rule 4-101(c) that allows in-house counsel to reveal client information when the lawyer believes the information is necessary to the lawyer's claim or defense in a dispute between the attorney and client, who is also the corporation.

The plaintiff, Julia Beth Crews, worked for Buckman Laboratories International, Inc., as associate general counsel. She learned that Buckman's General Counsel, Katherine Davis, did not have a Tennessee license to practice law. Buckman Laboratories attempted to correct the defect internally, but after Ms. Davis failed to fulfill the requirements necessary for a Tennessee license, the plaintiff

reported her for the unauthorized practice of law to the Tennessee Board of Law Examiners. Subsequently, Ms. Davis caused the plaintiff considerable difficulty in performing her job. The plaintiff filed suit, claiming “constructive termination” after her computer was taken and she was forced to take personal leave.

The Tennessee Court of Appeals held that the plaintiff had not stated a claim upon which relief could be granted, reasoning that a claim by in-house counsel of retaliatory discharge was unnecessary and potentially damaging to the attorney-client relationship. The Tennessee Supreme Court, however, recognized that competing interests exist between the ethical obligations of the attorney under the Code of Professional Responsibility and the “benefits and responsibilities” provided by the corporation to its employees. Lawyers often choose between compliance with the ethical rules and loyalty to the corporation that employs them. As a result, the corporation should not be allowed to penalize the lawyer for complying with his ethical obligations.

This case highlights the importance of a lawyer’s ethical obligations in the practice of her profession. The Tennessee Supreme Court validated a lawyer’s right to sue his corporate employer for termination resulting from actions taken pursuant to professional ethical obligations.

PROPERTY

Grantor must bind heirs and assigns of grantees for covenants to run with land. *Tennsco Corp. v. Attea*, No. M2001-01378-COA-R3-CV, 2002 Tenn. App. Lexis 423, No. 27393 2002 WL 1298808 (Tenn. Ct. App. June 13, 2002).

By Newman Bankston

Applying Tennessee law, the Tennessee Court of Appeals analyzed the validity of property restrictions, at law and in equity, by analyzing the intention of the covenanting parties as manifested in the covenants which they administered. The court held that “real covenants” at law do not run with the land unless the covenant specifically binds the heirs and assigns of the grantees. Furthermore, “equitable servitudes” or “reciprocal negative easements” in equity do not run with the land unless the grantor creates a development plan or sales brochure for the property which benefits all the restricted property.

Mr. and Mrs. Daughtery conveyed property on the north and south sides of their historic home in Williamson County, Tennessee to Mr. Wills. The conveyance stipulated that “any building constructed on the land shall be a single family dwelling

of traditional design at least 4,000 square feet in size and on lots of one (1) acre or greater in size.” Mr. Wills subsequently quit-claimed the property to the Mallory Park, L.P., subject “to all restrictions, easements, and encumbrances or (sic) record.” Mallory Park, L.P. then conveyed the property to Tennsco Corporation by warranty deed. Contemporaneously, the Daughtery’s conveyed their home and their remaining property unrestricted to the Butters, who subsequently conveyed the home and property unrestricted to Mr. Attea. Tennsco Corporation brought suit against Mr. Attea to clear its clouded title.

Both the trial court and the court of appeals awarded summary judgment to Tennsco Corporation holding that a covenant does not run with the land unless: (1) the covenant touches and concerns the land; (2) the original covenanting parties intended for the covenant to run with the land; and (3) a privity of estate exists at law or the successor of interest had “notice” of the covenant in equity. At law and in equity, the covenants did not pass the second requirement of this established test. At law, the covenants did not specifically bind the heirs and assigns of the grantees. Furthermore, in equity, the grantor did not have a general plan or scheme of development evidenced by a map or sales brochure, or the intention that the restrictive covenants benefit all the property involved.

This decision explores the requirements for covenants to run with land conveyed by private parties. For a covenant to run with the land at law, the covenant must specifically bind the heirs and assigns of the grantees. In the same way, in equity, the grantor must appear to have had in mind a general plan or scheme of development and intended that the covenant benefit all the property involved.

Benefiting from confidential relationship with grantor creates presumption of undue influence. *Watson v. Ashley*, No. M2001-00668-COA-R3-CV, 2002 Tenn. App. LEXIS 422 (Tenn. Ct. App. 2002).

By Jimmy Summerlin

In *Watson v. Ashley*, the Tennessee Court of Appeals affirmed a decision by the Circuit Court of Franklin County setting aside a deed acquired by persons in a confidential relationship with a grantor of limited education and cognitive ability.

In *Watson*, the plaintiff, Charles Watson, was a tenant-in-common with his brother, Clyde, and mother in an eighty-five acre farm in Franklin County. The plaintiff’s mother dies in 1987 and devised her interest in the farm to her two sons in

equal shares. Subsequently, in 1993, Charles, who functions mentally at a six year old level and cannot read, was asked by his sister, Margaret, and Clyde to accompany them to an attorney's office to execute "some papers related to their mother's estate." In fact, the siblings had Charles execute a deed conveying his interest in the property to Clyde and a will devising two-thirds of his property to his brother. If Clyde should predecease Charles, the will provided that Clyde's share would pass to Margaret's children. At the same meeting, Charles also executed an unrestricted power of attorney naming Margaret as attorney-in-fact.

Clyde died in 1999 leaving a will devising a life estate in the farm to his wife and a vast majority of the remainder interest to two of Margaret's children. Charles then brought this action to set aside the deed alleging that it "was procured by fraud, by undue influence, or by trick, relying on his limited education and comprehension." The Court of Appeals agreed with the trial court's findings that both Margaret and Clyde were in confidential relationships with Charles, that each had profited from the conveyance, and that the presumption of undue influence was not overcome by the evidence presented.

Under Tennessee law, a presumption of undue influence is created when a party in a confidential relationship with the grantor benefits from a transaction with the grantor. Here, the court found that Margaret was in a confidential relationship because of her power as attorney-in-fact for Charles. Despite the fact that Margaret never exercised the power, she knew of the power, was present when it was executed, and testified at length about how she took care of Charles. The court also found Clyde to be in a confidential relationship with Charles based on substantial testimony that Clyde and Charles were in the farming business together and that, because of Charles' limited abilities, Clyde made all the business decisions. Given Charles' limited education and cognitive abilities, the court apparently had no problem finding that Margaret and Clyde had exercised dominion and control over Charles.

SECURITIES

Tennessee Supreme Court applies *Hawaii Market* test to define "investment contract" under the Tennessee Securities Act of 1980. *King v. Pope*, 91 S.W.3d 314 (Tenn. 2002).

By Ryan Malone

To better define the term "investment contract," as used in the definition of "security" in the Tennessee Securities Act of 1980, the Supreme Court of Tennessee

chose to utilize the *Hawaii Market* test, a definitional test used in many states to identify an investment contract. This test's four factors can be construed liberally, thus allowing the courts to use Tennessee's "Blue Sky" laws to protect the public against schemes that may circumvent the *Howey-Forman* test, which is typically used to identify an investment contract for purposes of the federal securities law definition of a security.

John King, a licensed securities agent, was enlisted by Quarter Call, Inc. ("QCI") to market a pay telephone sale-leaseback program. QCI agreed to sell phones to interested participants, and the participants would then lease the phones back to QCI. According to the promotional materials used by King and QCI, the participants would receive a fixed eighteen percent annual return. Under the agreement, any losses incurred by QCI or revenues generated by the phones would not be shared with participants, nor would the participants be responsible for any expenses related to the phones. The lease agreement could be terminated with sixty-days notice and upon payment of a termination fee. Only 100 early terminations would be accepted by QCI during each sixty-day period.

Not long after King began working with QCI, the Commissioner of the Department of Commerce and Insurance issued a cease and desist order. The basis of the order was that King and QCI were selling unregistered securities. King denied that the sale-leaseback arrangements were securities and requested a hearing before an administrative law judge. The judge applied the *Hawaii Market* test that was used by the Tennessee Court of Criminal Appeals in *State v. Brewer*, 921 S.W.2d 1 (Tenn. Crim. App. 1996), and found that the QCI program was an "investment contract," therefore, a security. The Supreme Court of Tennessee ultimately agreed with the administrative law judge's finding.

According to the Tennessee Supreme Court, the *Hawaii Market* test can be applied liberally more easily than the *Howey-Forman* test used in federal and other state jurisdictions. To find an "investment contract," the test highlights four factors, all of which must be present:

- (1) An offeree furnishes initial value to an offeror, and (2) a portion of this initial value is subjected to the risks of the enterprise, and (3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.

As the Tennessee Supreme Court noted, a liberal application of these elements will increase the number of instances in which an “investment contract” will be found, thereby allowing a better fulfillment of the purpose of the Tennessee securities regulation: to protect investors.

While this decision demonstrates an appropriate application of the rules, the detailed rationale used by the court in choosing one test over the other is the cornerstone of the opinion. The court noted that the *Hawaii Market* is more in keeping with public policy, and is not as judicially disputed as the *Howey-Forman* test, thus allowing for more consistent interpretations. This case clearly establishes what the law in Tennessee will be. As such, the court focuses on setting a strong foundation for future issues through a clear, carefully reasoned rationale that is easily understood.

TAX

Potential future debt not allowed for use as an offset against liabilities transferred in a section 351 exchange. *Seggerman Farms, Inc. v. Comm’r*, 308 F.3d 803 (7th Cir. 2002).

By Christopher B. Fowler

The Seventh Circuit Court of Appeals affirmed the tax court below, holding “that where a taxpayer retains liability as a guarantor on debts transferred pursuant to section 351, the plain language of section 357(c)...requires that the amount by which transferred liabilities exceed[s] the taxpayer’s basis in the transferred assets must be recognized as taxable gain [regardless of the personal guaranty].”

The Commissioner of Internal Revenue informed several taxpayers (the “Seggermans”) of a deficiency based on tax liabilities incurred from transfers of property subject to liabilities, made to Seggerman Farms Inc., (“Corporation”), in exchange for stock. “The Corporation also assumed various farm-related liabilities of [each of the taxpayers].” For each of the Seggerman’s transfers, “the dollar amount of liabilities transferred to the Corporation exceeded the transferor’s adjusted basis in transferred assets.” Because they signed commercial and personal guaranties, the Seggermans were personally liable for the Corporation’s debt.

Normally, section 351 of the Internal Revenue Code (“Code”) allows this type of exchange of property for stock without recognition of gain or loss by the taxpayer. Thus, a taxpayer meeting the conditions of section 351 can *usually*

exchange property for stock, and take a basis in the stock equal to the basis of the transferred asset, so as not to realize any gain or loss on the transfer.

Citing section 351, the Seggermans did not report as income the amount by which the liabilities transferred to the Corporation exceeded the adjusted basis in the transferred assets. In other words, the Corporation took over the taxpayer's debt, which is considered income under the Code, but the Seggermans did not recognize it as such because of section 351. However, section 357(c)(1) presents an exception to the non-recognition provision of section 351 and states that where "the sum of the amount of the liabilities assumed exceeds the total of the adjusted basis of the property transferred pursuant to [a section 351] exchange," "such excess shall be considered as a gain."

Despite the clear language of the Code, the Seggermans claimed that because they remained personally liable on the Corporation's debt, there was no taxable gain, because they might in fact have to personally repay the loan amounts in the future. The Seggermans argued the precedent cited by the Tax Court was outdated, and urged that its interpretation was overly strict and mechanical, and should give way to the "emerging equitable interpretation of section 357(c)." The court disagreed. Whereas the cases cited by the Seggermans involved a loan receivable and a promissory note respectively, representing real debt requiring an economic outlay, the Seggermans themselves were at present, merely guarantors.

The *Seggerman* decision illustrates that taxpayers may not use merely potential future debts, such as personal guaranties of loans, to offset liabilities transferred to a corporation in section 351 exchanges. This decision also emphasizes the importance of paying close attention to the Code when considering incorporation. If one provision gives you a result that seems too good to be true, there is probably another provision that you are missing.

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Teaching in the Concentration of Business Transactions
In the Spring 2003 Semester*

Wendy E. Bryant
United States Department of Energy

Shannon Coleman
Gentry, Tipton, Kizer & McLemore

Mary D. Copeland
United States Department of Energy

Tracy Edmundson
DeRoyal, Inc.

Mark P. Jendrek
Mark Jendrek, P.C.

Brian K. Krumm, Esq.

Dennis Ragsdale
Long, Ragsdale & Waters, P.C.

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