

## CASE COMMENTARIES

---

### ANTITRUST

---

**Internet service providers are not liable under anti-competition statutes for controlling prices when they owe no duty to competing providers.** *Pac. Bell Tel. Co. v. Linkline Commc'ns, Inc.*, 129 S. Ct. 1109 (2009).

By Coleton Bragg

Customers throughout the United States pay an Internet service provider (“ISP”) for internet access through various mediums and at differing speeds. One method for accessing the Internet occurs via a digital subscriber line (“DSL”), where an ISP provides customers high-speed internet access over telephone lines. This method requires an ISP to own, or have access to, the needed telephone wires that make DSL internet service possible. In most locations, only one incumbent ISP actually owns the required telephone lines and infrastructure, and this poses a problem for competing ISPs. Because non-incumbent ISPs also need access to the telephone lines to provide their customers DSL internet service, the non-incumbent ISPs are forced to pay a fee to the incumbent ISPs. This industry structure allows the incumbent ISP to control both the retail price it charges its own DSL customers and a portion of the cost incurred by its competitors (the non-incumbent ISPs) in their efforts to provide DSL service to customers.

Not surprisingly, some have questioned whether this industry arrangement harms competition due to the fact that incumbent ISPs can price-squeeze their non-incumbent ISP competitors. Section 2 of the Sherman Act of 1890 makes it unlawful to “monopolize, or attempt to monopolize, or combine or conspire with any other person or persons to monopolize any part of the trade or commerce . . . .” In *Pacific Bell Telephone Co. v. Linkline Communications, Inc.*, the United States Supreme Court addressed whether the Sherman Act had been violated where an incumbent ISP had no antitrust obligation to rent its telephone lines to a non-incumbent ISP competitor, and where the incumbent ISP allegedly price-squeezed its non-incumbent ISP competitors. Ultimately, the Supreme Court held that the incumbent ISP had not violated the Sherman Act because it had no antitrust duty toward its non-incumbent ISP competitor.

Pacific Bell Telephone Company (“AT&T”) owned “much of the infrastructure and facilities needed to provide DSL service in California” and controlled the telephone lines that “connect homes and businesses to the telephone network.” As described above, to serve their customers DSL, competing ISPs had to obtain access to AT&T’s telephone lines. The plaintiff, Linkline Communications, Inc. (“Linkline”), consisted of four independent ISPs that compete with AT&T in

the retail DSL market. Linkline did not own the required telephone lines and leased the required infrastructure from AT&T to provide DSL services to customers. Thus, AT&T served as an ISP to its customers and as a gatekeeper to the infrastructure Linkline needed for its customers.

Linkline filed suit against AT&T in July 2003, alleging that AT&T violated § 2 of the Sherman Act “by monopolizing the DSL market in California.” Linkline stated in its complaint that AT&T “refused to deal with the plaintiffs [Linkline], denied the plaintiffs access to essential facilities, and engaged in a ‘price squeeze,’” thus affecting Linkline’s profit margins “by setting a high wholesale price for DSL transport and a low retail price for DSL Internet service.”

The United States Supreme Court previously had held in *Verizon Communications, Inc., v. Law Offices of Curtis V. Trinko*<sup>1</sup> “that a firm with no antitrust duty to deal with its rivals at all is under no obligation to provide those rivals with a ‘sufficient’ level of service.” Based on this ruling, AT&T moved for summary judgment, arguing that *Trinko* was applicable. The district court agreed, holding that AT&T had no antitrust duty to deal with Linkline. However, the district court denied, and the Ninth Circuit affirmed, AT&T’s motion to dismiss in regard to the price-squeeze claims because *Trinko* did not address this issue.

On appeal, the United States Supreme Court followed its reasoning in *Trinko*, holding that AT&T did not violate § 2 of the Sherman Act because AT&T had “no antitrust duty to deal with its rivals at wholesale.” The Supreme Court reasoned that AT&T did not “attempt or conspire to monopolize” the DSL Market when comparing the facts of the case before it to the situation in *Trinko*. Similar to AT&T’s business model, in *Trinko* Verizon Communications, Inc. (“Verizon”) leased portions of its network to competing firms at wholesale rates.

The AT&T court noted that Verizon’s competitors then alleged in their complaint that Verizon’s “insufficient assistance” violated the Sherman Act “by impeding the ability of independent carriers to compete in the downstream market for local telephone service.” The Supreme Court held in that decision that the Sherman Act had not been violated because Verizon had no antitrust duty to deal with its competitors at the wholesale level, and therefore had no duty to deal with them under terms and conditions that the rivals find commercially advantageous.

*Trinko* does not specifically address Linkline’s price-squeeze claim; however, the Supreme Court reasoned that this was a moot point in the current case because AT&T owed Linkline no antitrust duty, and because Linkline did not provide evidential support for a predatory-price claim. Linkline’s price-squeeze claim would require that AT&T keep the prices it charged its DSL customers too low. Linkline

---

<sup>1</sup> 540 U.S. 398 (2004).

would have to show that AT&T's prices were set at a rate below Linkline's costs, and that AT&T would be able "to recoup its 'investment' in below-cost prices." Linkline's complaint did not show that either of those requirements had been met.

The Supreme Court's decision to reverse the Court of Appeals and hold AT&T innocent of violating § 2 of the Sherman Act reflects the high hurdles that must be met for a party to be found monopolizing an industry. The Sherman Act protects competition, and the courts, when analyzing both this case and prior precedent, are slow to make decisions that might have the opposite effect. Although it appears that the ISP industry structure gives an unfair advantage to the incumbent ISPs because they can affect their non-incumbent ISP competitors' profit margins, the courts want to ensure that a duty exists under the Sherman Act before imposing additional restraints on competition.

In addition, because the Sherman Act provides a high hurdle, sufficient evidence needs to be provided to succeed on a predatory-pricing claim. Future petitioners need to make sure they can prove that the rates incumbents charge are set below their own costs when the incumbent is returning profits. Therefore, it is imperative for transactional attorneys to determine whether a duty exists when advising clients on issues involving the Sherman Act.

---

#### BUSINESS ASSOCIATIONS

---

**In order to breach the fiduciary duty of loyalty during a sale of a corporation, directors must demonstrate bad faith in failing to fulfill their duty to maximize the sale price for shareholders.** *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235 (Del. 2009).

By Kristopher Frye

When shareholders bring a class-action lawsuit against a corporation and its directors, alleging they failed to exercise good faith in the sale of the company, the outcome is determined by measuring the conduct of the directors against well-settled legal principles of what constitutes bad faith. In the absence of bad faith, which is defined as a knowing disregard of fiduciary duties, the shareholders cannot prevail simply by alleging that the directors failed to take every possible step to achieve a higher sale price. The Delaware Supreme Court was confronted with this issue in *Lyondell Chemical Co. v. Ryan* and held that during the sale of a corporation, Delaware corporate directors must demonstrate bad faith in failing to fulfill their sole duty under *Revlon*<sup>2</sup> – to maximize the sale price for shareholders – in order to breach

---

<sup>2</sup> *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

the fiduciary duty of loyalty.

In *Lyondell*, shareholders brought suit alleging that the directors of Lyondell Chemical Company (“Lyondell”) failed to act in good faith while effecting a sale of the company to Basell AF (“Basell”). Prior to the sale of Lyondell to Basell, Lyondell was the third-largest publicly traded chemical company in North America. During the summer of 2006, Basell offered to purchase Lyondell for a price a \$26.50-28.50 per share. The Lyondell board rejected this offer as too low. Over the next year, Lyondell continued to prosper, but no other companies expressed interest in purchasing it. Then, in May 2007 Basell filed a Schedule 13D (“Schedule”) with the Securities and Exchange Commission disclosing its right to acquire an 8.3-percent block of Lyondell stock. According to the Lyondell board, this filing signaled to the market that Lyondell was “in play,” and in response the board called a special meeting. At the meeting, the board decided the company would adopt a “wait and see” approach, rather than actively solicit offers for a sale.

On July 9, 2007, Basell’s owner, Leonard Blatvanik (“Blatvanik”), met with Lyondell’s Chairman and CEO, Dan Smith (“Smith”), to discuss an all-cash deal at \$40 per share. Smith suggested that the offer was too low, and Blatvanik responded with an offer of \$44-45 per share. Smith still did not believe this offer was high enough to win the support of the Lyondell board, but nonetheless offered to present it to them. Smith spoke to Blatvanik again later that day, and Blatvanik raised the offer to \$48 per share on the condition that Lyondell pay a \$400 million break-up fee and complete the sale by July 16, 2007.

The next day, Smith called a meeting of the board to consider Basell’s offer. The meeting concluded in less than an hour with the board requesting a written offer from Basell with more details about Basell’s financing. Blatvanik agreed to the request, but demanded that Lyondell give Basell until July 11 to make a higher offer for Huntsman Corporation (“Huntsman”), another company Basell had offered to purchase. At Lyondell’s board meeting on July 11, the board weighed Basell’s offer and then authorized Smith to negotiate with Blatvanik. That same day, Basell announced it was no longer pursuing the merger with Huntsman and from July 12-15, the parties negotiated the terms of a merger agreement.

Smith was instructed to negotiate for a higher sale price, a provision that would allow Lyondell to shop for better offers, and a reduced break-up fee. Smith, however, only succeeded on reducing the break-up fee from \$400 down to \$385 million. On July 16, the deadline for completing the merger, the board met to consider the agreement. After weighing financial projections that suggested the offer price was fair, and considering the lack of any other offers at the time, the board voted to approve the merger and recommend it to the shareholders. At a special shareholders’ meeting on November 20, 2007, the merger was approved by more than 99 percent of the voted shares.

The issue here is whether the Lyondell board breached its fiduciary duty of loyalty by failing to act in good faith. In this interlocutory appeal, the Delaware Supreme Court reviewed *de novo* the trial court's decision to deny Lyondell summary judgment. The Court examined the history of its good-faith jurisprudence and concluded that the *Stone v. Ritter*<sup>3</sup> test was controlling. In *Stone*, the Delaware Supreme Court held that "imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations."<sup>4</sup>

The trial court denied summary judgment on the basis that it needed a more complete record before deciding on this issue. The Supreme Court, however, reversed the decision of the trial court, based on three critical errors in its analysis. First, the trial court imposed *Revlon* duties on the Lyondell directors after the filing of the Schedule, but before they decided to sell or before the sale had become inevitable. Second, the trial court mistakenly read *Revlon* as creating a specific set of requirements, such as conducting a market check or auction, before a sale can proceed. Third, the trial court erred when it equated an imperfect attempt by Lyondell to fulfill its *Revlon* duties with bad faith, as defined in *Stone*.

According to *Revlon*, the only duty is to "get the best price for the stockholders at a sale of the company."<sup>5</sup> The trial court erroneously focused on the time between the Schedule filing in May 2007 and the week of July 10, 2007, when Basell's merger offer was formalized. Admittedly, the directors did very little to effectuate a sale of the company during this period, but that does not necessarily constitute bad faith. According to the court, *Revlon* duties did not arise with the filing of the Schedule. Following the board meeting on July 10 when the merger was proposed, however, *Revlon* imposed a duty on the directors to maximize the sale price of the company.

The record showed that the directors met several times and attempted to negotiate better terms for the deal. The Court held that even on the limited record, there was sufficient evidence to show that the Lyondell directors did not knowingly disregard their fiduciary duties under *Revlon*, and thus were entitled to summary judgment. The Court noted that if the standard was due care rather than bad faith, the outcome may have been different. Under a due care standard, the shareholders would need only to show that the Lyondell directors failed to do everything they could to achieve a higher sale price. The controlling standard, however, is bad faith, which requires the directors to knowingly and completely fail to do all they could.

The holding in *Lyondell* is notable because the repercussions of a contrary

---

<sup>3</sup> *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

<sup>4</sup> *Id.* at 370.

<sup>5</sup>*Id.* at 182.

holding would be severe and far-reaching. It appears that the directors of Lyondell were presented with an exceptional offer. Plaintiff shareholders sought to invalidate what could be characterized as a “blowout” sale price, on the basis that for two months before the offer was tendered, the board did not actively solicit offers or conduct an auction or market check for the potential sale of the company during the week the merger negotiations were underway. Fortunately for the directors, the Court refused to impose such an inflexible and unreasonable burden.

Given the inherent difficulty in proving the intentional element of bad faith, transactional attorneys should feel confident in advising their corporate clients that they have satisfied their fiduciary duties when they have achieved the best possible sale price for the company and have not acted in a way that represents a purposeful disregard for one’s fiduciary duties. Of course, securing the best possible sale price does require due diligence and an adherence to the directors’ fiduciary duties. So while a court may be willing to accept something better than “utter failure” on the part of directors, shareholders may not be so forgiving. Therefore, it is advisable to provide shareholders with evidence that the board did work to achieve the best price.

**Vicarious responsibility is imputed to each partner in a joint venture, which may release third parties from obligations to an individual partner.** *Phelps v. Bank of America*, No. M2007-02135-COA-R3-CV, 2009 Tenn. App. LEXIS 260, 2009 WL 690695 (Tenn. Ct. App. Mar. 13, 2009).

By Stephen Quinn

A joint venture is a limited-purpose partnership where at least two people combine resources to pursue a common purpose and share profits, each with an equal right of control. As a type of partnership, unless otherwise provided, third-party dealings with a partner acting on behalf of the joint venture are treated as interactions with an agent of the joint venture, effectively binding the other partner. In *Phelps v. Bank of America*, the Tennessee Court of Appeals held that an agreement between a contractor and construction financier was a joint venture; therefore, a bank’s loan disbursement to the contractor on behalf of the property owner was a payment to the joint venture, relinquishing it from any claims against it by the financier.

A Nashville property owner, Joseph Angus sought to construct a duplex on his property but lacked financing. Angus solicited Bank of America for a construction loan. The bank declined to finance the construction, but informed Angus that it would provide a loan once improvements on the property were made and an appraisal was performed. Angus hired William Church, owner of C&C Construction, to construct the building. Church enlisted a former business partner, Wade Lee Phelps, to finance the duplex construction. Angus and Church signed a construction contract, which included a financing addendum signed by the Angus,

Church, and Phelps. Separately, Phelps entered into an agreement with Church to construct the duplex building. This agreement described the arrangement between Phelps and Church as a “joint venture,” where both parties would evenly share in any profits realized at closing.

Following construction and appraisal, the bank, Angus, and Church attended the loan closing. At the closing proceedings, the bank disbursed Angus’s loan to Church for the construction costs. Church, however, retained the construction payment for himself and withheld payment to Phelps. Subsequently, Phelps sued the bank for negligence and breach of contract in releasing the loan payment to Church. The trial court granted summary judgment to the bank, finding that the agreement between Phelps and Church was a joint venture. Therefore, the bank’s payment to Church constituted a payment to the joint venture, precluding Phelps from asserting claims against the bank based on its alleged failure to pay him.

On appeal, Phelps asserted that the trial court erred in concluding that its finding of a joint venture released the bank from an obligation to pay him the loan proceeds. Phelps principally relied on statements made in a conversation with a bank employee assuring him that he would be paid at closing. Phelps also suggested that the different responsibilities between Church and himself – construction and financing, respectively – prevented a finding of equal control, which is a necessary element in establishing a joint venture.

The Tennessee Court of Appeals affirmed the decision of the trial court, dismissing the claims against the bank. The Court upheld the trial court’s finding of a joint venture between Phelps and Church. The finding of a joint venture, coupled with the absence of privity of contract between the bank and Phelps, effectively negated the duty element necessary to support Phelps’s negligence claim.

In finding a joint venture, the Court relied on the evidence of a signed agreement between Phelps and Church, which specifically described their common-purpose business arrangement in the construction project as a “joint venture,” and included an equal profit sharing provision. The Court found Phelps’s evidence of a division in the work responsibilities (construction and financing) to actually support a finding of a joint venture because it indicated “that each had an equal right to control the venture, [and] exercised that control for the benefit of the enterprise and agreed to the division of responsibilities.” The Court also dismissed Phelps’s attempt to rely on alleged oral promises by a bank employee because the Tennessee Statute of Frauds specifically prevents a party from taking action against a lender or creditor in the absence of a signed writing.

The Court then explained that a joint venture functions as a type of partnership. Section 61-31-301(1) of the Tennessee Code provides that “[e]ach partner is an agent of the partnership for the purposes of its business.” The statute continues: “[a]n act of a partner, [acting within the scope of the partnership], binds

the partnership.” Therefore, the bank’s payment to Church, and his receipt of the funds, represented a payment to the joint venture. As a result, the Court concluded that Phelps failed to show why the bank would be liable for Church’s subsequent failure to pay him and affirmed summary judgment for the bank.

The Tennessee Court of Appeal’s decision in *Phelps v. Bank of America* serves as a reminder of the potentially damaging implications of the vicarious responsibility that accompanies a joint venture business arrangement. A partner to a joint venture is fully bound by the actions of the other partner in dealing with third parties unless the third party receives notice that the partner lacks the authority to act on behalf of the joint venture. The decision also emphasizes the importance of converting oral assurances into signed writings, particularly in dealing with a lender or creditor. Attorneys that represent partners in joint ventures should advise their clients of the vicarious responsibility risks that accompany joint ventures and encourage such clients to carve out express provisions for dealing with third parties on behalf of the joint venture.

**Where a partnership agreement requires all partners to consent to a contribution as a capital contribution before it is considered a capital contribution, evidence of the other partners’ consent must be present to receive such treatment.** *Braden v. Strong*, No. M2008-00216-COA-R3-CV, 2009 Tenn. App. LEXIS 54, 2009 WL 276737 (Tenn. Ct. App. Feb. 3, 2009).

By Joe Watson

There are times when an owner, partner, or shareholder provides capital to a business in the form of cash or property. If these contributions are treated as capital contributions, the contributor’s interest in the business increases. In a partnership setting, this interest represents the share of the business that each partner owns, and the capital accounts track the amount of contributions by and distributions to the partners. To receive capital contribution treatment, many partnership agreements require all partners to agree that the contribution is a capital contribution, and that the respective interests of the partners will change.

In *Braden v. Strong*, the Tennessee Court of Appeals addressed the issue of when a partner makes a contribution without expressly receiving consent from other partners that it is a capital contribution, and that partner argues that implied consent was given. The court held that where a partnership agreement requires consent that a contribution will be treated as a capital contribution, evidence of the other partners’ consent must be present before capital account adjustments are made.

In *Braden*, Paul Braden (“Braden”) and Nancy Strong (“Strong”) were partners in the Landscaping Concepts Partnership (“LCP”). The partnership agreement stipulated that any money contributed by either partner that was

consented to as a capital contribution would be credited to the partner's respective capital account. At some point during the partnership, Braden contributed an unspecified amount of money to the partnership. The partners never discussed whether the money would be treated as a capital contribution, and thus did not address whether the capital accounts or percentages of ownership would be altered. In addition, the capital accounts, as evidenced by federal tax returns, remained unchanged in 2005 after Braden had filed an action seeking capital account adjustments. When Braden later moved to dissolve the partnership, the circumstances were ripe for disagreement concerning the respective interests in LCP.

Braden initially filed suit seeking to dissolve the partnership, but also sought an accounting to determine the proper interests of the partners. The trial court ruled in favor of Braden and awarded him an increase in his capital account. On first appeal, the Tennessee Court of Appeals reversed and remanded the ruling to determine whether Strong consented to capital contributions by Braden, as required by the terms of the partnership agreement. On remand, the trial court acknowledged that Strong did not give express consent to Braden's capital contributions, but held that she provided implied consent. Because of this implied consent finding, the court increased Braden's capital accounts by \$261,361.84. Following this holding, Strong filed a second appeal.

Strong presented several issues in the second appeal: (1) whether the trial court erred in awarding Braden capital account adjustments; (2) whether the court should have allowed expanded accounting of other accounts and entities; (3) whether Braden breached his fiduciary duty and the partnership agreement; and (4) whether Strong should have been required to pay 51% of the accounting costs. However, for all of the issues other than the capital accounts adjustment, the Tennessee Court of Appeals simply deferred to the trial court's discretion without providing any substantial analysis. Thus, the only issue addressed was the capital contributions matter and whether Strong consented to such contributions.

According to the court, the capital accounts issue depended upon the determination of whether Strong consented to the capital contributions by Braden. In the first appeal, the court decided the legal contractual interpretation issue by holding that the partnership agreement allowed for capital account adjustments and shifts in the percentages of ownership, only if the partners consented to capital contributions. *Braden v. Strong*, No. M2004-02369-COA-R3-CV, 2006 Tenn. App. LEXIS 104, at \*32, 33, 2006 WL 369274, at \*12 (Tenn. Ct. App. Feb. 16, 2006). Hence, the issue facing the court in the second appeal was a factual one: whether Strong consented to Braden's infusion of cash as a capital contribution.

This time, the court reversed the trial court and held that Strong did not impliedly consent to capital contributions by Braden. Both the trial court and appellate court agreed that Strong and Braden never discussed capital contributions,

and thus, there was no express consent. The court, however, rejected the trial court's reasoning that a partner's contribution automatically results in implied consent from the other partners that it will be treated as a capital contribution. The court pointed specifically to two factors in concluding that Strong offered no implied consent. First, the partners never talked with each other or their accountant about changes in the capital accounts or percentages of ownership; and secondly, the partnership's tax returns did not reflect any change in capital accounts or ownership shares, even after Braden had filed a claim for capital account adjustments.

According to the court, "[t]he mere infusion of cash into a business should [not] be deemed a capital contribution." The court would not go along with the trial court's argument that the contribution had to come from some source and instead, reasoned that the money could have been treated as a loan, rather than a capital contribution. Consequently, the court reversed the trial court's capital credit award and Braden's accompanying account adjustment.

The court's decision in *Braden v. Strong* gives some teeth to clauses in transactional agreements that require consent before money given by a partner will be deemed a capital contribution. For a contributing partner, this opinion illustrates that to enjoy capital account credit, garnering some form of consent from the other partners is an absolute; simply paying money to the business is not enough. Conversely, if another partner contributes money to the business, the other partners should not have to worry about their respective ownership interests being affected without their consent.

In these situations, transactional attorneys should advise their clients that contributions must be consented to as capital contributions by the other partners before such contributions will affect capital accounts and ownership percentages. Ideally, partners making contributions to a partnership should obtain express written consent to ensure that their capital accounts are accordingly adjusted. Apart from advising clients about this consent requirement regarding capital contributions, transactional attorneys should also be aware that these same principles could apply to their own practice and the structure of their law firm.

---

#### CIVIL PROCEDURE

---

**Motions to dismiss on the pleadings are increasingly difficult to obtain absent an undisputed and clear factual record.** *Ind. State Dist. Council of Laborers v. Brukardt*, No. M2007-00271-COA-R3-CV, 2009 Tenn. App. LEXIS 269, 2009 WL 426237(Tenn. Ct. App. Feb. 19, 2009).

By Merrill Nelson

To satisfy the liberal pleading requirements under Tennessee law in a civil

complaint, a plaintiff merely needs to assert a short and plain statement showing the claimant is entitled to relief. When addressing a motion to dismiss for failure to state a claim, Tennessee courts view the factual allegations within a complaint as true, without considering the legal probabilities associated with the ultimate success of a claim. In *Indiana State District Council of Laborers v. Brukardt*, the Tennessee Court of Appeals addressed the inherent fallacy in dismissing a complaint on the pleadings without first developing a full factual record of the allegations, holding that the alleged facts were sufficient to allow the case to proceed.

In May 2005, Renal Care Group, Inc. (“Renal Care”) announced a merger with Fresenius Medical Care AG (“Fresenius”). Shortly thereafter, stockholders of Renal Care (“Plaintiffs”) filed a shareholder class action complaint against Gary Brukardt, President and CEO of Renal Care, and other board members (collectively, “Defendants”), alleging breach of fiduciary duty and self-dealing. Specifically, Plaintiffs alleged that the merger was sought by Defendants for an improper and misleading purpose, breaching their fiduciary duties of loyalty, due care, and good faith, and that their actions resulted in detrimental consequences to the Plaintiffs.

Upon receipt of the complaint, Defendants removed the case to federal court. The merger progressed, however, and the stockholders ratified, leading to the closing of the merger in March 2006. After the case was returned to state court, Plaintiffs filed an amended complaint on September 13, 2006. The amended complaint detailed the alleged improper actions of Defendants in seeking and procuring the merger with Fresenius. Several developments in late 2004 allegedly moved the Defendants to seek a merger. First, in October, the Department of Justice subpoenaed Renal Care in connection with a Medicare fraud investigation.

Second, in November, the Securities and Exchange Commission launched an investigation into the stock option practices of various companies. This investigation concerned the Defendants because the company had allegedly engaged in the highly improper practice of backdating stock options for directors on multiple occasions. The Plaintiffs alleged that this information only became available in a May 2006 *Wall Street Journal* article exposing the Defendants’ improper conduct. Third, in December, the DOJ confirmed that a business partner of the Defendants had agreed to pay a large settlement resulting from allegations of fraud against government health care programs.

In the wake of these developments, the complaint alleged that the Defendants had sought a merger to secure stronger indemnity protections against shareholder and government litigation. Furthermore, Defendants quickly identified Fresenius as the designated merger partner and allegedly ignored potential conflicts of interests related to both the merger and the two separate investment advisors to the Defendants in the deal. Finally, Plaintiffs charged that the Definitive Proxy Statement concerning the Acquisition (“Proxy”) filed with the SEC on July 21, 2005

for the company's shareholders' use in making a fully informed vote on the merger failed to disclose material information about the deal for the purpose of protecting each Defendant's personal liability.

The Defendants moved to dismiss the amended complaint on December 22, 2006. The trial court granted the motion on August 30, 2007, orally holding that the record, which included the complaint, the Proxy, newspaper articles, and press releases, showed that the Defendants had sufficient independence in their negotiations. The record also showed that there was no method that could have assessed a potential value to backdated stock options or Medicare fraud issues, because they had not yet matured at the time of the merger.

Reviewing the dismissal *de novo*, the Tennessee Court of Appeals reversed the trial court, holding that the complaint alleged sufficient facts to move forward with the lawsuit. The court found both procedural and substantive deficiencies with the trial court's decision. With limited exceptions, any evidentiary materials outside of the pleadings should not be considered on a dismissal motion for failing to state a claim. While the Court of Appeals determined that the proxy was permissible, the trial court's use of external press materials was erroneous because the materials were neither under judicial notice nor otherwise admissible to consider the truth of the claims. Consequently, this error "was of some import in the erroneous granting of the motion to dismiss."

The court outlined three separate examples of why the dismissal of the complaint was a misapplication of current law. A dismissal motion under Tennessee Rule of Civil Procedure 12.02(6) for failure to state a claim challenges the legal sufficiency of a complaint. It should only be granted when a plaintiff can show no set of facts that would entitle them to relief. Applying this principle, the court first examined the allegation of improper deal protection measures. While deal protection agreements are often proper in corporate mergers, under the controlling Delaware law corporate boards are not given complete discretion as to their validity if they are derogatory to shareholders. Courts must take on a fact-intensive inquiry to examine whether deal protection measures were properly undertaken. The Court emphasized the trial court's failure to engage in such an inquiry.

Next, the Court addressed the validity of dismissing allegations because they had not matured at the time of the transaction in question. Under Delaware law, a corporate board has the fiduciary duty to disclose all material facts under its knowledge that would significantly impact a broad stockholder vote. The applicable standard for a material fact is one that a reasonable shareholder would find important in a voting analysis. Emphasizing the seriousness of claims alleging backdated stock options and Medicare fraud, as well as the potential criminal and civil consequences, the Court of Appeals determined that the Plaintiffs' alleged facts concerning these activities precluded a finding that the failure to disclose

information about potential investigations into these activities was not material to Renal Care stockholders.

The final issue addressed was whether the case was barred by the affirmative defense of shareholder ratification. A Rule 12.02(6) motion to dismiss based on an affirmative defense is rarely sustainable because affirmative defenses often rely on factual findings that fall outside the pleadings. While affirmative defense dismissals are appropriate for issues of law on the face of a complaint, when an affirmative defense is raised on a factual issue such as shareholder ratification, Tennessee courts have consistently ruled against granting a motion to dismiss for failure to state a claim.

Here, the Court of Appeals concluded that the detailed factual allegations presented by the Plaintiffs were sufficiently unresolved to prevent an affirmative defense at this stage. Analyzing Renal Care's Certificate of Incorporation, specifically where it adopted § 102(b)(7) of the Delaware General Corporation Law, which provides a shelter for corporate board members under certain conditions, the Court held there were significant allegations concerning the conduct of the Defendants which precluded them from being protected under the statute. The Court rejected the Defendants' contention that the merger was essentially an extension of their previous coverage. Fresenius, a third-party indemnifier, was not bound by previous restrictions and extended liability coverage to the Defendants to cover breaches of good faith. This distinction both expanded the coverage available to rogue directors and erased the potential recovery actions for directors who did not receive the benefit of backdated stock options. In summation, the Court held that the trial court's determination that the Plaintiffs did not "demonstrate" any allegations of breach of fiduciary duty was an "unfortunate" description, because the language indicated obligations on the pleader that were outside the scope of the pleadings.

In practice, corporate litigators should interpret the holding in *Indiana State District Council of Laborers v. Brukardt* as a clear indication, given the minimal requirements and wide discretion afforded a plaintiff during the pleadings, that a motion to dismiss for failure to state a claim is pertinent only in cases with a clear factual record. Because corporate lawsuits typically involve transactional situations with a factual discrepancy, future successful motions to dismiss on the pleadings will be rare. A more effective action by a litigator seeking an early dismissal may be to go ahead and move for summary judgment, which permits a court to examine the merits of the case.

---

#### CONSUMER PROTECTION

---

**A drug manufacturer is bound not only by FDA regulations, but also by state**

**imposed duties of care.** *Wyeth v. Levine*, 129 S. Ct. 1187 (2009).

By Kirby Waddell

There is a question of whether compliance with FDA regulations means pharmaceutical manufacturers are protected from legal liability when injuries result from use of their drug. Where a consumer brings a state tort claim against a manufacturer for inadequate warning on drug labels, it invokes the manufacturer's state-law duty, while the manufacturer still remains subject to the duties imposed by federal regulations. Courts must consider how to resolve that issue and such was the conflict addressed in *Wyeth v. Levine*. The Court concluded that it is possible for a drug manufacturer to strengthen a drug label in compliance with both state and federal law, and that a state failure-to-warn action creates no obstacle to the accomplishment of Congress' purpose in entrusting the FDA with the responsibility of regulating drugs on the market.

Drug manufacturers are required to comply with federally instituted regulations and receive approval from the Food and Drug Administration (the "FDA") before introducing any new drug into the market. State tort law provides that drug manufacturers have a duty to warn of any risks associated with a drug. But, simultaneously, the FDA is in place to regulate the safety of drugs on the market, including approval and regulation of the labels that appear on each drug. Although the enactment of the federal Food, Drug, and Cosmetic Act ("FDCA") in the 1930s was intended to address safety concerns related to the distribution of drugs and other products, injuries still occur. When they do, state tort actions are available to protect consumers.

In *Wyeth v. Levine*, Diana Levine ("Levine") lost her forearm due to treatment she received for a severe migraine headache and nausea at a local clinic. The physician's assistant addressed Levine's ailments for a second time in one day by administering Phenergan – Wyeth's brand name antihistamine used to treat nausea – intravenously using the IV-push method, which involves the drug being injected directly into a patient's vein. Following administration, the drug entered Levine's artery, causing gangrene and resulting in the amputation of her forearm. When Levine's injury occurred, Phenergan had an FDA approved label warning of the dangers of gangrene and amputation if the drug were inadvertently injected into an artery. The warning was there because manufacturers have been required by the FDA since 1962 to show that a drug is safe for use "under the conditions prescribed, recommended, or suggested in the proposed labeling before it could distribute the drug."

Levine brought a state law failure-to-warn action against Wyeth in a Vermont trial court, alleging that Wyeth failed to provide adequate warning regarding the significant risks imposed by administering Phenergan using the IV-push method. Specifically, Levine argued that Phenergan's label failed to instruct clinicians to use

the IV-drip, rather than IV-push, method of intravenous administration because it carried less risk of gangrene and loss of limb. She further alleged that the IV-push method was not reasonably safe considering that the foreseeable risk of developing gangrene outweighed the benefits of the drug.

The trial court entered judgment for Levine on the jury verdict that Wyeth had in fact failed to provide adequate warning of the risks associated with the IV-push administration of Phenergan. The court declined to accept Wyeth's argument that Levine's failure-to-warn claim was preempted by federal law since Phenergan's labeling had been approved by the FDA. The trial court awarded Levine damages for pain and suffering, medical expenses, and loss of her livelihood as a professional musician, and held that federal law did not preempt Levine's claim. Wyeth appealed, but the Vermont Supreme Court affirmed the judgment. The United States Supreme Court granted certiorari.

Before the Supreme Court, Wyeth raised two issues involving the preemption of federal law. The first was whether Levine's state law claims were preempted due to impossibility for Wyeth to comply with both the state law duties to provide stronger warning and the federal labeling duties imposed by the FDA. Wyeth contended it could not have changed the label to comply with state law duties while operating in accordance with the FDA regulations because the FDA requires approval of the exact text of a drug label. The majority presented evidence, contrary to Wyeth's contention, of an FDA "Changes Being Effected" ("CBE") regulation, which allows a manufacturer to make some labeling changes without receiving the FDA's approval if the change is to "add or strengthen a contraindication, warning, precaution, or adverse reaction." The majority also indicated that "[t]hrough many amendments to the FDCA and to FDA regulations, it has remained a central premise of federal drug regulation that the manufacturer bears responsibility for the content of its label at all times." Although the FDA has the ability to reject any changes to the labeling, Wyeth offered no evidence that the FDA would have rejected those changes. Therefore, the Court held it was possible for Wyeth to strengthen Phenergan's label in compliance with both state and federal law.

Also at issue was whether Levine's state law claims presented an obstacle to the accomplishment of Congress' purpose and objective for "entrusting an expert agency with drug labeling decisions." Supporting its contention, Wyeth presented the preamble to a 2006 FDA regulation which stated that "FDA approval of labeling . . . preempts conflicting or contrary State law." The preamble continued, saying state law claims "threaten [the] FDA's . . . role as the expert Federal agency responsible for . . . regulating drugs." The majority discredited Wyeth's assertion by noting that Congress did not authorize the FDA to preempt state law directly. Therefore, the Court must determine the amount of weight to afford the FDA's opinion in its preamble.

Although the Court recognized that an agency has “an ability to make informed determinations about how state requirements may pose ‘an obstacle to the objectives of Congress,’” agencies lack authority to declare preemption absent a delegation by Congress. The Court emphasized that the 2006 preamble failed to explain its reasoning and contradicts other evidence of Congress’ purpose. The Court stipulated that “the weight we accord the agency’s explanation of state law’s impact on the federal scheme depends on its thoroughness, consistency, and persuasiveness,” and ultimately determined that the FDA’s 2006 preamble merits no deference.

Wyeth also cited the 2000 *Geier v. American Honda Motor Co.*<sup>6</sup> case, where the Supreme Court held that state tort claims for failure to install airbags in a Honda conflicted with a federal Department of Transportation regulation stipulating that airbags were not required for all cars. The Court distinguished *Geier* from the present case, however, because it afforded no weight to the 2006 preamble and lacks further evidence that Congress regarded state tort litigation as an obstacle to achieving its purposes. Accordingly, the Court affirmed the judgment of the Vermont Supreme Court in a split decision.

Justice Breyer offered a separate opinion, concurring only in the judgment, in which he criticized the majority’s discussion of implied preemption based on the interpretation of Congress’ purposes and objectives. He stated that “[t]he majority, while reaching the right conclusion in this case, demonstrates once again how application of ‘purposes and objectives’ pre-emption requires inquiry into matters beyond the scope of proper judicial review.” Justice Breyer discussed the Supremacy Clause and noted that federal law may only preempt state law if the statutory text of the federal law so stipulates. He stated that “our federal system in general, and the Supremacy Clause in particular, accords pre-emptive effect to only those policies that are actually authorized by and effectuated through the statutory text.”

Justice Alito, joined by two others, dissented in the opinion and proclaimed that state tort law is “squarely preempted” by federal law in this case. The dissent’s key criticism of the majority’s finding was that a jury should not be able to find IV-push administration unsafe and the warning label inadequate, when the FDA had determined otherwise.

As *Wyeth v. Levine* demonstrates, there are vastly conflicting views on the appropriate course of action when state and federal law overlaps. What both the majority and concurring opinions in *Wyeth* illustrate is that state-law duties often exist alongside federal regulations to ensure full consumer protection and ensure the constitutional balance between state and federal law. The implications of the

---

<sup>6</sup> 529 U.S. 861 (2000).

Supreme Court's decision in both the majority opinion and the strong concurring opinion may reach further than the majority anticipated, making it very difficult for a state law claim to be preempted by federal law, and thus subjecting manufacturers to vast amounts of liability for their products. Where a manufacturer is subject to duties imposed by both state and federal law, a transactional attorney should advise his or her client not to consider obligations complete by merely following the standards of federal regulations; rather, a manufacturer must frequently consider all risks and update labels and information given to the FDA.

---

### CONTRACTS

---

**A party to a contract may not avoid his or her duty to act in good faith by failing to provide the other party with a term essential for the completion of the contract.** *German v. Ford*, No. W2007-02768-COA-R3-CV, 2009 Tenn. App. LEXIS 94, 2009 WL 604951 (Tenn. Ct. App. Mar. 10, 2009).

By Justin Faith

Although courts will not enforce an agreement that is missing an essential term, one party cannot terminate an agreement after hindering the other party's performance by failing to provide a basic term of that agreement. Where two parties have executed a sufficiently definite document that appears to be a contract based on the parties' intentions, the court favors finding a binding agreement rather than a preliminary negotiation, even if the document lacks agreement on non-essential matters. This is especially true when the drafting party of the agreement seeks to use language to avoid operation of the agreement. Once a contract is established, there is a duty of good faith and fair dealing, which includes the implied condition that one party will not prevent the performance of the other party.

In *German v. Ford*, the Tennessee Court of Appeals addressed whether an alleged contract involving an agreement between an investor and sub-investor that lacked express language requiring the investor to provide the sub-investor with the necessary information to perform was enforceable. Additionally, the court addressed whether the investor breached the covenant of good faith and fair dealing by failing to provide the sub-investor with required information necessary to perform. The court held that when a sub-investor enters into an agreement to finance an investor through posting a letter of credit, the investor has an implied duty to cooperate in the sub-investor's performance of its contractual obligation.

In *German*, Dyer Investment Company, LLC ("Dyer") agreed to provide the \$12.5-million financing to meet the minimum ticket sale requirement for a prize fight. Dyer would earn a profit if ticket sales exceeded the minimum requirement, and it would lose money if ticket sales were below the minimum requirement. Dyer

received backup financing from sub-investors, including William Lents (“Lents”), whereby the sub-investors would profit if ticket sales were above the minimum or pay the difference of their proportional investment if ticket sales were below the minimum. Dyer drafted an Investment Participation Agreement (“IPA”) that constituted the agreement between Dyer and the sub-investors. Lents agreed to guarantee \$2 million in order to receive a 10-percent return of profits on the assumed risk of ticket sales. Under the Agreement, Lents was required to post a letter of credit to insure his interest in Dyer’s profits or losses.

The IPA contained both a “time-is-of-the-essence” clause and representations and warranties that the agreement was legal and binding against both parties based on its terms. It did not, however, contain a deadline for Lents to post Dyer’s letter of credit. To reduce Dyer’s risk of loss, Dyer continued soliciting other sub-investors who signed IPAs, all while ticket sales for the fight continued to increase. Although Lents appeared prepared to issue the letter of credit while ticket sales were ongoing, Dyer never provided Lents with the basic information necessary to issue the letter of credit. Eventually, ticket sales reached the minimum requirement and Dyer, facing no risk of loss, informed Lents that the agreement was terminated. Dyer refused to pay Lents any percentage of the profits made because Lents never posted a letter of credit. Lents then sued Dyer for his proportional amount invested, alleging breach of contract and breach of the covenant of good faith and fair dealing. Dyer argued there was no enforceable contract by the terms of the IPA. Specifically, Dyer claimed that nothing in the IPA expressly required Dyer to provide Lents with the letter of credit information, and thus there was no legal obligation to pay any sub-investor that did not issue a letter of credit.

The trial court granted Dyer’s motion for summary judgment, finding there was no enforceable contract because Dyer retained the right to final approval of the letter of credit. The trial court essentially found the IPA to be a preliminary negotiation that was unenforceable until Lents delivered the letter of credit. Finding no breach of contract, the court also held there was no actionable claim for breach of good faith and fair dealing because there was no underlying contract.

On appeal, however, the Tennessee Court of Appeals found that the IPA between Dyer and Lents was an enforceable contract and that Dyer had a duty of good faith and fair dealing to not hinder Lents’s performance. The Court held that the IPA was more than just a preliminary agreement, as evidenced by three basic contract principles: (1) lack of agreement on minor matters does not preclude the finding of a contract; (2) the court presumes a document executed by both parties is interpreted to impose obligations on both parties; and (3) doubtful language is construed against the drafter of the agreement, especially when the drafting party attempts to use the language to defeat the agreement. A court will not enforce a contract that is too indefinite or lacks essential terms, but will consider the surrounding circumstances and conduct of the parties to determine if an agreement

was intended to be enforceable by the parties. The IPA was very clear and detailed, stating that “[u]pon the execution of this Agreement, [Lents] shall post an irrevocable standby letter of credit” from a financial institution acceptable by Dyer. Thus, this language created a binding obligation on Lents to post a letter of credit in the specified amount.

Although the IPA did not include a deadline for the letter of credit to be posted, the language and the express “time-is-of-the-essence” clause inferred that the obligation was immediate. The IPA language and surrounding circumstances show that Lents had a mandatory obligation to post Dyer’s letter of credit, guaranteeing financing for the specified amount soon after the parties signed the IPA. Lents repeatedly requested the necessary information from Dyer, and Lents appeared willing to post the letter of credit at any time. Dyer, however, neglected to perform its obligations under the IPA.

The Court held that Dyer could not assert it had no contractual obligation to approve or deny the letter of credit merely because the IPA gave Dyer sole discretion of approval. Dyer was under an obligation of good faith, in an objectively reasonable manner, to exercise its discretion in the approval or denial of Lents’ proposed letter of credit. But, Dyer made no attempt to determine if Lents’ proffered letter of credit was satisfactory. Although nothing in the IPA required Dyer to provide Lents with the necessary terms of the letter of credit by any particular time, the court found an implied or constructive condition in the IPA which required Dyer to cooperate in good faith with Lents’ performance by providing him with the necessary information to post the letter of credit in a reasonable time.

The Court reasoned that the facts of the case provided an example where an implied condition is “necessary to meet the ends of justice.” First, the specific language and detail of the IPA show a clear intent to have a binding contract with obligations on both parties. Second, Dyer was required to cooperate, rather than hinder, Lents’ ability to perform posting the letter of credit. Here, Dyer’s obligation to provide Lents an interest in the agreement was based on Lents posting of a letter of credit. The letter of credit could not be posted without Dyer’s cooperation, specifically through providing Lents with the basic information needed for the letter of credit. Dyer’s failure to cooperate in providing Lents with the requisite information constituted a breach of the implied duty to cooperate with Lents, which is a breach of the covenant of good faith and fair dealing. Without the requirement of cooperation, Dyer could shift all of the risk to sub-investors while avoiding any payment of potential profit. The Court found that Dyer would be unjustly enriched if it interpreted the agreement to guarantee a safety net of sub-investors without any risk of loss.

The Court’s decision to find an enforceable contract and imply a condition

requiring Dyer to cooperate with Lents' performance serves as a warning to any party that attempts to contract away risk through the performance of the other party, but hinders that performance through the omission of a necessary term. First, Tennessee courts will imply non-express terms of an agreement when the surrounding circumstances show the parties intended to have a binding contract. More importantly, Tennessee courts will also require parties in a contract to act in good faith by not hindering performance of the other party. In a contract where performance by one party is necessary to earn the compensation provided in an agreement and the performance cannot be completed without minimal cooperation by the other party, it is likely that Tennessee courts will find such cooperation to be an implied condition of the agreement. Transactional attorneys in Tennessee should advise clients that if they have a pending agreement that could be interpreted as a contract, they then have a duty of good faith not to hinder performance of the agreement's terms.

**A trial court's factual findings for a promissory fraud claim that involve issues of determining credibility and weighing oral testimony are accorded substantial deference by a reviewing court.** *Styles v. Blackwood*, No. E2007-00416-COA-R3-CV, 2008 Tenn. App. LEXIS 775, 2008 WL 5396804 (Tenn. Ct. App. Dec. 29, 2008).

By Robert Ingram

Promissory fraud is a tort creating liability for a party who enters into a contract without the intent to perform. It differs from fraud or misrepresentation by also requiring false representation of future conduct. To successfully plead a promissory fraud claim, Tennessee case law requires a plaintiff to prove specific elements. Additionally, the plaintiff must prove these elements with clear and convincing evidence when seeking to rescind or reform a written instrument.

In *Styles v. Blackwood*, the Tennessee Court of Appeals addressed the amount of deference to give a trial court's finding when determining whether a defendant in a promissory fraud claim ever intended to perform a future obligation. It also addressed how a trial court may make that determination. The Court ultimately held that a trial court's factual findings for a promissory fraud claim involving issues of determining credibility and weighing oral testimony should receive "substantial deference" from a reviewing court.

In 1998, Nancy Styles and her mother, Alba Hughes, met Ron and Shelley Blackwood (the "Blackwoods") through a mutual acquaintance. Mr. Blackwood was the leader of a singing group in Pigeon Forge called the Blackwood Quartet, and his wife was the sole proprietor of Universal Management, which represented the group. Hughes was an elderly woman who became interested in investing her money in the Blackwood Quartet because she wanted her children to own a part of Pigeon Forge.

The Blackwoods' interest in the agreement stemmed from wishing to acquire a venue in Pigeon Forge to have regular performances. Hughes and the Blackwoods signed a document memorializing an agreement, and Styles signed it as a witness. Within the document, Hughes agreed to invest \$75,000 in Universal Management to "obtain" and "secure" a theater for the Blackwood Quartet. In exchange, Universal Management agreed to pay Hughes net profits from the theater venture, as well as interest payments on a graduated schedule.

The Blackwoods then entered into another agreement with a theater owner in Pigeon Forge to perform regularly at his establishment for nine months. The Blackwood Quartet performed there until the owner closed the venue three years later. During this time, the Blackwoods started doing business as Blackwood Management, Inc., and did not distribute any profits or make any interest payments to Hughes. The Blackwoods sent letters to Hughes in 1999 and 2002 reassuring her of the investment, but they never paid Hughes anything that was stipulated in the agreement. Hughes died in 2002, and Styles alleged that Hughes's estate orally assigned the interest in the agreement to her. Nevertheless, the Blackwoods claimed that none of the original investment remained because they had spent it all on advertising for the performances. This led Styles to believe that the Blackwoods had never intended to perform their part of the bargain.

In 2004, Styles brought an action against the Blackwoods and both business entities for fraud in inducing an agreement and promissory fraud. Specifically, Styles claimed that the Blackwoods told Hughes that the investment money was for purchasing a theater, but they actually never intended to purchase one or pay Hughes a part of the profits or interest. During the bench trial, the Blackwoods made a motion to dismiss for lack of standing and asserted that the executor of Hughes's estate never used the term "assign" and thus never transferred the interest. But, the Blackwoods failed to provide any authority to support their motion. Therefore, the trial court denied the motion to dismiss. In addition, the Blackwoods objected to the parol evidence Styles attempted to admit during her testimony, which the court sustained. The court, however, ruled in Styles's favor by finding that the Blackwoods were "unbelievable," and that they never intended to perform the future obligations when they made representations to Hughes.

On appeal, the Tennessee Court of Appeals affirmed the trial court's judgment by holding that Styles had standing, and held that a reviewing court must give "substantial deference" to a trial court's fact finding in a promissory fraud claim when it involves determining credibility and weighing oral testimony. Under Tennessee Rule of Appellate Procedure 13(d), a non-jury trial receives *de novo* review on appeal, and factual findings are presumed correct unless a preponderance of the evidence contradicts them. Thus, the Court held that Styles had standing because a preponderance of the evidence showed Hughes's estate orally assigned the interest to her. Since the Blackwoods did not offer any authority at trial to support their motion

to dismiss, the Court declined to pursue the issue on review.

Next, the Court addressed the degree of deference that a reviewing court must give a trial court's fact finding in a promissory fraud claim when it involves oral testimony. The elements of promissory fraud in Tennessee are: "(1) a promise of future conduct; (2) that was material; (3) made with the intent not to perform; (4) that the plaintiff reasonably relied upon (5) to plaintiff's injury." Naturally, the intent element is the most difficult for the fact finder. In general, Tennessee case law grants considerable deference to a trial court's credibility determinations and weighing of oral testimony. Thus, the court held that a trial court's fact finding is accorded "substantial deference" in a promissory fraud case when it involves both determining credibility and weighing oral testimony.

The court balanced the parties' testimony, the trial court's observations of the witnesses' demeanor, and the Blackwoods' failure to perform any of their obligations under the agreement, and determined that Styles had met her burden for showing promissory fraud. Since failure to perform is insufficient alone to show fraudulent intent, the trial court's observations based on the parties' testimony were the significant factor for the Court. Therefore, the Court concluded that the trial court did not err considering the "totality of the circumstances."

The Court then addressed the question of whether parol evidence is admissible in a promissory fraud action involving a written agreement. According to Tennessee case law, the parol evidence rule is not applicable in cases involving fraud in inducement to execute a contract. Therefore, the Court held that the fraud-in-inducement rule applied to promissory fraud, and concluded that the trial court erred when it sustained the Blackwoods' parol evidence objections to Styles's testimony. The Court determined that Styles was still able to show that the Blackwoods misrepresented the nature of the investment to Hughes, despite the restricted testimony.

Finally, the Court rejected the Blackwoods' argument that Mrs. Blackwood, as the sole proprietor of Universal Management, was the only party liable for the judgment in Styles's favor. Because Styles's claim sought judgment under tort theories, both Blackwoods and their business entities were liable for promissory fraud despite Mrs. Blackwood doing business as Universal Management and being the only party contractually obligated to perform. The Court affirmed the trial court's finding that Mr. Blackwood played a significant role in perpetrating the promissory fraud against Hughes. The Court determined from the record that Mr. Blackwood had admitted to being involved in and responsible for the business operations of both companies. Since Mr. Blackwood participated in the misrepresentation and drafting of the agreement, the Court concluded that "principles of equity and fairness" supported the trial court's decision to hold Mr. Blackwood and Blackwood Management, Inc. liable for promissory fraud.

The Tennessee Court of Appeals' decision to affirm the trial court's judgment in *Styles v. Blackwood* serves as a warning for transactional attorneys who fail to capture the parties' intentions in the terms of a written agreement. When a written agreement fails to elaborate these intentions and one party believes that the other did not intend to perform because of their failure, the contract drafter has exposed the latter party to liability under a promissory fraud claim. Furthermore, the case provides a tactic for plaintiffs to escape the parol evidence rule, which allows further *post hoc* interpretation of the written terms and thus more exposure to liability. In this case, defined or more specific terms would have shown that there was at least an attempt to perform.

Additionally, this case shows that transactional attorneys should counsel their clients to make good-faith attempts to perform future obligations. Failure even to attempt to perform a future obligation provides the basis for a promissory fraud claim that, again, allows a trial court to admit parol evidence despite the existence of a written document. Finally, this case demonstrates that promissory fraud as a tort and the court's loose posture towards standing creates rights, obligations, and liability for parties who are not signatories to a contract. Transactional attorneys should limit these risks through additional terms in the written agreement.

**A party cannot avoid contractual obligations because of a misnomer when the party clearly knew with whom it was conducting business.** *Realty Ctr. New Homes Div., LLC v. Dowlen Constr., LLC*, No. E2008-00137-COA-R3-CV, 2008 Tenn. App. LEXIS 782, 2008 WL 5423997, (Tenn. Ct. App. Dec. 30, 2008).

By T. Jessica Manning

In *Realty Center New Homes Division, LLC v. Dowlen Construction, LLC*, the Tennessee Court of Appeals addressed the use of misnomers in contracts when the real identity is clearly known by the contracting parties. The Court also looked at the effect of the Tennessee Real Estate Broker License Act of 1973 on contracts where the name of a party is incorrect, ultimately concluding that when one party attempts to avoid its obligations under a contract because the other party used the wrong name in the contract, the contract is valid if there is evidence that the complaining party knew the identity of the other party.

The facts of the case state that plaintiff ("Realty Center") and defendant ("Dowlen") entered into a two-year contract in May 2005 allowing Realty Center to sell townhouses Dowlen was building in two Hamilton County subdivisions. The agreement stated that the contract could be cancelled by either party at any time upon 90 days notice. Realty Center signed the contract as "Realty Center/GMAC New Homes Division, LLC," although it was licensed as a real estate broker under the name "Realty Center New Homes Division, LLC." The agreement was subsequently terminated by Dowlen, who later refused to pay commissions due to

Realty Center under the terms of the contract.

Realty Center filed a complaint seeking commissions for all sales contracts existing at the time of the agreement, as well as all contracts signed after the 90-day notice of termination. Dowlen's answer raised several defenses, including that the named plaintiff was not a party to the contract. Dowlen also filed a counterclaim against Realty Center, alleging that because Realty Center signed the contract in a name that varied from its license name, Realty Center was unlicensed, which is a violation of the Tennessee Real Estate Broker License Act of 1973 ("Act"). Dowlen also asked for compensation from the harm caused to it because Realty Center used the trade name "GMAC" without permission.

The trial court granted partial summary judgment in favor of Realty Center, and held that (1) at all times under the claims Realty Center was a licensed real estate broker; (2) that Realty Center did not violate the Act; and (3) that Dowlen did not have standing to challenge the use of "GMAC" by Realty Center. The trial court also found that Realty Center had properly supported its motion for summary judgment by presenting evidence sufficient to shift the burden of proof to Dowlen to show that summary judgment should not be granted concerning whether Realty Center had the authority to use the name "GMAC." After a bench trial and a modification of the judgment, Realty Center was awarded commissions, interest, and discretionary amounts.

Dowlen filed an appeal against the trial court's grant of partial summary judgment. It challenged the court's dismissal of its defenses under the Act, the dismissal of its counterclaim, and the grant of commissions to Realty Center. Dowlen presented four arguments on appeal, first arguing that Realty Center's complaint failed to state a claim upon which relief could be granted because the contracts referred to in the complaint were between Dowlen and a different entity, "Realty Center/GMAC New Homes Division, LLC." Second, Dowlen argued that the contracts were made and signed by "Realty Center/GMAC New Homes Division, LLC," and that no such entity was licensed as a real estate broker in Tennessee at the time the sales occurred; thus the action was barred by Tennessee law. Third, Dowlen claimed Realty Center violated Tennessee criminal law because the contracts were not signed by a licensed broker, meaning the contracts were unenforceable as a matter of law. Last, Dowlen sought to avoid paying commissions to Realty Center and attempted to recover commissions already paid because Realty Center was unlicensed and used the "GMAC" trade name without permission, resulting in damages to Dowlen.

Dowlen's first claim stated that Realty Center contracted with it using the trade name "GMAC" without authorization. The Court of Appeals agreed with the trial court, finding that it was not Dowlen's place to bring a claim for unauthorized trademark usage. Additionally, Dowlen did not offer any evidence supporting its

claim that it had suffered damage as a result of Realty Center's use of the name "GMAC" in the contracts. Therefore, Dowlen lacked the requisite standing to bring such a claim.

Dowlen next argued that the trial court erred in dismissing its affirmative defenses and counterclaim and asserted that they should be allowed because Realty Center was not a licensed real estate broker. The Court, however, relied on a Tennessee Supreme Court decision in finding that the misnomer itself did not render the contract invalid or inoperative. While the name on the contract between Dowlen and Realty Center was not identical to the name on Realty Center's license, it was clear that Dowlen understood with whom it was contracting. The Court went on to say that Dowlen did not rely on Realty Center's licensure under the contract or at any other time. In fact, it noted that Dowlen never expressed concern to Realty Center that it was a different entity than the one stated in the contract.

The Court pointed out that the law in Tennessee regarding misnomers has long been established, and that Realty Center submitted enough proof that it was the entity with which Dowlen had contracted. Further, the Court found that Dowlen admitted Realty Center had adequately performed its duties under the contract, and that Realty Center did not intentionally misrepresent itself. The Court also noted that Dowlen at all times was fully aware that Realty Center was a party to the contract. It went on to say that Dowlen could not escape its contractual obligations on the premise that the party was licensed in a name slightly varied from the name on the contract.

The Court further explained that business names consist of several different words, making them easy to transpose or confuse. The Court believed that Dowlen was trying to avoid liability by ignoring the rule that has been the law in Tennessee for over 100 years. Although Dowlen argued that "Realty Center/GMAC New Homes Division, LLC" was an unlicensed entity, the Court stated that the entity existed only as a misnomer and therefore was neither licensed nor unlicensed. It construed the Act to allow Realty Center to obtain real estate in that name if it chose to do so, but doing so was not a requirement. The Court also found that the Act was not established to require a business to be licensed in the same name under which it contracts.

The Tennessee Court of Appeals' decision to uphold the contract between Realty Center and Dowlen is based on settled Tennessee law. A party to a contract cannot abandon its obligations because of a simple misnomer when it clearly knew who it was doing business with, nor can a party attempt to avoid contractual duties by construing the law to require all real estate firms to be licensed under the same name in which they contract. While the law in Tennessee is not significantly changed by this decision, Tennessee attorneys should advise their clients to contract under their license name, or disclose to the other party that they are using a different name

to avoid the potential pitfalls of litigation. Attorneys should also advise their clients that a contracting party may use a misnomer, but that doing so will not relieve any obligations under the contract.

---

## INSURANCE

---

**If a life insurance policy owner defaults on his or her premium payments and the premiums are payable in monthly or more frequent intervals, the company is not required to notify the policy owner of a lapse in his or her coverage.**

*Waldschmidt v. Reassure Am. Life Ins. Co.*, 271 S.W.3d 173 (Tenn. 2008).

By Andrew Sumner

The issue presented in *Waldschmidt v. Reassure America Life Insurance Co.* was whether certain exemptions apply to insurance companies when they fail to provide statutorily required information to the life insurance policy owner, thus allowing the insurer to refuse payment on the policy. Although § 56-7-2303 of the Tennessee Code provides specific guidelines for insurance companies to follow when life insurance policy owners fail to make premium payments, determining when and to what extent insurance companies should follow these guidelines and under what circumstances certain statutory exemptions apply can be difficult.

These concerns are especially significant when a policy owner voluntarily elects to divide his or her yearly premium payments into monthly installments, defaults on a monthly premium payment, and dies within six months of the default. Here, the Tennessee Supreme Court looked at the frequency of the policy owner's premium payments and determined that because the payments were monthly, the insurance company was exempted from providing notice of default.

In *Waldschmidt*, Robert H. Waldschmidt, as trustee of Robert W. McLean's bankruptcy estate, placed a hold on each of McLean's bank accounts. Included in this hold was an account that provided monthly payments for McLean's yearly life insurance premium. As a result, McLean's life insurance company – Reassure America Life Insurance Company (“Reassure”) – was unable to withdraw the premium payment that was due on August 5, 2007 from McLean's bank account. On August 10, 2007, Reassure sent a letter to McLean informing him of its inability to withdraw funds from the bank account and warned him that failure to pay the premium would result in a lapse in coverage. McLean informed Waldschmidt of the notification and Waldschmidt promptly changed the mailing address associated with the insurance policy from McLean's address to his own. On September 5, 2007, Reassure sent an additional notification informing Waldschmidt that, because Reassure had not received McLean's August premium payment, McLean's life insurance policy had “lapsed without value.” McLean died 20 days later on

September 25, 2007, and Reassure refused to disburse the \$1,000,000 due under McLean's life insurance policy.

Waldschmidt subsequently filed an adversary complaint in bankruptcy court against Reassure, contending that McLean's life insurance coverage had not lapsed before McLean's death. Waldschmidt asserted that Reassure violated § 56-7-2303(a) of the Tennessee Code because Reassure failed to provide sufficient notice of McLean's default in payment before Reassure declared McLean's coverage lapsed. Conversely, Reassure maintained that because McLean had chosen to make monthly payments on his yearly life insurance premiums, § 56-7-2303(d) did not require Reassure to provide the notice necessitated by § 56-7-2303(a).

Because the Tennessee Supreme Court had never interpreted § 56-7-2303, the bankruptcy court entered an order on May 22, 2008 deferring two certified questions of law for the Supreme Court. The first issue concerned whether § 56-7-2303(d) excluded Reassure from the statutory notice requirement listed under § 56-7-2303(a) because McLean elected to pay his yearly insurance premiums in monthly installments, or whether § 56-7-2303(a) required Reassure to provide McLean with sufficient notice of McLean's default in payment and lapse in coverage.

Under § 56-7-2303(a), insurance companies are required to provide defaulting policy owners with specific information within six months of a default in payment before declaring the policy owner's life insurance coverage lapsed. This required information includes the amount of the policy owner's premium, the amount due on the policy, and the contact information of the person or company to which the amount is payable. The notice must also indicate that a failure to pay the premium will result in a lapse in coverage of the policy. On the other hand, § 56-7-2303(d) is treated as an exemption, and provides that insurance companies are not required to satisfy the notice requirement when the policy owner's premiums are payable on "monthly or at more frequent intervals." A life insurance premium is payable monthly "if it must or may be paid on a monthly basis."

The plain meaning of these statutes infers that the type of life insurance *premium* (yearly or monthly) is inconsequential; instead, the applicability of the § 56-7-2303(d) exemption depends on the frequency of each premium *payment*. "[I]f [the premium payment] must or may be paid on a monthly basis," § 56-7-2303(d) controls and the notice requirement listed under § 56-7-2303(a) is waived. While many life insurance policies (including McLean's) provide policy owners with yearly premiums, the fact that a policy owner willfully elects to make monthly payments on an annual premium does not defeat the § 56-7-2303(d) exemption.

Consequently, the court held that although a defaulting policy owner may choose to voluntarily pay monthly installments on his or her annual life insurance premiums, when such a situation arises, the premium payments remain payable on "monthly or at more frequent intervals." As a result, the court held that § 56-7-

2303(d) exempts the insurance company from having to provide proper notice of the policy owner's default in payment and lapse in coverage.

The second issue certified for the court was conditioned on the court's adjudication of the first certified question. The second issue concerned the sufficiency of the "default in payment" notice that Reassure provided McLean and Waldschmidt. If the court had found that § 56-7-2303(a) required Reassure to provide McLean with notice of forfeiture, the court would have been forced to determine whether Reassure satisfied each element of the notice requirement, as specified by § 56-7-2303(a). The court would have also had to establish whether McLean's life insurance policy lapsed before his death. However, because the court found that § 56-7-2303(d) exempted Reassure from providing McLean with the "default in payment" notification, the court held that it was unnecessary to make a determination on this second certified question.

As *Waldschmidt v. Reassure America Life Insurance Co.* demonstrates, something as seemingly insignificant as the frequency of premium payments can have a profound impact on the capacity of life insurance policy beneficiaries to recover proceeds after a default in payment occurs. Likewise, the frequency of such payments also influences the specific procedures that life insurance companies must follow when a policy owner fails to provide payment on his or her premium. When such a situation arises, attorneys that represent insurance companies and potential life insurance policy owners should be aware of the distinct requirements and exemptions under § 56-7-2303 and take appropriate steps to protect the interests of their respective clients. By failing to take these measures, a policy owner's life insurance coverage could unexpectedly lapse, causing the beneficiary to fail to receive the potentially sizeable payouts that he or she may have anticipated.

---

## LABOR & EMPLOYMENT

---

**Collective bargaining agreements that require union members to arbitrate specific statutory claims are enforceable.** *14 Penn Plaza LLC v. Pyett*, 129 S. Ct. 1456 (2009).

By Byron Pugh

Employers and labor unions can negotiate a collective bargaining agreement ("CBA") that requires union members to submit their grievances into an arbitration process. The United States Supreme Court established boundaries and created protections in *Alexander v. Gardner-Denver Co.*, 415 U.S. 36 (1974), and *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20 (1991), that seek to prevent employees from losing their right to bring discrimination and other statutory claims before a court of

law. Nevertheless, confusion remained as to whether a CBA can waive an individual employee's right to judicial redress. In *14 Penn Plaza LLC v. Pyett*, the United States Supreme Court held that when a CBA "clearly and unmistakably" mandates arbitration of specific statutory claims, it is "enforceable as a matter of federal law."

Steve Pyett ("Pyett") and his co-workers worked in the building-services industry and were members of the Service Employees International Union ("SEIU"). According to the National Labor Relations Act of 1935 ("NLRA"), the SEIU is the "exclusive bargaining representative" of the building-services employees in New York City. For over 70 years, the SEIU and the Realty Advisory Board of Labor Relations, Inc. ("RABLR") have engaged in industry-wide collective bargaining. The CBA between the two entities required union employees to file "all claims of employment discrimination to binding arbitration." The CBA states:

§ 30 NO DISCRIMINATION. There shall be no discrimination against any present or future employee by reason of race, creed, color, age, disability, national origin, sex, union membership, or any other characteristic protected by law, including, but not limited to, claims made pursuant to Title VII of the Civil Rights Act, the Americans with Disabilities Act, the Age Discrimination in Employment Act, . . . . *All such claims shall be subject to the grievance and arbitration procedures . . . as the sole and exclusive remedy for violations . . . .*<sup>7</sup>

As a member of RABLR, 14 Penn Plaza LLC ("Penn") owns and operates an office building in New York City where Pyett worked. Pyett was directly employed as a night lobby watchman by co-petitioner Temco Service Industries, Inc. With the approval of the SEIU, Penn hired a union friendly security contractor – Spartan Security – to staff the lobby and entrances of its building with licensed security guards. With licensed security guards, Penn no longer needed Pyett in his capacity. Pyett was thus reassigned to other jobs, which he claimed caused financial and emotional harm.

The SEIU filed grievances on behalf of Pyett, alleging that the reassignment violated the CBA provision against age discrimination. None of the claims were successful, so the SEIU requested arbitration under the CBA. Following the first hearing, the SEIU withdrew the age discrimination claims. In May 2004, during the arbitration period, Pyett filed a complaint pursuant to the Age Discrimination in Employment Act of 1967 ("ADEA") with the Equal Employment Opportunity Commission ("EEOC"). Based on the evidence, the EEOC determined that a violation did not occur, but informed Pyett of his right to sue.

Pyett filed suit against Penn in the United States District Court for the

---

<sup>7</sup> *14 Penn Plaza LLC v. Pyett*, 129 S. Ct. 1456, 1460 (2009) (emphasis added).

Southern District of New York, claiming that the reassignments violated the ADEA, as well as state and local anti-age discrimination laws. Penn responded by filing a motion to compel arbitration of Pyett's claims. The district court denied the motion, holding that "even a clear and unmistakable union-negotiated waiver of a right to litigate certain federal and state statutory claims in a judicial forum is unenforceable."<sup>8</sup>

Upon review, the Second Circuit Court of Appeals affirmed the district court's opinion in an effort to clarify the *Gardner-Denver* and *Gilmer* decisions. The Court in *Gardner-Denver* held that a CBA cannot waive a worker's right to a judicial remedy against an employer who violates statutory protections. Twenty years later, the Court in *Gilmer* ruled that an individual employee who waives his or her right to the federal courts in exchange for arbitration must arbitrate. The Second Circuit held that a CBA containing a statutory arbitration provision that attempts to waive an employee's access to a federal forum is unenforceable.

The Supreme Court granted Penn's writ of certiorari in order to resolve the circuit split. Pyett argued that the arbitration provision was unenforceable for three reasons: (1) the arbitration provision regulates an individual's "statutory right" guaranteed by the ADEA, not the contractual economic benefits of the CBA; (2) the decision in *Gilmer* precludes the waiver of an individual's "substantial right;" and (3) the *Gardner-Denver* decision places an employee's statutory antidiscrimination rights above the labor union's interests. The Court rejected each argument and turned a critical eye to the dicta regarding arbitration in *Gardner-Denver*.

The Court reversed the appellate decision, holding that a CBA which "clearly and unmistakably" requires arbitration of ADEA claims is enforceable. First, the Court reasoned that arbitration procedures and collective bargaining arrangements are favored because they involve economic tradeoffs. Similar to contract negotiations, a labor union may agree to an arbitration provision in exchange for additional concessions from the employer.

Second, the decision in *Gilmer* precludes arbitration if it was the intention of Congress to prevent a waiver of a judicial solution for the statutory claims at issue. This intent would be shown in the language of the statute or the legislative history. Nothing in the ADEA or its legislative history, however, suggests intent to preclude arbitration. Furthermore, the *Gilmer* decision did not draw a distinction between arbitration provisions approved by individual employees and those negotiated by labor unions. Without such a distinction, the *Gilmer* rule is applicable in individual agreements as well as CBAs. The Court spoke definitively on at least one requirement: arbitration provisions must be "explicitly stated" in the CBA. Finally,

---

<sup>8</sup> *Id.* at 1462-63 (citation omitted).

the holding in *Gardner-Denver* is not applicable because the decision is based on a CBA arbitration provision concerning contractual claims, rather than statutory claims.

Without relying on *Gardner-Denver*, the Court based its holding on the statutory language of the NLRA, the ADEA, and the holding in *Gilmer*. The NLRA gave the SEIU and the RABLR the exclusive power to collectively bargain regarding “conditions of employment.” The Court in past decisions considers an arbitration provision in a CBA to be a condition of employment. The final CBA in *14 Penn Plaza LLC* clearly and unmistakably precluded employees from filing discrimination claims, specifically claims brought under the ADEA, in a judicial forum. Moreover, Congress did not in any way include language in the statute that would forbid arbitration. Therefore, the arbitration provision in the CBA was enforceable.

Finally, the Court sought to remove some “skepticism” about arbitration proceedings embodied in the *Gardner-Denver* holding. The Court criticized the decision for confusing arbitration of discrimination claims with a prospective waiver of the substantial right. Arbitrating an ADEA claim does not waive an employee’s right to file a claim; rather, it limits *where* it can be filed. Furthermore, the Court rejected the notion that arbitration tribunals are somehow incapable of rendering a sound legal decision and cautioned courts not to mistake an arbitrator’s efficiency for incompetency.

Although the dissenting opinion accuses the majority of taking a cursory look at *Gardner-Denver* and ignoring *stare decisis*, the holding in *14 Penn Plaza LLC v. Pyett* provides clear guidelines for employers, labor unions, and employees. Employers and labor unions that choose to employ a statutory arbitration provision should no longer fear reprisal from the judiciary. As the Court notes, arbitration provisions provide considerable economic benefits to employers, especially in high-cost, employment discrimination litigation. The employee whose union is their exclusive collective bargaining representative, however, should proceed with caution. In light of this ruling, a transactional lawyer is strongly advised to encourage corporate clients to insist on a “clear and unmistakable” arbitration provision for statutory discrimination claims when negotiating a CBA.

**An employer cannot penalize an employee who brings forth an allegation of sexual harassment in response to questions presented during an employer’s internal investigation of sexual harassment.** *Crawford v. Metro. Gov’t of Nashville & Davidson County*, 129 S. Ct. 846 (2009).

By Will Woods

Title VII of the Civil Rights Act of 1964 contains an anti-retaliation provision that prohibits employers from penalizing employees who report

discrimination in the workplace known as the “opposition clause.” The statute also contains a provision known as the “participation clause,” which prohibits discrimination against employees who have participated in any way in an investigation undertaken by their employer. The ostensible rationale behind this policy is that employees should not be deterred from bringing legitimate causes of action against their employers due to fear of losing their jobs.

The issue addressed by the Supreme Court in *Crawford v. Metropolitan Government of Nashville & Davidson County* was whether Title VII protects an employee who does not voluntarily file a sexual harassment claim, but instead discloses such discrimination in response to questioning from an employer during an internal investigation of sexual harassment. The Court held that the protection afforded by the opposition clause under Title VII extends to an employee who brings forth an allegation of sexual harassment when answering questions during an employer’s investigation of sexual harassment complaints.

In *Crawford*, the metropolitan government of Nashville (“Metro”) conducted an internal investigation after learning of alleged instances of sexual harassment by Gene Hughes, the employee relations director of the Metro School District. Veronica Frazier, a Metro human resources officer, interviewed multiple Metro employees, including Vicky Crawford, regarding Hughes’s alleged misconduct. When asked whether she had observed Hughes engage in “inappropriate behavior,” Crawford described several incidents involving lewd gestures made by Hughes. She revealed that Hughes had pressed his crotch up against her office window on multiple occasions, and during one incident had grabbed Crawford’s head and pulled it toward his crotch.

Metro terminated Crawford’s employment soon after the investigation was concluded, citing embezzlement as the reason for her dismissal. In response, Crawford filed a charge of discrimination with the Equal Employment Opportunity Commission (“EEOC”) for violation of Title VII, alleging that Metro’s actions constituted retaliation, and thus violated both the opposition and participation clauses.

The United States District Court for the Middle District of Tennessee, however, granted summary judgment in favor of Metro, holding that Crawford’s allegations did not satisfy either the opposition or the participation clause. With regard to the opposition clause, the court held that Crawford’s responses to questions concerning Hughes’s misconduct did not constitute opposition because she had not formally filed a complaint against her employer. In addition, the court found that her claim failed under the participation clause because, pursuant to Sixth Circuit precedent, Title VII protection extended only to employees who were participating in an internal investigation that was undertaken as a result of a pending charge filed with the EEOC. Since Metro’s internal investigation was not initiated in

response to an EEOC charge, Crawford was not afforded such protection.

On appeal, the district court's ruling was affirmed based on analogous reasoning. The Court of Appeals for the Sixth Circuit maintained that because Crawford had failed to actively pursue a claim against Metro prior to her termination, she had not sufficiently opposed the sexual harassment in order to trigger protection under the opposition clause. The court also held that Crawford failed to establish any violation of the participation clause, reiterating the district court's finding that Metro's internal investigation had not stemmed from an employee complaint filed with the EEOC.

After granting Crawford's petition for certiorari, however, the Supreme Court held that Crawford's actions during the investigation were sufficient under the opposition clause to trigger Title VII protection. In an opinion written by Justice Souter, the Court concluded that Crawford's responses to the questions presented during the investigation conveyed her clear opposition to Hughes's behavior, regardless of whether she had initiated a formal complaint. The Court first noted that the specific language of the opposition clause prohibits an employer from discriminating against an employee who has "opposed any practice made an unlawful employment practice" by the statute. The Court then noted that Webster's New International Dictionary identifies the word "oppose" as denoting the phrase "to resist." It could thus reasonably be assumed that because Hughes's actions were highly inappropriate, Crawford naturally disapproved of such behavior, and therefore adequately "resisted" it. The Court further noted that according to the guidelines set forth by the EEOC, whenever an employee informs an employer that that employer has engaged in discriminatory conduct, such communication "virtually always" constitutes opposition to such activity.

Metro, in turn, attempted to convince the Court that requiring an employee to initiate a formal complaint was necessary on public policy grounds. Metro argued that if the standard for proving retaliation by an employer was lowered, employers would have less incentive to investigate discrimination in the workplace. The Court rejected this argument because it ignored the doctrine of vicarious liability. Citing previous Supreme Court decisions, the Court claimed that employers would still have a significant incentive to avoid workplace discrimination because they could still be held liable for cultivating an "actionable hostile environment." Additionally, in the event that an employee failed to formally take action against an employer, the employer would then have a viable defense to a Title VII claim as long as the employer took reasonable steps to prevent or remedy any discriminatory conduct, such as initiating an internal investigation.

Finally, the Court held that Metro's argument would promote unsound policy because it would make employees less likely to come forward with legitimate claims of discrimination. If employees could be reprimanded simply for responding to

questions from an employer, employees like Crawford would have no incentive to report discriminatory conduct. Not only would an employer be allowed to penalize employees for revealing discriminatory behavior during an internal investigation, but the employer would also likely be able to escape liability if the employee filed a Title VII suit after the investigation. In such a scenario, the employer would be able to argue that reasonable steps had been taken (i.e. the investigation) to remedy the alleged discrimination. The Court held that this placed the employee in an unreasonable position and undermined the very purpose of Title VII.

The Supreme Court's ruling in *Crawford* represents an expansion of the protection afforded to employees under Title VII. An employee who presents allegations of discrimination to an employer as part of an internal investigation is shielded from reprimand for taking such action. *Crawford* does not, however, clearly delineate the extent of such protection. For one, the Court did not address whether Metro's actions were also in violation of the participation clause. In addition, the Court remanded the case without ruling on the defenses raised by Metro apart from the limits of the opposition and participation clauses. Finally, as noted by Justice Alito in his concurring opinion, the Court did not provide a clear definition of the term "oppose" for purposes of enforcing the opposition clause. For instance, it is unclear whether conduct such as silent opposition would be given Title VII protection, since it could be argued that silent disapproval of discrimination also constitutes "resistance."

The Court in *Crawford* clearly indicates that voicing allegations of employment discrimination during an internal investigation is sufficient to trigger Title VII protection, thus enhancing an employee's incentive to report discriminatory conduct. The Court's ruling does not, however, clearly establish the scope of the protection available under the opposition clause. Specifically, the Court's decision fails to adequately define the term "oppose" under the statute. Therefore, transactional attorneys should caution their clients to refrain from reprimanding employees who disclose to the employer any instance of employment discrimination, because such communication may constitute sufficient opposition, thus triggering Title VII protection.

---

#### REAL ESTATE

---

**Lienors that provide materials for projects involving multiple building units must apportion liens between each individual unit in order to have priority against subsequent purchasers and encumbrances.** *Williamson County Ready Mix, Inc. v. Pulte Homes Tenn. Ltd. P'ship*, No. M2007-01710-COA-R3-CV, 2008 Tenn. App. LEXIS 800, 2008 WL 5234730 (Tenn. Ct. App. Dec. 15, 2008).

By Brittany Brent

In *Williamson County Ready Mix, Inc. v. Pulte Homes Tennessee Limited Partnership*, the Tennessee Court of Appeals analyzed Tennessee's materialman's lien statutes with respect to materials provided for the construction of a townhome development. The Court held that a lienholder that provides materials for the construction of multiple buildings – each containing multiple townhome units – is required to apportion the amount of its liens between each townhome in order for the liens to have priority against subsequent purchasers and encumbrances. An unapportioned lien, however, is still sufficient to perfect a lien against the original owner of the property.

Williamson County Ready Mix, Inc. (“Ready Mix”) entered into a contract with Excalibur Construction (“Excalibur”) for Ready Mix to provide Excalibur with concrete and other materials for the construction of the townhome development Creekside of Brentwood (“Creekside”). Ready Mix provided the materials on a building-by-building basis. Excalibur contracted with Pulte Homes Tennessee Limited Partnership (“Pulte”) – the owner and general contractor of Creekside – to provide concrete foundations, driveways, walkways, patios, and HVAC pads for the development. Pulte paid Excalibur according to the parties' contract, but Excalibur failed to pay Ready Mix and subsequently declared Chapter 7 bankruptcy.

In September 2006, Ready Mix served five notices of non-payment – one for each building in Creekside – on Pulte, the townhome owners, and the mortgage holders (collectively “the defendants”). At the same time, Ready Mix served five sworn notices of lien on the defendants. In December 2006, Ready Mix filed a sworn complaint against the defendants alleging claims under both the mechanic's and materialman's lien statutes, as well as a claim for unjust enrichment. Ready Mix requested an attachment against the defendants' real property, referencing the sworn complaint and claiming a debt of \$40,752.54. Ready Mix's sworn complaint originally did not include a dollar amount, and it only identified the numbers of the recorded notices of lien, but was later amended to include the amount associated with each of the five liens.

After the trial court denied the defendants' motion for partial dismissal or, in the alternative, to quash the writ of attachment, the defendants answered the complaint and moved for summary judgment. The defendants argued five grounds for dismissal of Ready Mix's materialman's lien claims, in addition to arguing that Ready Mix's unjust enrichment claim should be dismissed because Pulte made full payment to Excalibur, the entity with which it contracted. Ready Mix also moved for summary judgment. The trial court granted the defendants' summary judgment motion as to the unjust enrichment claim, but granted Ready Mix's motion for summary judgment as to the liens, concluding that Ready Mix was entitled to enforce the liens by sale of the property or Pulte's interest to compensate Ready Mix under its contract.

On appeal, the Tennessee Court of Appeals modified in part and affirmed in part, ultimately holding that a lienor who provided materials for multiple townhome units was statutorily required to apportion the amount of its liens between each townhome in order for the liens to have priority against subsequent purchasers and encumbrances.

The first issue the court considered was whether Ready Mix was required to serve the notices of non-payment on Excalibur rather than on Pulte, since Excalibur was the company with which Ready Mix contracted. The court concluded that under § 66-11-145(a) of the Tennessee Code, Ready Mix properly served the notices on Pulte, as the owner and general contractor of Creekside, rather than on Excalibur, a subcontractor.<sup>9</sup>

Secondly, the court considered the central issue of the case: whether § 66-11-118(b)(1) required Ready Mix to apportion its claims and file a separate lien on each defendant's townhome, rather than file a blanket lien that encompassed each building. Section 66-11-115(b) requires a materialman, within 90 days of expiration of the materialman's contract or completion of the building or improvement, to notify the owner of the property that a lien is being claimed. Additionally, § 66-11-112(a) states that in order to perfect a lien against subsequent purchasers or encumbrances without notice, the lienor must record the lien in the register of deeds office in the county in which the property is located. The statute does not, however, require the same recordation in order to perfect a lien against the owner of the property, as written notice is sufficient.

Finally, § 66-11-118(b)(1) governs the procedure for liens involving multiple lots or improvements. The statute provides that a lienor that furnishes materials for more than one building, condominium unit, or other improvements shall apportion its contract price between the separate buildings, units, or improvements and file a separate claim of lien for the amount demanded against each.

In analyzing the application of these statutes, the court determined that because Ready Mix provided materials for the construction of separate townhome units, § 66-11-118(b)(1) required Ready Mix to apportion its liens between each townhome unit. In doing so, the court rejected Ready Mix's argument that since it provided materials on a building-by-building basis, it could apportion its liens in the same manner. The Court accordingly held that since Ready Mix failed to apportion its liens among each townhome unit, its recordation of the unapportioned lien notices was not sufficient to provide notice to subsequent purchasers or encumbrancers, as required by § 66-11-115. Since written notice is all that is

---

<sup>9</sup> The mechanics' and materialman's lien statutes cited (Tenn. Code Ann. § 66-11-101, *et seq.*), were substantially amended by 2007 Tenn. Pub. Acts ch. 189.

statutorily required to perfect a lien against the original owner of property, however, the notice of lien served on Pulte was sufficient without apportioned recordation.

Next, the court considered whether Ready Mix's lien claims should fail because it did not obtain a separate writ of attachment for each townhome. Pulte argued that the single writ issued was overly broad, and that it should have been issued only against Pulte's remaining ownership interest in the property. Noting that the problem was one of form and not of substance, however, the court concluded that Ready Mix should be permitted to amend the writ to more accurately describe the property attached.

Finally, the court considered whether Ready Mix's failure to include in its complaint a statement of the amount of debt or demand was fatal to its claims, rendering the liens improperly enforced under § 66-11-115(c). Section 66-11-126 of the Tennessee Code requires that when a lienor had not contracted with the owner, its writ of attachment must be accompanied by (1) an affidavit setting forth the facts, describing the attached property, and making the necessary parties defendants; and (2) a warrant for the sum claimed. The court, however, determined that the complaint accompanying the writ, containing a verification signed by Ready Mix's executive vice-president and secretary making the necessary oath, was sufficient to satisfy the requirement.

Moreover, § 29-6-113 governs the proper issuance of an attachment and statutorily required Ready Mix or its agent or attorney to make an oath in writing, stating (1) the nature and amount of debt or demand; and (2) that the claim is just. The complaint accompanying Ready Mix's writ did not include the amounts claimed, and thus there was no sworn statement as to the amount of the liens. Again noting that the problem was one of form and not of substance, the court concluded that Ready Mix's amended complaint corrected the defect because it included the dollar amounts associated with each lien.

The decision in *Williamson County Ready Mix, Inc. v. Pulte Homes Tennessee Limited Partnership* clarifies that lienors who provide materials for projects involving multiple building units must apportion liens between each individual unit in order to have priority against subsequent purchasers and encumbrancers. In practice, transactional attorneys representing companies that provide materials to developments involving multiple building units should advise their clients that careful adherence to the materialman's lien statutes is imperative. Failing to properly apportion, record, or notice liens can be fatal to successfully perfecting a lien, thus preventing lien holders from recovering funds to which they are entitled by contract.

---

## TAX

---

**An agreement that does not allow a lender to require return of securities at**

**any time upon short notice reduces the lender's opportunity for gain under IRC § 1058(b)(3) and is not considered a securities lending agreement.** *Samueli v. Comm'r*, 132 T.C. 4 (2009).

By Lindy Degnan Harris

A securities lending agreement involves the transfer of securities from a lender to a borrower in exchange for collateral as security for the borrower's obligation to return the securities upon termination of the lending agreement. Neither the original transfer of securities to the borrower nor the subsequent transfer of securities back to the lender is a taxable event, so long as the agreement is properly structured under the Internal Revenue Code ("IRC"). The arrangement must not alter the lender's economic position, and it must not reduce the lender's risk of loss or opportunity for gain in the securities loaned.

In *Samueli v. Commissioner*, the Tax Court considered whether an agreement, which was documented as a securities loan but did not enable the lender to require the borrower to return the securities at any time upon short notice, reduced the lender's opportunity for gain under IRC § 1058(b)(3). The Court held that the agreement was not a securities lending agreement under the IRC, because the inability of the taxpayer to require the return of the securities on all but three days of the 450-day term reduced the taxpayer's opportunity for gain on the securities. Thus, the taxpayers were not entitled to the claimed interest deductions on the agreement because it did not exist.

In October 2001, the Samuelis purchased \$1.64 billion of agency STRIPS (the "Securities") on margin from their broker, Refco Securities, Inc. The Samuelis immediately loaned the Securities back to Refco under a fixed-term securities loan. Refco posted \$1.64 billion in cash collateral with the Samuelis, who then used the cash collateral to repay the margin loan. The Samuelis were required to pay a variable rate interest fee on the collateral in the form of a "borrow fee." They made a \$7.8-million interest payment in December 2001 and received that amount back from Refco two weeks later. Refco recorded the transaction as additional cash collateral, allowing the Samuelis to borrow an additional \$7.8 million because the Securities had increased in value.

Under the agreement, the lending arrangement would terminate on January 15, 2003. Rather than return the Securities, Refco was required to purchase the Securities on the termination date. The Samuelis also had the right to early termination of the agreement on July 1 or December 2, 2002, but did not exercise that right. On January 15, 2003, Refco purchased the securities for \$1.69 billion, the amount at which the Securities were trading at that time. The Samuelis then paid Refco \$1.68 billion, which included repayment of the \$1.64 billion cash collateral plus unpaid variable rate fees that had accrued during the term of the agreement. The Samuelis made a profit of approximately \$13 million on the transaction.

On their 2001 tax return, the Samuelis claimed an interest deduction for their portion of the \$7.8 million wired to Refco as an accrued interest payment on December 28, 2001. On their return for 2003, the Samuelis reported that they realized a \$50,661,926 gain from the transaction, which they classified as a long-term capital gain because they held the securities for longer than one year. The Samuelis also classified the \$1.68 billion that they paid as accrued cash collateral fees and deducted \$32,792,720 as interest for 2003.

The Commissioner determined that the transaction did not qualify as a securities lending arrangement under § 1058 of the IRC. Rather, the Commissioner determined that the Samuelis purchased the Securities from Refco in October 2001 and then immediately sold the Securities back. Then, pursuant to a forward contract obligation, the Samuelis repurchased the Securities and immediately resold them to Refco in January 2003 as part of a separate transaction under the same agreement.

The Commissioner therefore determined that the Samuelis realized no gain or loss on the sale in 2001 and realized a short-term capital gain of approximately \$13 million on the sale in 2003. As a result, the Samuelis could not deduct the cash collateral interest fees claimed, because no debt existed. The Commissioner thus found that the Samuelis had federal income tax deficiencies of \$2,177,532 in 2001 and \$171,026 in 2003.

The Samuelis petitioned the Tax Court, and both parties moved for summary judgment. The court ruled in favor of the Commissioner, holding that the transaction did not qualify as a securities lending arrangement under § 1058(b)(3), and that the Samuelis could not deduct interest claimed paid because the debt claimed was related to a transaction that did not exist.

Section 1058 of the IRC, which governs securities lending arrangements, generally provides that the delivery of securities to the borrower at the outset of the transaction and receipt of the securities by the lender upon termination of the transaction are not taxable events, as long as all of the requirements of that section are satisfied. The Court specifically considered § 1058(b)(3), which requires that a securities loan agreement must not reduce the lender's risk of loss or opportunity for gain in the securities loaned. Because the agreement prevented the Samuelis from causing Refco to transfer the Securities back to the Samuelis on all but three days of the 450-day transaction period, the Court found that the agreement did in fact reduce the Samuelis' opportunity for gain within the meaning of § 1058(b)(3). The Samuelis' opportunity for gain was reduced because the agreement limited their ability to sell the Securities any time the possibility of a profitable sale arose. Therefore, during the term period, their opportunity for gain as to the Securities was reduced because their ability to realize a gain on the Securities was less with the agreement than it would have been without the agreement.

The Court also concluded that the legislative history of § 1058 supported the

holding, because it was enacted to codify firmly established law requiring that a securities loan agreement should not alter the economic position of the lender. Further, the lender must be able to terminate the loan agreement upon demand. The court also stressed the economic reality of a transaction as the basis for characterization, rather than the stated classification of the parties involved. Here, the Court held that the economic reality established the transaction not as a securities lending arrangement, but as two separate sales of the Securities without any resulting debt obligation throughout the term of the agreement.

The decision in *Samueli v. Commissioner* implies that in order to qualify for favorable tax treatment under § 1058, securities loan agreements should be structured to give the lender the right to require, on short notice, the return of loaned securities or other identical securities at any time throughout the term of the loan. The required notice should likely not be more than three days, because the regular-way stock settlement for corporate securities is usually three days. Although the Court did not base its decision on the Samuelis' motives underlying the transaction, it seems apparent that the agreement was designed to provide them with tax benefits. It is unclear, however, just how extensively the specific circumstances of this case affected the Court's decision. To be safe, attorneys should closely examine the economic reality of the proposed transaction, and should include a provision allowing the lender to terminate the agreement and require the borrower to return the stocks at any time upon short notice. Thus, the substance of the agreement will be in harmony with the form, and courts will be more likely to enforce the agreement as intended by the parties.

**Withholding of deferred payments due to ongoing litigation does not qualify for the common law claim of offset, thus the revenue must still be recognized under Treasury Regulation section 1.446-1(c)(1)(ii)(A) (2006).** *Trinity Indus., Inc. v. Comm'r*, No. 12395-06, 2009 T.C. LEXIS 2, 2009 WL 195934 (T.C. Jan. 28, 2009).

By Jimmy Mitchell

For most companies, the accrual basis method of accounting is required in the recording and analyzing of income generated from daily operations. Under this method, income is generally recognized upon the culmination of a series of events that fixes a company's right to receive payment. Thus, in the year when the last event occurs that unconditionally fixes the right to receive income, the accrual basis taxpayer has an obligation to report the income. In *Trinity Industries, Inc. v. Commissioner of Internal Revenue*, the United States Tax Court addressed the issue of whether Trinity, as an accrual basis taxpayer, was required to accrue deferred payments that its customer had claimed rights of offset to from damages arising under a previous contract. The Court ultimately held that the deferred payments must be accrued.

In *Trinity Industries*, Trinity Marine, a subsidiary of Trinity Inc., entered into a contract to build barges for J. Russell Flowers, Inc. (“Flowers”) and Florida Marine Transporters, Inc. (“Florida Marine”). The terms of this contract provided that payment was due upon the delivery of each completed barge. From September 1997 to March 2000, the barges were manufactured and delivered, while Trinity accrued and reported income in the taxable year when the barges were delivered.

Upon completion of the specified terms of the initial contract, Trinity entered into a second contract with Flowers and Florida Marine to construct and deliver a specified number of barges. The second contract differed from the first in regards to payment terms. Generally, each barge had a purchase price of \$1,290,000, of which \$1 million was to be paid upon completion and delivery, and the remaining \$290,000 to be paid with interest within 18 months of delivery. Between April 2001 and September 2002, Trinity manufactured and delivered the requisite number of barges. In 2001, Trinity fully accrued the proper amount of income from the delivered barges, including the deferred payments.

In 2002, due to alleged defects discovered in barges delivered under the first contract, Flowers and Florida Marine withheld the deferred payments that had come due, instead opting to place the appropriate amounts in an escrow account to offset any eventual recovery of damages resulting from the alleged defects. From 2002-04, the deferred payments came due but were not remitted. In its accounting for this time period, Trinity accrued only the amounts received upon delivery of the barges and not the \$4,520,000 of deferred payments that were withheld by Flowers and Florida Marine.

On May 15, 2002, Florida Marine filed a petition for an unspecified amount of damages against Trinity. This complaint culminated with a settlement agreement on March 12, 2004, whereby Trinity agreed to credit Florida Marine with the \$2,200,000 of unpaid deferred obligations and also to repair the defective barges sold under the first contract. In exchange, Florida Marine agreed to pay Trinity the remaining \$617,400 balance due under the second contract over a 12-month period.

On October 7, 2002, Flowers filed a complaint against Trinity in the United States District Court for the Northern District of Mississippi seeking an order of rescission, which would require Trinity to repurchase 56 barges sold to Flowers under the initial contract. On April 28, 2005, Trinity and Flowers reached a settlement agreement where Trinity agreed to repurchase certain barges sold to Flowers under the first contract and to also pay \$5,764,000 in damages. Per its obligation under the agreement, Flowers agreed to pay Trinity the \$8,020,000 it withheld under the second contract. The agreement specified that this amount was to be offset by the agreed-upon damages, which resulted in Flowers owing Trinity \$2,256,000.

Upon the settlement of the two separate complaints, a question arose

concerning Trinity's accounting practices during the time period in which the deferred payments were withheld. As previously stated, Trinity did not accrue the income from the withheld deferred payments in 2002, which resulted in a \$4,250,000 understatement of Trinity's 2002 consolidated income. As a consequence of this understatement, Trinity had an overstatement of its 2002 consolidated net operating loss carryback, which was claimed on its consolidated return for the fiscal year ending March 31, 1999. This matter was brought before the United States Tax Court, which held that the full contract price of the barges delivered in 2002 should have been recognized as income in that year, and the withholding of deferred payments under the common law claim of offset was not justification for Trinity's decision to postpone the accrual.

Treasury Regulation § 1.446-1(c)(1)(ii)(A) (2006) dictates that under the accrual method of accounting, income is generally recognized when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. The Tax Court was not persuaded by Trinity's argument that its situation fell within an exception to the general rule of the accrual method, where accrual of income may not be required if collectability is doubtful or it is reasonably certain that it would not be collected at the appropriate time. Trinity's situation failed to fall within the parameters of this exception because there was never an argument between the parties concerning the fact or the amount of Flowers' and Florida Marine's obligation to Trinity under the second contract.

Trinity's second argument was that under § 461(f) of the Internal Revenue Code, it should be allowed to deduct \$4,520,000 in 2002 on the grounds that it "transferred" this amount to Flowers and Florida Marine to quell the damages claims arising from the alleged defects in barges delivered under the first contract. The Tax Court disagreed with this argument and held that Trinity could not claim a deduction in 2002 pursuant to this section because the element of "transfer" was not satisfied. The Court reasoned that for a transfer to take place, there must first be control over the funds or property in question. Because Trinity never had the requisite control over the withheld deferred payments, the Court found that Trinity did not transfer money or other property in satisfaction of Flowers' and Florida Marine's asserted liabilities. Further, the Court determined that even if the aforementioned requirement had been met, the deferred payments did not come due and therefore were not truly withheld from Trinity until 2003, which precluded any deduction for 2002.

The Tax Court's decision serves to highlight and emphasize a fundamental concept of the accrual basis of accounting. It is imperative for companies utilizing this accounting method to realize that the most relevant factor in determining when to accrue income is the time when the "fixed right to receive" the income has been established, and not the time of the actual receipt of the payment. The accrual method of accounting is very effective, but attorneys should take special care to

ensure their clients are fully aware of the importance of distinguishing the point at which the “right to receive” the income has occurred. Further, if an attorney’s clients are involved in tax litigation, it is imperative that the attorney maintains continuous communication with the company’s CPA in order to ensure that income is accounted for properly throughout the litigation.