CASE COMMENTARIES

BANKRUPTCY

A nonrecourse creditor cannot use Section 1111(b) of the Bankruptcy Code to transform into a recourse creditor if its application would put the creditor in a better position than it would have been outside of bankruptcy. *In re Montgomery Ward, LLC*, 634 F.3d 732 (3d Cir. 2011).

By Jeff Upshaw

When a party files for bankruptcy protection, courts often allow the bankrupt party to continue using some of its mortgaged properties after reorganization. The Bankruptcy Code allows nonrecourse creditors of such mortgaged property to treat the outstanding mortgage as recourse debt; therefore, the mortgage is recoverable against the bankrupt party personally. However, the use of this provision is limited. The court in *In re Montgomery Ward, LLC* confronted three issues: (1) whether res judicata precluded the Plan Administrator of Montgomery Ward's second bankruptcy filing ("Montgomery Ward II Plan Administrator") from contesting the nature of a lease and sublease agreement, (2) whether Montgomery Ward was liable for common area maintenance ("CAM") expenses under the lease and sublease agreement, and (3) whether Montgomery Ward was personally liable for the mortgage that was taken out to construct a department store ("Mortgage").

Prior to its bankruptcy filings, Montgomery Ward held a strong position in the retail merchandising business. Montgomery Ward filed for Chapter 11 bankruptcy on two separate occasions. The first bankruptcy claim, filed in 1997, was focused on reorganization, while the second claim, filed in 2000, was intended to close Montgomery Ward's operations and liquidate its remaining assets.

In the early 1970's, Montgomery Ward was involved in the development of the Jefferson Square Mall in Joliet, Illinois. In the beginning stages of development, Montgomery Ward entered into a contract with Jolward Associates Limited Partnership ("Jolward"), in which Jolward agreed to build a department store. Montgomery Ward put up its interest in the land as collateral in exchange for the Mortgage, which was financed by State Farm Life Insurance Co. ("State Farm"). The financing agreement stated that Montgomery Ward assumed "no personal liability for the payment of any principal, interest or premium on the [Mortgage] Notes." Because State Farm could only recover against Montgomery Ward's interest in the property, and not against Montgomery Ward personally, the Mortgage was nonrecourse. Jolward leased the department store and the land back to Montgomery Ward through a lease and sublease agreement ("Lease"), which specified Montgomery Ward's obligations for rent and CAM expenses related to the property.

In the first bankruptcy proceeding, the debtor-in-possession ("Ward I Debtor-In-Possession") agreed to remain bound by the Lease. Jolward had previously assigned its rights under the Lease to State Farm. Montgomery Ward was past due on rent payments, as well as CAM expenses accrued in prior years, but the parties were able to settle this dispute with State Farm, receiving the full amount in arrears.

During or before the second bankruptcy proceeding, Dika-Ward purchased State Farm's interest in the Mortgage and the Lease and subsequently filed proofs of claim on both interests. Dika-Ward argued that Montgomery Ward was personally liable for the Mortgage because the proceedings of the first bankruptcy rendered the mortgage "recourse" under section 1111(b) of the Bankruptcy Code. Montgomery Ward rejected their outstanding obligations under the Lease relating to outstanding rent payments, as well as unpaid CAM expenses.

Dika-Jefferson, a subsidiary of Dika-Ward, also filed a proof of claim for unpaid CAM expenses. Montgomery Ward settled the Dika-Jefferson claim by conveying its interest in the land to Dika-Jefferson ("Ward II Stipulation"). Montgomery Ward filed an objection to Dika-Ward's claim for damages under the Lease, asserting that the Ward II Stipulation satisfied the debt and also that the Lease was, in reality, an agreement for structured financing, under which Dika-Ward's only remedy would be to seize the collateral used to secure the financing. Dika-Ward then claimed, citing the doctrine of res judicata, that Montgomery Ward could neither reject these obligations nor dispute the nature of the Lease. Dika-Ward contended that Montgomery Ward was precluded from arguing this issue because the Ward I Debtor-In-Possession had the opportunity to argue it at the first bankruptcy proceeding.

Res judicata is a legal theory that bars the re-litigation of an already decided issue. A claim is barred under this principle if "there has been (1) a final judgment on the merits in a prior suit involving (2) the same claim and (3) the same parties or their privies." The "same party" requirement can be stretched to include a nonparty, "if the nonparty had a substantive legal relationship with a party, and a successor in interest has such a relationship with its predecessor."

A mortgage may be treated as recourse in bankruptcy law if the bankruptcy client continues to use the mortgaged property in its reorganization. In such a case, the original nonrecourse creditor is allowed a claim under section 502 of the Bankruptcy Code as if its security interest were recourse. Usually, a nonrecourse claim can only be recovered by foreclosing on the mortgaged property. However, recourse claims are recoverable against both the debtor's property and the debtor personally if there is a remaining debt after seizure of the property. Treating the nonrecourse claim in this way does not, however, change the essence of the interest. The claim is designated as nonrecourse for distribution purposes only.

On appeal, the Third Circuit Court of Appeals held that the Ward II Plan Administrator was not the "same party" as the Ward I Debtor-In-Possession, and, therefore, res judicata did not preclude the Ward II Plan Administrator from arguing the nature of the Lease. Regardless of the Lease's classification, the court held that, because the Ward II Stipulation released Montgomery Ward from any liability for CAM expenses, the Ward II Debtor-In-Possession was not liable to Dika-Ward for CAM expenses. Finally, the court held that the Mortgage, while treated as recourse under section 1111(b) of the Bankruptcy Code, remained a nonrecourse claim. If the Mortgage became a recourse claim, it would have the "result of placing the nonrecourse creditor in a *better* position than it would have been outside of bankruptcy, a result not contemplated by Section 1111(b)."

The court's holding narrowed existing points of law. Res judicata, a murky doctrine, poses difficult issues in terms of defining its elements. The "same party" element is somewhat of a "term of art," given the advent of non-mutual res judicata. In holding that the Ward I Debtor-In-Possession and the Ward II Plan Administrator were not the "same party," the court tapered the "same party" requirement of res judicata. While the Ward I Debtor-In-Possession and Ward II Plan Administrator could conceivably be considered "in privity," the Ward II Plan Administrator's interests were broader, and, therefore, the parties did not represent the same interest.

Furthermore, the court narrowed the benefits to a nonrecourse creditor that is able to temporarily treat its claim as recourse under section 502 of the Bankruptcy Code. While the court upheld the use of this doctrine, it also limited its use to situations in which the nonrecourse creditor would be put in a worse position than it would have been outside of bankruptcy.

These holdings represent a significant development for bankruptcy attorneys. The court construes res judicata principles in a narrower sense than might have been previously contemplated in this area of law. The court's holding gives a significant advantage to a corporation that files for bankruptcy more than once, as it now has a strong precedent for arguing issues that were not raised in a prior bankruptcy proceeding. Furthermore, bankruptcy attorneys now have more leverage in dealing with nonrecourse creditors that are treated as recourse creditors pursuant to section 1111(b) of the Bankruptcy Code. As long as the bankruptcy attorney can prove that the nonrecourse creditor, if treated as a recourse creditor, would be better off than it would have been outside of bankruptcy, then the creditor will retain its status as a nonrecourse creditor. Consequently, the creditor can only recover against the encumbered property, not the bankruptcy client personally.

Section 363(f) of the Bankruptcy Code does not exonerate a purchaser of assets from all future tort claims arising subsequent to the sale of assets, regardless of when the product that caused the accident was purchased. *Morgan Olson, LLC v. Frederico*, 445 B.R. 243 (Bankr. S.D.N.Y. 2011).

By Heather Grossner

It is well settled that the sale of an estate's interest in property, including claims that arise from the assets being sold, discharges the purchaser from *in personam* liability for pre-confirmation claims pursuant to section 363(f) of the Bankruptcy Code. Stated differently, Section 363(f) removes all of the accompanying liabilities from the transferred assets so that the buyer can purchase the assets without fear that the estate's creditors will enforce their claims against those assets. However, until *Morgan Olson, LLC v. Frederico*, the issue of whether to extend this rule to discharge the purchaser from liability for *all* future tort claims arising subsequent to the sale of assets remained unsettled. The United States Bankruptcy Court for the Southern District of New York clarified this issue and held that Section 363(f) does not discharge the purchaser of an estate from all future tort claims. Instead, the purchaser of the estate assumed all future claims arising from accidents that occurred subsequent to the sale of assets, regardless of when the product was purchased. The court's limited holding was that the prior bankruptcy sale did not affect the claimants' ability to pursue their claim against the purchaser of the assets.

In *Morgan Olson*, Grumman Olson Industries, Inc. (the "Debtor") designed, manufactured, and sold products for the truck body industry, which were incorporated into vehicles sold by Ford Motor Company and General Motors Corporation. The Debtor filed a petition for Chapter 11 bankruptcy in the United States Bankruptcy Court for the Southern District of New York on December 9, 2002. Thereafter, the court approved the sale of certain assets of the Debtor, pursuant to section 363(f), to MS Truck Body Corporation, a predecessor of Morgan Olson, LLC (collectively, "Morgan"). The order for the sale of the assets (the "Order") clarified Morgan's liability for future tort claims arising from allegedly faulty products manufactured and sold by the Debtor prior to the sale to Morgan. First, the Order released Morgan from potential creditors seeking to collect on claims against the estate by seizing the assets that the Debtor sold to Morgan. Second, the Order released Morgan from successor liability and any obligations of the Debtor arising after the Debtor sold the assets to Morgan. Because of these two provisions in the Order, Morgan assumed that the Order exonerated it from *all* future liability.

On October 15, 2008, Ms. Frederico sustained serious injuries when the FedEx truck she was driving crashed into a telephone pole. The Fredericos commenced a personal injury action in the Superior Court of New Jersey on October 8, 2009, and alleged that the Debtor manufactured, designed, and sold the defective FedEx truck in 1994 and that Morgan, as the Debtor's successor, was liable to them.

On March 24, 2010, Morgan commenced the present suit, seeking declaratory and injunctive relief that the Order exonerated it from any liability arising from products manufactured, designed, and sold prior to its purchase of the Debtor's assets. Both parties moved for summary judgment and disputed the Debtor's role in the manufacturing and sale of the FedEx truck. However, this dispute was immaterial to the real question that the court faced, which was whether the Order relieved Morgan from *all* liability to the Fredericos.

In reviewing the original Order, the United States Bankruptcy Court for the Southern District of New York held that the Order did not affect the Fredericos' right to sue Morgan based on practicality and due process. However, the court did not determine whether Morgan was liable to the Fredericos, as the only task the court faced was to interpret the Order. The first issue the court dealt with was whether it had proper subject matter jurisdiction to adjudicate Morgan's claim. The court relied on a previous finding that bankruptcy courts retain jurisdiction to interpret and enforce their previous orders. Here, this court had enforced the prior Order; therefore, it had the right to examine that order and interpret whether or not it exonerated Morgan from all future liability. Additionally, the court examined the following *Petrie* factors to determine whether it had proper subject matter jurisdiction: (1) the dispute was based on rights established by the sale order; (2) the bankruptcy court retained post-confirmation jurisdiction to interpret and enforce its own orders; and (3) the dispute involved an issue already before the bankruptcy court. After applying these factors, the court affirmed that it had proper subject matter jurisdiction because, under the first *Petrie* factor, the resolution of the dispute between Morgan and the Fredericos was based on rights the Order created, and, under the second *Petrie* factor, Morgan's request for declaratory relief begged the court to interpret and enforce the Order while enjoining the Fredericos from proceeding with their personal injury claim.

Next, the court determined that the scope of Section 363(f) of the Bankruptcy Code not only provides *in rem* relief, cleansing all property sold of all claims and interests of creditors, but it also authorizes the bankruptcy court to grant *in personam* relief that exonerates the purchaser from successor liability. The Fredericos sought *in personam* relief and were attempting to collect from Morgan. They based their claim on Morgan's actions after the sale, including Morgan's benefiting from the product's goodwill, holding itself out as the manufacturer of the Debtor product line, and continuing to market the Debtor's product line to FedEx.

The third issue the court faced was whether the Fredericos' right was a claim of liability. The court recognized that, although "claim" has a very broad and encompassing meaning, the term is limited in two types of tort claims. The first type includes those claims by persons who had pre-petition contact with or exposure to the debtor's product but have not yet manifested symptoms or discovered their injury. The second type includes claims of people who are injured after the asset sale because of a defective product manufactured and sold prior to the asset sale, which includes the Fredericos' claim.

The court looked at multiple tests to determine whether the Fredericos' rights were claims, including the "fair contemplation test," which explains that, if the occurrence of a future event that would trigger the liability was within the contemplation of the parties when the parties created their relationship, the future event is a claim. Another test that the court examined was the "accrued state law claim test," which defines a claim as an event that results in an injury for which compensation is justified when a person is exposed to a product before the asset sale. Finally, the court looked at the "conduct test," which recognizes a claim when all actions constituting the tort, except the injury itself, occurred prior to the asset sale.

After weighing all of these tests and mixtures thereof, the court found that the Fredericos' right to payment fell within the "conduct test" and "fair contemplation test" because the Fredericos had no contact with the Debtor prior to the accident and held no claims against the Debtor's estate at the time of the bankruptcy sale. The court found that an issue of greater importance was that the Fredericos had no notice of the bankruptcy sale. This was problematic because sale orders that purportedly free purchasers from future liabilities are not binding against parties who do not receive adequate notice. Additionally, a future claims representative did not protect the Fredericos' rights. Thus, the court held that it would be grossly unfair to treat the Fredericos' rights as claims that the Order exonerated.

Morgan Olson should remind transactional attorneys to warn their clients who are interested in purchasing the assets of a company in a bankruptcy sale that a bankruptcy sale order does not exonerate that purchaser from all future tort claims, even those that occur after the sale as a result of defective products manufactured and sold prior to the bankruptcy sale. This liability, depending on the type of company and assets that the purchaser is interested in purchasing, may persuade a client that he or she should not purchase the assets due to the risk of future liabilities. However, attorneys could suggest that the client take precautions and prepare for future tort claims by establishing a trust fund for the sole purpose of paying future liabilities. The holding in *Morgan Olson* is not a new holding but, rather, a reminder that a sale order, although it may claim to release a purchaser from future liability, does not necessarily do so because of the importance of due process and practicality for plaintiffs who deserve to recover.

BUSINESS ASSOCIATIONS

Corporations do not have "personal privacy" protection under Exemption 7(C) of the Freedom of Information Act. *FCC v. AT&T, Inc.*, 131 S. Ct. 1177 (2011).

By Jed Crumbo

By requiring United States government agencies to make their records and documents publicly available upon request, the Freedom of Information Act ("FOIA") ensures that federal agencies operate with transparency. FOIA, however, does include several exemptions designed to protect certain types of information from public disclosure. 5 U.S.C. § 552(b)(7)(C) ("Exemption 7(C)") protects law enforcement records whose disclosure "could reasonably be expected to constitute an unwarranted invasion of personal privacy." In *FCC v. AT&T, Inc.*, CompTel—a trade association representing several telecommunications companies—submitted a FOIA request seeking documents obtained by the government from AT&T during the course of an FCC investigation. The issue before the Court was whether the phrase "personal privacy," as it is used in Exemption 7(C), applies to corporations like AT&T and not just to individuals. In a unanimous decision, the Supreme Court held that corporations do not have "personal privacy" protection under Exemption 7(C) of FOIA.

In August 2004, AT&T reported to the FCC that it might have overcharged the federal government for services it provided as part of an FCC-administered program. During the FCC Enforcement Bureau's investigation of the matter, AT&T was required to provide the government with various documents. These documents included responses to interrogatories, invoices, pricing and billing information, and the names and job descriptions of employees. The FCC concluded that some documents were in fact exempted from public disclosure. Under 5 U.S.C. § 552(b)(4), documents pertaining to billing practices and staff identities were protected as "trade secrets and commercial or financial information." The FCC also concluded, however, that Exemption 7(C)'s "personal privacy" protection was not applicable to corporations like AT&T.

AT&T sought review in the Third Circuit Court of Appeals. The circuit court reversed the FCC's ruling, holding that FOIA "unambiguously indicates that a corporation may have a 'personal privacy' interest within the meaning of Exemption 7(C)." The circuit court based its holding on the fact that Congress had expressly defined "person" to include corporations as well as individuals in 5 U.S.C. § 551(2). Because the word "person" was the root word of "personal," Exemption 7(C) must be interpreted as applicable to corporations. The FCC petitioned the Supreme Court for review and the Court granted certiorari. On appeal the Supreme Court reversed, holding that corporations do not have "personal privacy" for the purposes of Exemption 7(C).

The Supreme Court's analysis was one of thorough statutory interpretation. The Court first addressed AT&T's argument that Congress's inclusion of corporations in the statutory definition of "person" in 5 U.S.C. § 551(2) necessarily meant that corporations have "personal privacy" protection under Exemption 7(C). The Court rejected this argument by delineating a substantial difference in meaning between the words "person" and "personal."

In the absence of a statutory definition of a term, the Supreme Court typically gives the term its ordinary meaning. "Personal," the Court asserted, ordinarily refers to individuals. The Court observed that "[w]e do not usually speak of personal characteristics, personal effects, personal correspondence . . . as referring to corporations or other artificial entities." In fact, the common usage of the word "personal" suggests that the word means the exact opposite of business-related.

When interpreting statutory language, the Supreme Court also examines the context of the language. Relying heavily on Congress's definition of "person" in 5 U.S.C. § 551(2), AT&T's argument was that, in a legal context, the word "personal" refers to individuals *and* corporations. The Court rejected this argument, finding that the statutory definition of "person" is not transferable to the term "personal." Even though "person" may have a legal definition that differs from its ordinary one, "personal" does not.

Instead, the Court found that the context of Exemption 7(C) indicates that Congress intended Exemption 7(C) to apply only to individuals and not to artificial entities like corporations. When viewed in the context of the other FOIA exemptions, the meaning of the phrase "personal privacy" in Exemption 7(C) became clear to the Court. The Court first looked at 5 U.S.C. § 552(b)(6) ("Exemption 6"), which protects "personnel and medical files and similar files the disclosure of which would constitute a clearly unwarranted invasion of personal privacy." Citing many cases in which it referred to Exemption 6 as involving an "individual's right of privacy," the Court saw no reason to interpret Exemption 7(C), which contained identical language, any differently. The Court then looked at 5

U.S.C. § 552(b)(4) ("Exemption 4"), which protects "trade secrets and commercial or financial information obtained from a person and privileged or confidential." The Court reasoned that this exemption's reference to "a person" clearly applied to corporations because corporations have privileged or confidential information rather than personally private information. Thus, because Congress chose to mimic the language of Exemption 6 rather than Exemption 4 in drafting Exemption 7(C), Congress must have intended Exemption 7(C) to apply only to individuals.

When construing statutory language, the Supreme Court also considers terms immediately surrounding the language. In this case, the Court found that the presence of the word "privacy" next to "personal" ensures that Congress did not intend to give corporations personal privacy protection under Exemption 7(C). "Personal," as used in the phrase "personal privacy," suggests a type of privacy "evocative of human concerns" unassociated with corporations in any way. Noting that AT&T failed to cite a single case or statute that expressly acknowledged a corporation's "personal privacy," the Court found that AT&T provided no sound reason for the Court to disregard the ordinary meaning of the phrase "personal privacy."

The Court bolstered its holding by noting that the federal government itself had long interpreted the phrase "personal privacy" in Exemption 7(C) to pertain to individuals and not to corporations. The Court identified a memorandum, issued by the Attorney General soon after Congress added Exemption 7(C) to FOIA in 1974, declaring that Exemption 7(C) "pertains to the privacy interests of individuals" and "does not seem applicable to corporations or other entities." By declining to extend Exemption 7(C) protection to corporations, the Court thus affirmed the federal government's long-standing interpretation of Exemption 7(C).

The Court's decision in *FCC v. AT&T* serves as a reminder to corporations that FOIA's exemptions do not grant them blanket protection from information requests submitted by competitors to the government. Considering that the only reason that AT&T's documents ever became vulnerable to public disclosure was because of a government investigation, the real lesson to corporations and their attorneys may simply be to stay out of trouble with the government. Attorneys should realize that a government investigation of a corporate client is not only distracting and expensive, but also exposes many of that client's documents to potential public disclosure. While this case prompts transactional attorneys to recognize the limitations of FOIA's exemptions, it also highlights the usefulness of Exemption 4. The FCC relied on this exemption to protect AT&T's most sensitive information, such as cost and pricing data, billing information, and staff identities. Thus, Exemption 4 represents the most robust safeguard available to corporations opposing FOIA requests.

A legally valid partnership may result if all relevant evidence shows clear and convincing proof of a partnership in fact, even if the actual intent of the parties is unclear or unknown. *Swecker v. Swecker*, No. E2010-00046-COA-RC-CV, 2011 Tenn. App. LEXIS 25, 2011 WL 303263 (Tenn. Ct. App. Jan. 26, 2011)

By Evan Daniels

In *Swecker v. Swecker*, the Tennessee Court of Appeals considered whether a father-son business venture formed a legally valid partnership despite never entering into a formal partnership agreement. In upholding the trial court's determination that a partnership existed, the court specifically noted that the actual intent of parties is "not essential" in forming a business partnership, that "[doing] the things which constitute a partnership" is the true test of whether a partnership exists, and that the parties need not understand the legal ramifications of partnership in order to form one. As a result, the court found that the evidence before them eliminated "any serious doubt" that a partnership actually existed.

In the mid 1970s, Richard Swecker began helping his father, Joseph Swecker, run a dairy that Joseph owned and operated on family-owned land. In 1986, Richard and his wife moved into a home owned by Joseph that was located on the property, and, starting in 1997, Richard assumed greater responsibilities with the dairy. Shortly thereafter, Richard and Joseph opened a joint bank account "for the purposes of managing the income and expenses of the farming operations." Additionally, approximately 260 head of cattle were registered jointly to them, and checks issued to the diary were made payable to both men with regular deposits made into the joint bank account.

Joseph passed away on June 25, 2008, and Richard continued to operate the dairy, which he claimed continued to produce profits. Shortly after Joseph's death, Richard sued Steven Swecker and Joseph G. Swecker, representatives of Joseph Swecker's estate, for failure to provide him with a share of the dairy's profits, which Richard claimed Steven and Joseph G. had collected. Moreover, Richard asked the court to declare that a partnership existed between him and his father in the operation of the dairy. Steven and Joseph G. counterclaimed, arguing that Richard received a set monthly salary that made him merely an employee and not a partner. The counterclaim also argued that Richard should reimburse the estate for alleged mismanagement of the dairy's business operations.

After trial, a memorandum opinion of the trial court held that the evidence clearly and convincingly established that Richard and his father worked as co-owners of the dairy and that the arrangement formed a partnership. Therefore, the trial court resolved that Joseph's death had dissolved the partnership and that the parties should liquidate the dairy's business assets, as the estate had started to do prior to trial. Moreover, the trial court ordered that Richard receive a fifty percent share of the profits gained from selling the dairy's assets.

On appeal, the Tennessee Court of Appeals affirmed the decision of the trial court, relying, in particular, upon the Tennessee Supreme Court's decision in *Bass v. Bass* and a Tennessee Court of Appeals decision in *Messer Griesheim Industries, Inc. v. Cryotech of Kingsport, Inc.* In *Bass*, the Tennessee Supreme Court noted three important factors to work through in order to determine whether a legal partnership exists. Bass v. Bass, 814 S.W.2d 38, 41 (Tenn. 1991). First, the intention of the parties to form a partnership is "not essential" in establishing one. Second, "the intent to do the things which constitute a partnership" is what actually establishes a legally valid partnership. Finally, the parties themselves need not be aware of the legal consequences surrounding a partnership in order to form one. Similarly, in *Messer Griesheim Industries*, the Tennessee Court of Appeals held that a partnership forms when money, assets, labor, or skills are shared with the intent that profits resulting from these shared resources will likewise be shared. Also, the burden of proof to show that a partnership exists rests with the party who wishes the partnership to be established. Messer Griesheim Industries, Inc. v. Cryotech of Kingsport, Inc., 45 S.W.3d 588, 605 (Tenn. Ct. App. 2001).

Using this line of reasoning, the court of appeals affirmed that Richard met the burden of proof by showing a partnership existed. In particular, the court explained that a legally valid partnership could be implied, even without an express agreement, as a result of their shared property, labor, skill, experience, and money. In particular, the court dismissed the objections of Joseph Swecker's estate that Richard was merely an employee, stating that just because Richard was compensated a certain amount every month did not necessarily prove that Joseph did not intend to share the dairy's profits with Richard. Furthermore, the court of appeals determined that the trial court correctly found the evidence to be clear and convincing that a partnership existed as a result of the shared bank account, checks issued in both names for the dairy's goods, and jointly registered cattle.

Swecker serves as a reminder that courts will often look to the substance of non-contractual agreements rather than their form. While Joseph seemingly never indicated whether he considered Richard a partner, the combination of their labor and resources sufficiently established Richard's right to half the venture's assets. This speaks to the importance of clarifying each party's disposition towards the other when engaging in a joint-venture. That is to say, if a business owner does not want to risk giving employees or partners a greater share of profits beyond a set salary or a certain percentage of profits, the business owner should seek to protect the business through explicit statements in written agreements defining the relationship each employee and partner has to the venture. Likewise, the responsibilities entrusted to such subordinate parties should match the expressed form of the agreement reached. Alternatively, parties seeking to establish greater shares of profit in partnerships ought to seek explicit agreements outlining the terms of the arrangement.

While the significant lesson of *Swecker* reinforces the notion that whatever parties can do to express their intent will likely prevent most major disagreements, the case also illustrates the vagueness of the law in Tennessee. Even though Tennessee law defines "partnership" as "an association of two (2) or more persons to carry on as co-owners of a business for profit," T.C.A. § 61-1-202, *Bass, Messer Griesheim Industries*, and now *Swecker* all seem to suggest that a "co-owner" could potentially be an individual or group of individuals who do not necessarily begin their association with a business as "co-owners" at all. While the intent of an employer in hiring an employee seems clear enough, *Swecker* and the other cases suggest the totality of circumstances surrounding what the employee actually does and accomplishes for the employer may be influential enough to confer partnership status. *Swecker* itself hints at this possibility. The counterclaim filed by Steven and Joseph G. Swecker hinged on the argument that Richard was an employee of the dairy and not a partner. While the court obviously found this representation of the facts unconvincing, a similar fact pattern might generate an even closer case.

Ultimately, *Swecker* emphasizes the point that business ventures best protect themselves through written agreements rather than by relying on the judicial system to interpret the totality of circumstances. Even though *Swecker* might cast doubt on how "co-owner" is defined in Tennessee law, such vagueness can be avoided with clearly delineated conditions outlining the terms of employment, partnership, and profit sharing. Nevertheless, business ventures seeking to avoid the possibility of a court-imposed partnership for minor stakeholders should carefully consider the responsibilities of employees and the access to business resources available to such individuals. In doing so, such arrangements should make abundantly clear to any potential third party observer that the substance of a given business arrangement matches the form in which it appears.

The filing of a certificate of limited partnership does not ensure recognition of that partnership where the party alleging partnership does not partake in the business activities of the alleged partnership. *Tanner v. Whiteco, L.P.*, 337 S.W.3d 792 (Tenn. Ct. App. 2010).

By Matthew Delinko

A partnership is two or more people acting as co-owners of a business, which is governed by a written or oral partnership agreement. If the alleged partnership is acting without a partnership agreement, the court may imply a partnership. Further, the filing of a certificate of limited partnership is not sufficient to establish a partnership without the satisfaction of the other statutory requirements. In *Tanner v. Whiteco, L.P.*, the Tennessee Court of Appeals decided the issue of whether the Appellee entities, Orangeco Limited Partnership ("Orangeco") and Whiteco Limited Partnership ("Whiteco"), were partnerships under Tennessee law and, therefore, were liable under the agreements entered into with Sherry Tanner ("Ms. Tanner"). The Tennessee Court of Appeals held that Orangeco and Whiteco were not partnerships because "there was not clear and convincing evidence in the record from which to infer the existence of a partnership between Norman . . . and any of his children."

Tanner v. Whiteco involved two parties entering into a general partnership agreement in order to develop and market residential real property, as well as a trust agreement for another piece of property. On July 16, 1998, Norman Vann Thomas, Sr. ("Norman") filed Orangeco's certificate of limited partnership with the Tennessee Secretary of State. After the filing, Norman instructed one of his four children, Catherine Maness ("Catherine"), to place the Orangeco certificate in the filing cabinet because "he was doing estate planning and . . . she and her siblings had an interest in the limited partnership." On December 30, 1998, Norman filed Whiteco's certificate of limited partnership with the Tennessee Secretary of State and asked Catherine to file the Whiteco certificate in the filing cabinet, as well. He also told Catherine that she and her siblings "had an interest in Whiteco."

On July 17, 1998, Ms. Tanner, under the name of Destin Partnership, entered into a general partnership agreement with Orangeco. The agreement specified that Ms. Tanner was to receive a percentage of the income Orangeco received from the sale of real property. On June 29, 1999, Ms. Tanner entered into a trust agreement with Whiteco, which gave both parties a fifty percent interest in Brownville-St. Elmo Shopping Center, L.L.C.

Norman died on July 10, 2007. After his death a check was written to Steve Vesco, an escrow agent for Orangeco, to cover the funeral expenses. All four of the Thomas children signed a receipt and waiver acknowledging that they were interest holders in Orangeco and Whiteco and that the funds would be used to cover the funeral expenses.

Ms. Tanner brought suit because Orangeco and Whiteco failed to perform under the Destin Partnership Agreement. Ms. Tanner claimed that she was owed over one million dollars but had received less than one hundred thousand dollars.

A "partnership" is defined in T.C.A. § 61-1-101(6) as "[an] association of two (2) or more persons to carry on as co-owners of a business or other undertaking for profit . . . ." These persons must have "entered into a business relationship for profit, combining their property, labor, skill, experience, or money." According to the Tennessee Revised Uniform Limited Partnership Act, the formation of a limited partnership requires three actions. First, T.C.A. § 61-2-201 requires "the filing of a properly executed certificate with the Secretary of State." Secondly, pursuant to T.C.A. § 61-2-101(8), there must be one or more general partners as well as one or more limited partners. Third and finally, there must be an agreement between the parties. The agreement between the parties can be written or oral, and "where neither exists, a court may imply the existence of a partnership." In order to imply the existence of a partnership agreement, there must be clear and convincing evidence that the parties intended to entered into a partnership. Further, the burden of proof is on the party alleging the existence of the partnership.

The trial court found that neither Orangeco nor Whiteco were limited partnerships under Tennessee law and that Norman was the only partner in either alleged partnership. On appeal, the Tennessee Court of Appeals held that "there was not clear and convincing evidence in the record from which to infer the existence of a partnership between Norman . . . and any of his children." The court refused to infer a partnership because Ms. Tanner presented no evidence of a written or oral partnership agreement for Orangeco or Whiteco. The court also considered and rejected the three reasons Ms. Tanner cited as justification for inferring a partnership agreement: (1) the filing of the certificates of limited partnership; (2) Catherine receiving the certificates from her father, filing them, and being told she had an "interest" in Orangeco and Whiteco; and (3) the children signing the receipt and waiver identifying an interest in Orangeco and Whiteco.

The court reasoned that the organization under the Tennessee Limited Partnership Act does not result in the formation of a partnership. Two parties are required to form a partnership, and, according to the trial court's findings, Norman was the only person involved in Orangeco and Whiteco. As to Catherine receiving and filing the certificates, the court decided that giving the certificates to her to file was not sufficient to establish a partnership. Also, Norman telling Catherine that she and her siblings had an "interest" in Orangeco and Whiteco was also insufficient to establish a partnership. The court explained that the children did not "combine their property, skills, experience, or money with their father's" from the time of filing the certificates to his death. Further, concerning the signing of a receipt and acknowledgement, the court stated that the children's actions after their father's death did not create a partnership. The court reasoned that an interest holder is not a partner and also that the children's interests in the alleged partnerships were merely due to their status as beneficiaries of his estate.

Tanner v. Whiteco stands for the idea that, although an alleged partnership may seem to have the requisite number of partners, the lack of an agreement between those parties or the lack of those parties carrying on as co-owners may fail to meet the standards of a "partnership" in Tennessee. To avoid similar problems, it is important to discover whether the alleged partnership has a written or oral partnership agreement before doing business with that alleged partnership. Doing so will avoid litigation on the issue of whether or not the business is a partnership and will not leave the decision to the court to imply the existence of a partnership. Such litigation might be significant as clear and convincing evidence is required to establish an implied partnership, and the burden of proof is on the party alleging the partnership. Finally, it is also important to confirm that there are at least two parties participating in the partnership. If not, the filing of a certificate of limited partnership is not enough to establish a partnership.

CONTRACTS

Tennessee courts will interpret unambiguous contracts as complete representations of the contracting parties' intentions and hold each party to their obligations as defined by the terms, regardless of any discrepancy between the plain language of the contract and the parties' actual objectives. *Collateral Plus, LLC v. Max Well Med., Inc.,* No. M2010-00638-COA-R3-CV, 2011 Tenn. App. LEXIS 150, 2011 WL 1167192 (Tenn. Ct. App. Mar. 29, 2011).

By Trevor McElhaney

In Tennessee, when a court interprets and finds a contract to be unambiguous and unequivocal, the contract will be "interpreted according to its plain terms as written, and the language used taken in its 'plain, ordinary, and popular sense.'" In *Collateral Plus, LLC v. Max Well Med., Inc.,* the Tennessee Court of Appeals addressed whether a placement fee provision within a loan management agreement is enforceable when the agreement states unequivocally that it terminates upon the repayment of the underlying loan. The court held that any requirement not explicitly written as a condition precedent to the termination of the contract would not be enforced. In order to fully appreciate the court's holding, it is necessary to examine the specific factual nature of the case.

Collateral Plus, LLC ("Collateral") is a business that provides financing to early stage companies that, due to uncertainty, have trouble obtaining traditional bank financing. Max Well Medical, Inc. ("Max Well") was in financial trouble and sought help from Collateral to obtain financing. Collateral entered into a Loan Management Agreement ("LMA") with Max Well whereby Collateral provided letters of credit and other credit enhancements and agreed to act as paying agent for a line of credit from SunTrust Bank up to an amount of $4,500,000. In return, Max Well agreed to pay, among other fees, "a placement fee of $900,000, payable upon a change of control of [Max Well], sale of [Max Well], or the acquisition of [Max Well's] assets." The LMA specifically defined the "Term" of the agreement in relevant part as "the date first written above and shall continue in full force and effect until such time as [Max Well's] indebtedness with respect to the Loan has been paid in full." The "Term" section of the LMA further provided that if and when Max Well sold its assets, Collateral would work to refinance the balance of the loan for an additional eleven months. In return, Max Well agreed to pay several additional fees, including the placement fee due on the sale of Max Well's assets.

When the agreement was executed, both parties were under the impression that Max Well would execute a put/call option, selling its assets to a separate company it was dealing with, given certain financial performance targets were met. If the proposed put/call option and subsequent sale of the company did not work out, both parties assumed that Max Well would simply go out of business.

However, Fresenius Medical Care North America ("Fresenius") acquired the holder of the put/call agreement, and, along with Specialty Care Services Group ("SCSG"), acquired thirty-one percent of Max Well's outstanding stock. As part of the deal, Fresenius and SCSG guaranteed $4 million of Max Well's debt. With this guarantee, Max Well paid off the balance of the $4.5 million line of credit that was subject to the LMA between them and Collateral. Approximately one year later, Fresenius acquired the remaining sixty-nine percent of Max Well's outstanding stock. At that time, Collateral demanded the placement fee of $900,000 from Max Well. Max Well declined to pay the fee on grounds that the LMA had terminated upon repayment of the outstanding balance of its $4,500,000 line of credit and, as a result, terminated any obligation to pay the replacement fee.

Collateral filed suit against Max Well for payment of the $900,000 placement fee. Max Well moved for summary judgment, arguing that the plain language of the LMA made the payment of the placement fee conditional upon the survival of the LMA. Collateral filed a cross-motion for summary judgment, arguing that Max Well owed the $900,000 placement fee to Collateral at the execution of the LMA.

The trial court granted summary judgment in favor of Collateral, holding that the credit enhancements were a "significant benefit" to Max Well and that, in exchange for the benefit, Max Well promised to pay the $900,000 placement fee set forth expressly in the agreement. Further, the trial court ruled that, in order to keep with the plain language of the agreement, Collateral earned the placement fee upon the execution of the LMA through the guaranties and other credit enhancements that allowed Max Well to obtain the $4.5 million loan from SunTrust Bank. Max Well duly filed a Notice of Appeal contending, in relevant part, that the trial court erred in its conclusion that the placement fee survived the termination of the LMA and erred in granting Collateral's motion for summary judgment.

On appeal, the Tennessee Court of Appeals reversed the trial court's grant of summary judgment in favor of Collateral and held that Max Well's motion for summary judgment should have been upheld. In its ruling, the court stated that the purpose of interpreting a contract is to "ascertain and give effect to the contracting parties' intentions, and where the parties have reduced their agreement to writing, [interpret] their intentions [as] reflected in the contract itself."

First, the court determined that the primary issue was based on the interpretation of the language used in the LMA. It concluded that Collateral and Max Well were "sophisticated parties, engaged in a specialized arrangement, and represented by counsel throughout the contracting process." Therefore, the court refused to interpret the contract as to what the parties may have intended to say. Rather, the court noted that the parties agreed in their memoranda and in open court that the LMA was unambiguous. Unlike the trial court, the court of appeals also found the LMA to be unambiguous and, therefore, would interpret the language used in its "plain, ordinary, and popular sense." Further, in looking at the "Term" section of the LMA, the court noted that the LMA clearly provides that, if the LMA were renewed upon the sale of Max Well's assets, Max Well would still be required to pay the placement fee of $900,000. In light of this, there was no reason to include specific language in the LMA obligating Max Well to pay the placement fee upon renewal of the LMA if the parties' original intention was for the placement fee to survive the termination of the LMA.

Second, the court was not persuaded by Collateral's argument that the court should imply a reasonable time for performance because the LMA did not specify a specific time. Although the court agreed with Collateral's argument that a "reasonableness" requirement is implied in all contracts, it held that the "reasonableness" implication did not apply to the LMA, because the LMA specifically stated the conditions by which the placement fee would be owed by Max Well. Once again, because the LMA was unambiguous, the court reasoned that it would not look past the four corners of the contract in its interpretation.

Neglecting to specifically state within the LMA that Max Well owed the placement fee under any and all circumstances proved to be a costly mistake for Collateral. The Tennessee Court of Appeal's decision, granting summary judgment for Max Well, serves as a reminder to all transactional attorneys in the state of Tennessee that, when drafting an agreement between two parties, any provisions that a party expects to be performed should always be reduced to writing in clear and unambiguous language. Further, this case proves that simple things, such as the repetition of a provision, will be taken into account in interpreting the parties' intentions. To be certain that the parties' intentions will be enforced, the language should be so clear that the contract could not be interpreted any other way. Therefore, anything that is discussed, anticipated, or expected between two parties should be in plain view for the court to interpret. From the ruling in *Collateral Plus, LLC v. Max Well Medical Inc.,* it is clear that Tennessee courts "will not make a new contract for parties who have spoken for themselves . . . and will not relieve parties of their contractual obligations simply because these obligations later prove to be burdensome or unwise." Therefore, Tennessee attorneys should always examine their clients' contracts with great specificity and detail in order to ensure that every provision of their clients' contracts will be upheld.

INSURANCE

An insured can recover from his agent on a failure to procure claim when an obtained policy later becomes void because of the agent's own acts, even when the insured separately settles with the insurance company. *Morrison v. Allen,* 338 S.W.3d 417 (Tenn. 2011).

By Annie Ellis

A relationship between an insured and his agent may be helpful to the former when selecting insurance coverage. When the insured places full trust in the agent, he expects his desired results, placing full confidence in the agent's expertise and knowledge of the ins and outs of the complicated field of insurance coverage. When an agent fails to obtain this insurance and an incident occurs that the expected policy would have covered, the insured can rightfully recover from the agent based on a failure to procure claim. Further, when an agent obtains coverage that is drastically different than what the insured bargained for, a cause of action for failure to procure might still exist because the law recognizes that an insured has reasonable expectations that the agent will properly deliver what was agreed upon. In *Morrison v. Allen*, the Tennessee Supreme Court addressed the degree of liability that follows an agent when the insurance policy he obtains is successfully contested due to his own acts or omissions and whether any recovery is limited by an insured's own failure to read the insurance application that was prepared by the agent.

Howard Morrison ("Mr. Morrison") purchased a $300,000 term life insurance policy in 2000 from First Colony, and his wife, Kristen Scott Morrison ("Mrs. Morrison"), was the beneficiary. The policy contained a two-year incontestability clause, which meant that First Colony could not deny coverage to the Morrisons because of any misrepresentations in the application after the Morrisons held the policy for two years. This clause took effect just before 2002, when Mr. Morrison was convicted of driving while impaired.

After developing a social relationship with Paul Allen and Jody Roberts ("Defendants"), both certified financial planners with Wiley Brothers, the Morrisons decided to pursue alternative life insurance coverage. After discussing their expectations with the Defendants, the Defendants recommended two policies with American General that had lower premiums than the Morrisons' then-existing policy. The Morrisons never specifically requested that the replacement policy be incontestable, and there was no evidence that the Defendants explained that this new policy was contestable for two years, unlike Mr. Morrison's then-existing policy that had reached the incontestability stage. After collecting limited information at an initial meeting, one of the Defendants contacted Mrs. Morrison to ask for her driver's license number and her son's social security number, but the Defendants made no further inquires before sending the Morrisons the completed insurance applications, with sticky-notes indicating where the Morrisons needed to sign the documents.

The Morrisons trusted that the Defendants had taken care of everything, so they signed where directed, without reading the applications. The Morrisons did not notice a "no" answer to a question inquiring about any convictions for driving under the influence of alcohol. Still, the Morrisons signed that they had read and understood the policy. In addition, Mr. Morrison signed a separate document stating that he understood that he should not cancel his prior-existing policy until the new policy was issued. When an American General nurse traveled to the Morrison home to collect medical information and asked Mr. Morrison if he had any driving violations, he answered "yes."

Two months after the policies took effect, Mr. Morrison died unexpectedly from injuries sustained in a car accident. Mrs. Morrison, as the beneficiary, filed a claim for coverage with American General, who denied the claim. American General reasoned that Mr. Morrison had made a misrepresentation because the application answered "no" to the question about driving violations, even though he had candidly told the nurse that his driver's license had been suspended. American General had standing to deny the claim because the alleged misrepresentation occurred within the two-year contestability period.

Mrs. Morrison sued American General, the Defendants, and Wiley Brothers, alleging breach of the $1,000,000 life insurance contract, violation of the Tennessee Consumer Protection Act ("TCPA"), and general negligence. Mrs. Morrison settled her claim with American General for $900,000. After this settlement, Mrs. Morrison focused on recovering from the Defendants based on a breach of contract theory for failure to procure an enforceable insurance policy, a tort theory of negligence, and a claim under the TCPA for reckless practices.

The trial court awarded Mrs. Morrison the full $1,000,000, plus interest, for a breach of contract for failing to procure an enforceable policy, $300,000 for the Defendant's negligence in allowing the Morrisons to cancel the prior First Colony policy, and another $300,000 for willful and knowing recklessness, in violation of the

TCPA. The trial court did not use Mrs. Morrison's settlement with American General to offset the substantial amount. The court of appeals affirmed in most aspects but disagreed with the trial court's decision not to discount the judgment based on Mrs. Morrison's prior settlement.

The Tennessee Supreme Court began its analysis by definitively stating the necessary elements for a failure to procure claim: (1) an undertaking by the agent to procure coverage; (2) the agent's failure to use reasonable diligence; and (3) the client was warranted in assuming she was properly insured. The court reasoned that, if the agent is at fault when a policy is successfully contested by the insurance company, the insured does not receive the benefit of her bargain and is entitled to recovery. The court concluded that there is no distinction between the agent's total failure to procure and the procurement of coverage that later becomes void by fault of the agent.

The court agreed that the Defendants had a casual attitude and were not attentive to detail when collecting information before searching for an appropriate policy. The Defendants described some incorrect answers on the applications as honest mistakes, even when there was clear evidence that the Defendants knew the answers were incorrect. For example, the Defendants had watched the Morrisons smoke cigars, yet indicated that they did not smoke on the application. The court held firm that a client should be able to trust that an agent will ask the important questions and accurately record the answers so that a policy cannot be successfully contested later. The court reasoned that agents serve as insurance professionals and should be held to high standards.

The court found it insignificant that the Morrisons failed to read the applications. The Morrisons hired the Defendants to purchase a policy suitable to their needs, and the failure to procure an enforceable policy was a breach of their employment contract. The Morrisons had relied on the expertise of the Defendants in assuming they were properly insured after signing where directed and completing a medical examination. The failure of the Morrisons to specifically contract for an uncontestable policy was irrelevant because insurance obtained and later voided at the fault of the agent has the same value as no insurance at all. The court affirmed the lower court's decisions to hold the Defendants liable for failure to procure.

As to the prior settlement, the majority found that American General's liability did not extinguish the Defendants' liability and reversed the appellate court's decision to give credit to Mrs. Morrison's prior settlement. Dissenting justices declined to accept this conclusion, reasoning that this would place Mrs. Morrison in a better position than policy coverage of $1,000,000, contrary to the fundamental purpose of contract law.

On the theory of negligence, the court found that the elements were not met because a separate document explained that the prior policy should only be canceled with caution. Therefore, the court reversed the trial court's award of $300,000 for negligent practice. Accordingly, it reversed the doubling of this award based on reckless practice violations of the TCPA.

The Tennessee Supreme Court made it more difficult for insurance agents to absolve themselves from liability when a client signs that he read and understood an insurance policy. An employment contract was created between the Morrisons and the Defendants, establishing a heightened duty of care. Insurance agents must understand that they are liable when they fail to satisfy the needs of the insured, even with the insured's signature of understanding. Tennessee transactional attorneys must advise insurance agents that submitting an inadequate insurance policy is the equivalent of failing to obtain a policy at all. Further, as *Morrison* explains, Tennessee agents cannot expect to find sympathy from the court when a plaintiff independently recovers from an insurance company.

REAL ESTATE

When entering into contracts, corporate officers and other company representatives must expressly and unambiguously define themselves as such in order to shield themselves from personal liability. *Associated Shopping Ctr. Props., Ltd. v. Hodge,* No. M2010-00039-COA-R3-CV, 2011 Tenn. App. LEXIS 138, 2011 WL 1025753 (Tenn. Ct. App. Mar. 22, 2011).

By Tommy Gossett

It is a well-established rule of law that when interpreting contracts one must ascertain the intent of the parties involved by looking at the contract as a whole and giving legal effect to that intention. Further, when a person associated with a particular company signs a contract, it often must be determined by the contract's language whether he or she intended to do so as an individual or in his or her representative capacity with the company. In *Associated Shopping Ctr. Props., Ltd. v. Hodge*, the Tennessee Court of Appeals discussed whether the individual defendant, Hodge, was an additional lessee and, thus, was personally liable for the debt owed under the lease agreement based on contract interpretation and Hodge's intent.

In *Associated Shopping Ctr. Props., Ltd. v. Hodge*, Associated Shopping Center Properties, LTD ("Associated") entered into a lease agreement with Décor Fabrics, LLC ("Décor") for the use of property to operate a business under the name "Material Things." Décor was owned and operated by three individuals: Tracy Hanchey, Décor's President; Jacqueline Westra, Décor's Vice-President; and Edward Hodge, Décor's Chief Financial Officer. The lease itself consisted of two individual sections: (1) a preprinted form agreement that contained several blank lines where additional information could be written in by hand, such as the identity of the leasee(s), the demised premises, or the lease term and (2) a typed addendum entitled "Attachment A." The single "Lessee" explicitly identified in the preprinted form lease was "Décor Fabrics, LLC," which was handwritten in the blank. Yet, "See Attachment A" was also handwritten immediately next to Décor Fabrics, LLC. "See Attachment A" was similarly handwritten in Paragraph 1.0 titled "Lease Term" and Paragraph 2.0 titled "Minimum Rental and Cost of Living Adjustment." The Paragraphs were crossed through, and the words "See Attachment A" were written over the crossed-through paragraphs.

The first paragraph of Attachment A stated that "Lessee shall be Décor Fabrics, LLC, with the following members also as individual Lessees: A. Tracy

Hanchey, member and President. B. Jacqueline Westra, member and Vice President. C. Edward Hodge, member and CFO." In addition, Attachment A stated significant information such as the lease term, annual rent calculation, and improvements and renovations Associated agreed to complete before Décor moved into the space. Also, a paragraph on the first page of the lease stated that "any attachment to this Lease Agreement shall be a part of this agreement." The signatures of Mr. Hodge and Ms. Hanchey followed only by their birthdays and social security numbers appeared on the Lease on the signature line provided for the Lessee. Ms. Westra's signature appeared on a separate piece of paper indicating that she had read and agreed to the terms of the lease. There is absolutely no indication that Mr. Hodge's, Ms. Hanchey's, or Ms. Westra's signatures were made in their representative capacity.

Due to unforeseen delays, the beginning date of the lease term had to be pushed back. Therefore, Mr. Smith, the Management Agent for Associated, mailed a letter to Ms. Hanchey's attention at Décor's address suggesting that the parties modify the start date to reflect when Décor actually moved into the space. After receiving the letter, Mr. Smith and Ms. Hanchey executed "Lease Amendment #2," which provided that the previous letter would be considered Lease Amendment #1. Lease Amendment #2 also stated that the later date had been agreed upon as the official start date and that "all other terms and conditions in the original lease remain the same."

Décor experienced financial problems three months into the lease and failed to make the rent payments when due. As a result, Associated mailed a notice of default to all members of Décor, Ms. Hanchey, Ms. Westra, and Mr. Hodge, stating that they owed a total of $44,016.58 in unpaid rent. Associated sent subsequent notices of default and finally determined that Ms. Hanchey, Ms. Westra, and Mr. Hodge would be individually responsible for the unpaid rent, a deficiency for the remainder of the lease term, and other additional expenses. Consequently, Associated filed suit against Ms. Hanchey, Ms. Westra, and Mr. Hodge in their individual capacities, claiming that they were additional lessees and thus personally liable under the terms of the lease. Ms. Hanchey never filed an answer, so a default judgment was entered against her. However, Ms. Westra and Mr. Hodge each filed an answer arguing they were not personally liable for breach of the lease because Décor was the sole lessee and because they merely signed the lease in their representative capacities as officers of Décor. Ultimately, the trial court held the provisions of the lease were unambiguous and named Mr. Hodge and Ms. Westra as additional, individual lessees, thus making them personally liable for the amount owed. Both Ms. Westra and Mr. Hodge filed an appeal; however, Ms. Westra settled before the court heard the case. Mr. Hodge contended the following: (1) he was not an individual lessee, (2) the parties never intended him to be an individual lessee, and (3) his only involvement with the lease was as a member and CFO of Décor.

On appeal, the Tennessee Court of Appeals first held that the provisions of the contract, when read in harmony with each other, were unambiguous and must be interpreted as written, rather than according to the unexpressed intention of the parties. Tennessee case law states that a contract is ambiguous only when it is of uncertain meaning and may fairly be understood in more ways than one. Therefore, the mere use of the singular form of "lessee" in the preprinted form agreement without language expressly excluding the possibility of additional leases is not sufficient to create a conflict with the express identification of additional lessees in Attachment A. The court's holding is solidified by the fact that the paragraph identifying the Lessee expressly instructed the parties to "See Attachment A," which listed additional lessees acknowledged by name. Likewise, the court found that the paragraph clearly labeled "Attachments" and including the language "any attachments to this Lease Agreement shall be a part of this agreement . . . as agreed between Lessor and Lessee at the time of signing of the agreement" was unambiguous proof of the parties' deliberate intent to include the attachment stating Mr. Hodge's name as individual lessee. "See Attachment A" clearly appeared three times on the first page of the lease and affected three significant provisions. As such, the court held that Mr. Hodge must have read Attachment A in order to understand the significant provisions. The court fully agreed with the trial court's ruling that Attachment A was as clear as it could be in specifically identifying Mr. Hodge as an additional, individual lessee.

The Tennessee Court of Appeals next held that, because the contract clearly stated that Mr. Hodge was also an "individual lessee" and because his signature on the Lease was followed by his personal social security number, Mr. Hodge was personally liable for the debt owed to Associated and was not acting in his representative capacity. Tennessee law consistently rules that a person's signature, without limiting or descriptive words before or after it, is the universal method of signing a contract to assume a *personal* obligation. Also, on the last page of the pre-printed form lease, Associated is identified as Lessor with the notation of "C. Gregory Smith, Jr. Management Agent" appearing below the signature line. The court held, based on that evidence, that unlike Mr. Smith, who signed as Management Agent of Associated, Mr. Hodge did not make any notation that he signed the lease in his representative capacity. Therefore, the lease, when considered as a whole, expressly and unambiguously identified Mr. Hodge as an additional lessee, bound in his individual capacity.

The Tennessee Court of Appeals' decision to uphold the rule of law that the court must interpret a contract as a whole as written, rather than according to the unexpressed intention of the parties, shows that, when feasible, the court will hold that the parties are bound by the terms expressly within the contract. Therefore, whether a person intended to sign a contract in his or her individual or representative capacity will be determined from the contract's express language. When drafting a contract, an attorney should include words limiting the personal obligation of the client where possible throughout the contract. Additionally, when an individual signs a contract, an attorney should *always* read the entire contract and not allow the client to sign his or her personal name unless the client intends to be bound by all provisions or clauses contained anywhere within the contract. Further, the Tennessee Court of Appeals' holding that Mr. Hodge was an individual lessee, signing the contract in his individual capacity, reinforces that a court will not look past the contract itself and dabble in the subjective intent of individual parties. Today's attorney must understand that terms within a contract will be strictly enforced. Moreover, when drafting a contract, an attorney should clearly denote limiting or descriptive words, before or after the client's signature, to clearly avoid personal obligation. Attorneys should also verbally warn a client that when signing a contract on behalf of a corporation or business, his or her signature should *always* be followed by words denoting the officer's representative capacity so that the signature will bind *only* the company.

SECURITIES

A claim for violations of § 10(b) of the Securities Exchange Act and SEC Rule 10b-5 requires a plaintiff to prove that the defendant's representation or omission materially affected the "total mix" of information made available to a reasonable investor. *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011).

By Taylor Wirth

It is understood that a corporation must communicate both positive and negative information regarding its financial security with its shareholders. A company violates both Security Exchange Commission regulations and federal law by making or omitting material facts relating to the purchase or sale of its securities. What constitutes "material," however, remains a source of ambiguity. In *Matrixx Initiatives, Inc. v. Siracusano*, the Supreme Court held that no single factor is dispositive in determining the materiality of a corporation's representations; rather, the "total mix" of information available to a reasonable investor must be considered.

In *Matrixx*, the respondents filed a class action against Matrixx Initiatives, Inc. ("Matrixx"), the pharmaceutical manufacturer of Zicam cold products. The plaintiff's complaint alleged that the drug company made misleading statements regarding the safety of its cornerstone product, Zicam Cold Remedy ("Zicam"), which constituted 70% of the company's profits. That product's main ingredient, zinc gluconate, was reportedly the cause of severe side effects, including loss of smell or anosmia.

Beginning in 1999, Matrixx received complaints from both physicians and consumers regarding the safety of Zicam, specifically linking the use of zinc to anosmia. Three years later, a research and development executive at Matrixx corresponded with a physician who alerted the company to several studies illustrating zinc's harmful effect on a consumer's sense of smell. In 2003, despite Matrixx's protest, the American Rhinologic Society hosted a presentation, "Zicam Induced Anosmia," which offered empirical evidence of eleven consumers experiencing a loss of smell after taking the cold remedy. That same year, a product liability lawsuit against Matrixx was filed, alleging that Zicam was the cause of anosmia. Eventually, four lawsuits against Matrixx would be filed.

Despite an accumulation of evidence that Zicam was unsafe, Matrixx made contradictory public statements, maintaining that its revenues would rise 50% to 80% and earnings per share could increase by as much as 38%. During this time, the manufacturer failed to disclose to the SEC that two product liability lawsuits had been filed against it, representing the possibility of a "material adverse effect" on the product's success. In response to a news story about Zicam usage and anosmia, Matrixx issued a press release dismissing the consumer complaints and downplaying negative health reports. After stock prices fell, Matrixx vowed to conduct tests on its product in relation to onset of anosmia.

Plaintiffs filed a class action suit, alleging that Matrixx violated § 10(b) of the Securities Exchange Act and SEC Rule 10b-5. The rule prohibits manipulative or deceptive securities transactions and requires a plaintiff to prove the following elements: (1) the defendant made a material statement or omission; (2) scienter; (3) an association between defendant's misrepresentation and plaintiff's security transaction; (4) plaintiff's reliance upon defendant's misrepresentation; (5) economic loss; and (6) loss causation.

In the district court, Matrixx successfully moved to dismiss the complaint on grounds that the plaintiffs had insufficiently pled the elements of materiality and scienter. The court held that the plaintiffs did not provide significant evidence linking Zicam with loss of smell; therefore, the plaintiffs provided insufficient proof of Matrixx's intent to defraud. The Court of Appeals for the Ninth Circuit reversed, stating that the district court erred by requiring a showing of significant statistical evidence. Rather, the materiality of a statement "requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him." Thus, the appellate court found that the plaintiffs' complaint sufficiently linked Matrixx's product with loss of smell. The court held on appeal that Matrixx's conduct after learning of negative reports and subsequently withholding information indicated a sufficient showing of its intention to defraud consumers.

The United States Supreme Court affirmed the decision of the Court of Appeals for the Ninth Circuit. The element of materiality requires the plaintiff to prove that the defendant's act or omission would be considered material by a reasonable investor upon consideration of a "total mix" of the facts. Rejecting Matrixx's "bright-line rule" that an adverse event relating to its product is proven only with proof of significant statistical evidence, the Court instead opined that "the source, content, and context" of the information must be assessed, and that no factor is dispositive in its determination.

Upholding the "total mix" standard, the Court proffered several instances in which the absence of statistical evidence could still lead a reasonable investor to consider information regarding a product's possible side effects as material. For example, data extracted from studies with small sample sizes, non-randomized experiments, and expert testimonies were considered highly persuasive in establishing causation, despite the lack of traditional statistical significance. Further, the Court noted that the FDA based its regulations on a variety of factors in assigning causation to pharmaceutical products, naming significant statistical evidence among them.

Turning to Matrixx's contention that scientific and legal challenges to Zicam's safety were immaterial, the Court instead concluded that the defendant's failure to disclose such information "significantly altered the 'total mix' of information made available." The complaint included information pertaining to several medical reports made available to Matrixx, product liability lawsuits filed against the company, and admissions that Matrixx executives sought to further research the damaging claims. When considering the whole, the Court held, a reasonable investor would regard the negative reports as materially affecting the financial strength of Zicam, and thus potential transactions of Matrixx securities.

Lastly, the Court affirmed the finding that Matrixx "acted with scienter, 'a mental state embracing intent to deceive, manipulate, or defraud.'" Following from its finding on materiality, the Court held that, pursuant to the PSLRA, scienter is established when a reasonable investor, considering the totality of the facts, can draw an inference of the necessary intent. Because Matrixx knew of the existing medical complaints and actively discredited the negative reports by issuing multiple press releases, the Court reasoned that the company acted recklessly in protecting the financial security of the Zicam pharmaceutical line. Thus, Matrixx acted with the requisite intent to satisfy the element of scienter.

The holding in this case exposes corporations to liability for the non-disclosure of information once considered immaterial to investors. *Matrixx Initiatives, Inc. v. Siracusano* illustrates that a corporation may not be shielded from lawsuits brought by its investors when it communicates, or fails to communicate, relevant information about its financial stability, even when that information may not be supported by statistically significant evidence. Corporations must now operate with heightened transparency and evaluate their actions and statements if they seek to avoid claims of fraud.

Practitioners should proceed with caution when representing clients involved in the buying and selling of securities. Due to the discretionary nature of the "total mix" test, transactional attorneys must carefully evaluate a company's conduct in relation to the elements of § 10(b) of the Securities Exchange Act and SEC Rule 10b-5. When advising business clients on whether information must be disclosed to avoid legal action, attorneys must balance anticipated investor reactions, possibly adverse to a company's profits, with corporate interests.

During a Delaware court appraisal proceeding, corporations may disavow previously prepared and distributed corporation-specific data during the court's independent evaluation of the fair market value of the shares. *Golden Telecom, Inc., v. Global GT LP,* 11 A.3d 214 (Del. 2010).

By Zackarij R. Gardner

In Delaware, court appraisal of a corporation's stock after a merger or acquisition provides a statutory means by which an acquired corporation's shareholders may ensure that the merger price is the fair value of the stock held by the shareholders. When shareholders believe that the merger price is not the fair value of the stock, they may elect for a court appraisal. This appraisal proceeding prevents the undervaluation of the stock, ostensibly making a corporation more attractive to potential buyers, and allows shareholders to receive fair value for their stock. In *Golden Telecom, Inc. v. Global GT LP*, the Supreme Court of Delaware addressed two related issues: first, whether a court must defer to the merger price in making its fair value appraisal of an acquired corporation; and second, whether a corporation is bound by previously prepared corporation-specific information during an appraisal proceeding where the information prepared was distributed to shareholders in a tender offer fairness opinion.

In *Golden Telecom, Inc. v. Global GT LP*, Vimpel-Communications ("VimpelCom") began its attempt to acquire Golden Telecom, Inc. ("Golden") in early 2007. Altimo and Telenor Group (collectively, "Altimo and Telenor") together held a majority of VimpelCom's stock with 35% and 30%, respectively. Altimo and Telenor were also the largest shareholders of Golden's stock, holding, respectively, 27% and 18%. In May of 2007, Golden created a special committee comprised of members unaffiliated with Altimo and Telenor to handle any potential merger transactions.

In September 2007, VimpelCom proposed to buy Golden for $80 per share. This offer and three subsequent offers were rejected by Golden. In early December 2007, VimpelCom made an offer of $105 per share. The special committee recommended that the offer be accepted, and the Board of Directors approved the deal. The special committee solicited no other potential buyers, and Altimo gave notice that it would not accept a bidder other than VimpelCom.

In late December 2007, Golden distributed a fairness opinion prepared in support of the merger price. Shortly thereafter, the companies signed a Merger Agreement that included a cash tender offer for the outstanding shares of Golden's common stock. It also required that all shares not tendered be converted into the right to receive the same amount in cash per share. The vast majority of shareholders tendered their shares; however, Global GT LP and Global GT Ltd. (collectively, "Global") refused to tender their shares. Instead, Global elected to have the merger price appraised by a court as allowed under Delaware law. The court of chancery appraised the stock as having a value of $125.49 per share at the time of the merger and entered a judgment for Global accordingly.

Golden appealed the judgment, arguing that the court of chancery erred by not deferring to the merger price. Supporting its argument by pointing to the arms-length nature of the negotiations and the efficient market price, Golden contended that the merger price indicated the fair value of the stock. It requested that a rule requiring conclusive or, alternatively, presumptive deference to the merger price in appraisal proceedings be adopted. Golden also objected to the court of chancery's valuation of the stock, arguing that the vice chancellor erred by not giving weight to market evidence regarding the value of the stock. Golden argued that the court erred by making factual findings unsupported by the record while accepting and giving weight to evidence given by Global. Global contested all of Golden's claims and cross-appealed. Global contended that the court erred by using a tax bracket other than the one used by Golden in its fairness opinion and that the court erred by not considering other evidence it had offered.

On appeal, the Supreme Court of Delaware held: (a) that the court of chancery was not required to defer to the merger price in its fair value appraisal evaluation; (b) it did not abuse its discretion in its valuation of the shares; and (c) the court did not err by accepting the tax rate proffered by Golden during the appraisal proceeding, where a different rate was used in the tender offer fairness opinion. Delaware law, codified at Delaware General Corporate Law Section 262(h), dictates that the courts "shall determine the fair value of the shares . . . together with interest, if any, to be paid upon the amount determined to be the fair value" by "tak[ing] into account all relevant factors." It does not, on the other hand, mandate judicial deference to an agreed-upon merger price. The Delaware Supreme Court noted that courts must evaluate the "fair value" of the stock as a "going concern" to the stockholder rather than the value of stock in the context of an acquisition.

The Delaware Supreme Court found that no deference is to be given to a merger price and that courts must independently evaluate the fair value of a corporation's stock as a going concern by considering all factors involved. To hold otherwise, the court noted, would be contrary to the unambiguous language of the statute, because it would effectively remove the courts from the appraisal process and make that process less flexible. The appraisal process is necessarily flexible to ensure that the fair value is reached. Forcing deference to the merger price would harm the purpose and utility of judicial appraisal. Therefore, the court rejected Golden's request to adopt a rule requiring judicial deference to merger prices. It went on to reject the contention that the court erred in its valuation of the stock, primarily because the court had considered all of the relevant factors. Thus, it was proper for the court to adopt one expert's model and evidence over another's.

The Delaware Supreme Court also refused to adopt a bright line rule preventing companies from disavowing corporation-specific data that they previously sent to stockholders. The court stated that, although Global was correct in asserting that stockholders are entitled to rely on the truthfulness of information given to them by corporations, the judicial appraisal is an independent evaluation. The evaluation requires flexibility and does not require a company to adhere to data prepared to convince stockholders of the fairness of a tender offer. The court noted that a "fair price" at the time of the tender offer stage under the circumstances of a merger transaction is different than a "fair price" of a corporation as a going concern at the appraisal stage. The court concluded that Delaware courts should weigh any inconsistencies between the data offered by a company during the tender offer stage and the data offered during the appraisal stage. Therefore, the Delaware Supreme Court affirmed the decision of the lower court.

The Delaware Supreme Court's decision reinforces the Delaware legislature's intent to provide an independent means by which shareholders may ensure that the merger price is the fair value of their shares; however, it also creates uncertainty in the merger process for the corporations and shareholders involved. No presumptive deference to the merger price is mentioned in the statute, and the court made clear that Delaware courts will not imply a presumption. During a merger or acquisition, Delaware corporations must exhaustively search for the fair value of the corporation to be acquired because Delaware courts will consider all of the factors involved during their appraisals without deference to merger prices. A corporation cannot rely on what it believes to be the efficient market price during a court's appraisal because the court will not simply look at the transaction data; rather, courts look at all relevant matters. Additionally, courts are not limited to the information provided by corporations before or during the merger, and, importantly, a corporation may offer information different from what it previously disseminated to shareholders.

However, this creates some uncertainty for Delaware corporations and the attorneys representing them. Transactional attorneys and their clients may go through the merger process believing they have found the "fair value" of the corporation, but a court may come to a different conclusion. As the Delaware Supreme Court noted, the fair value as a going concern at the appraisal stage is different than the fair value during the tender offer stage. Due to this uncertainty, it behooves attorneys representing Delaware corporations to find a merger price that all shareholders will agree to, so that the uncertain court appraisal process may be avoided. Although this may add time and expense to the initial process, it will avoid the greater time and monetary costs of lengthy court appraisals—a fact clients will likely appreciate.

Transactional attorneys who fail to take the time necessary to find a price amenable to all shareholders are more likely to cost the corporate client additional time and money, and, therefore, the client will be less likely to seek out the services of the cost-increasing attorney for future transactions. Thus, it may be more prudent to offer a preliminary tender offer to gauge likely shareholder support for the offer before offering a final tender offer and completing the merger process to ensure that clients' time and money are not unnecessarily wasted.

SHAREHOLDER LITIGATION

When a shareholder fails to present an allegation to a corporation's directors, a derivative action cannot be maintained unless particularized pleadings demonstrate that such a demand would have been futile as to a majority of the directors. *In re Healthways, Inc. Derivative Litigation*, No. M2009-02623-COA-R3-CV, 2011 Tenn. App. LEXIS 129, 2011 WL 882448 (Tenn. Ct. App. Mar. 14, 2011).

By Todd B. Skelton

Under Delaware General Corporation Law, for shareholders to pursue a derivative action, they must either make a demand on the board of directors to bring the suit or establish that such a demand would be futile. If the board refuses, shareholders may bring the action by showing that the board wrongfully refused the demand. If a demand was not made, shareholders must demonstrate why making the demand would have been futile to excuse the demand requirement. In *In re Healthways, Inc. Derivative Litigation* ("*In re Healthways*"), the Tennessee Court of Appeals addressed the requirement that plaintiffs plead demand futility with particularity when a shareholder of Healthways, Inc. ("Healthways") bypassed the board in filing a derivative action.

Healthways was a Delaware corporation with its principal place of business in Tennessee. As its name suggests, Healthways was a healthcare company providing disease management solutions "to help people maintain or improve their health and . . . reduce overall healthcare costs." Healthways was a provider in the Centers for Medicare & Medicaid Services of Health and Human Services' Medicare Health Support Pilot Program ("MHSPP"). MHSPP sought to improve the quality of healthcare provided to beneficiaries and implement cost saving measures for the Medicare and Medicaid programs. Failure to meet a five percent cost savings criteria at the end of the first phase could make Healthways liable for fees paid to the company and disqualify Healthways from MHSPP's second phase.

Quarterly reports from October 2007 to May 2009 allegedly showed that Healthways was not meeting the MHSPP cost savings criteria. On January 7, 2008, it was announced that the MHSPP criteria had been lowered "from 5% net savings to budget neutrality." Consequently, Healthways stock climbed to $67.21 per share, only to drop to $31.54 on February 26, 2008, when the company released a press release issuing revised financial targets for the year. During the period from October

29, 2007, to January 9, 2008, three Healthways directors sold a total of 228,824 shares.

The plaintiff, a Healthways shareholder named Roy T. Forrest ("Plaintiff"), filed a shareholder derivative suit on June 27, 2008, which was later consolidated with a separate derivative action. The consolidated complaint "nam[ed] fifteen current or former officers or directors of Healthways as defendants." Healthways maintained eleven director positions on its board. Plaintiff alleged that the defendants breached their fiduciary duties by disseminating false and misleading information and failing to properly oversee and maintain adequate internal controls. Plaintiff further alleged that certain defendants breached their duty of loyalty by trading on insider information. Plaintiff filed the action without making a demand on Healthways' board of directors. The trial court dismissed the action "on the ground that plaintiff failed to allege with requisite particularity that such demand would have been futile."

Delaware law provides that "when demand has not been made . . . the complaint is subject to dismissal unless the plaintiff can plead with requisite particularity why it would be futile to make a demand upon the board of directors." If the complaint is pled with the requisite particularity, the demand requirement is excused. The demand futility standard established in *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993) provides that demand may be excused as futile if "the particularized factual allegations of a derivative [shareholder] complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." When the corporate charter includes an exculpation clause, demand will not be excused for a director's breach of the duty of care but may be excused "where there are particularized allegations that the directors breached their duties of loyalty or good faith."

On appeal, the Tennessee Court of Appeals held that, when a shareholder fails to present the allegation to the corporation's directors, a derivative action can only be maintained if particularized pleadings demonstrate that such a demand would have been futile as to a majority of the directors. Ultimately, the court affirmed the dismissal of the derivative action. In doing so, the court first considered the insider trading and misappropriation of information claim. Facts about the directors' inside knowledge of MHSPP and Healthways' earnings allowed an inference that three directors knew material, non-public information and traded on the basis of such information. The directors were not protected by Healthways' exculpation clause because insider trading constitutes a breach of the duty of loyalty. Demand to the three directors would have been futile but was not excused with regard to the insider-trading claim for lack of a majority of directors.

The court next considered a related claim regarding whether the board's Governance Committee allowed the improper sales to occur. None of the three directors who allegedly traded on non-public information were on the committee. The court found no breach of the duty of good faith because Plaintiff did not allege that the committee had knowledge of the trades. Moreover, no particularized facts supported an inference that the directors breached their duty of loyalty, so demand was not excused.

The court next considered whether the members of the Audit Committee failed to maintain adequate internal controls or breached their fiduciary duties by disseminating false and misleading information. By merely alleging that the directors received quarterly reports regarding MSHPP and listing the committee's responsibilities as described in the charter, Plaintiff failed to establish any failure of the directors' responsibilities regarding the receipt of information. Demand was not excused because the allegations regarding inadequate internal controls were not sufficient to support finding a breach of the duty of good faith. Further, Plaintiff made only conclusory allegations that the directors were accountable for Healthways' press releases and financial statements, and there were no allegations that the directors participated in the dissemination of false and misleading information. Therefore, demand was not excused because there was no breach of the duties of good faith and loyalty.

Additionally, the court determined that potential futility for two directors that were employed by Healthways still did not excuse demand. One served as Chief Executive Officer and President, and the other was a consultant who was already "counted" for purposes of demand futility from the insider-trading claim. *Rales* requires that demand be futile as to a majority of directors, and Plaintiff could at most demonstrate futility for four of the eleven.

Finally, the court rejected Plaintiff's allegation that a federal court's denial of a motion to dismiss a securities action regarding the alleged insider trades was relevant to the demand futility analysis. The demand futility standard was higher than the standard for a motion to dismiss. Even if the analyses had not been distinct, Plaintiff still would have been unable to establish the majority required to excuse demand.

In re Healthways construes the Delaware General Corporation Law, which is important because of the number of Delaware corporations doing business throughout the United States. The decision has implications for counsel of both corporations and potential plaintiffs. *In re Healthways* demonstrates the importance of drafting comprehensive exculpation provisions into corporate charters. The Healthways exculpation clause limited the liability of its directors for monetary damages for breaches of the duty of care, and the Plaintiff needed to establish a breach of the duties of loyalty or good faith to excuse demand. An exculpation clause can therefore force a plaintiff to find a different claim on which to sue. Additionally, *In re Healthways* provides guidance for pleading demand futility. Counsel must carefully weigh the decision of whether or not to make a demand on the board. Not surprisingly, the general view is that boards typically reject the demand. Once the board refuses, a shareholder must prove that the board did so wrongfully. The board has on its side the business judgment rule, a defense in which courts generally defer to board decisions. On the other hand, a shareholder can file the suit without making a demand but must prove demand futility. Rebutting the business judgment rule requires showing that directors were interested, so plaintiffs must commit on the front-end the resources necessary to filing a complaint that pleads with requisite particularity facts sufficient to demonstrate that demand would have been futile as to a majority of the directors. If demand is not excused, however, the action is dismissed and the shareholder must then make the demand.

TAX

Residents who work long hours, are highly skilled, and enjoy similar benefits to career employees do not qualify for the income tax exemption given to students employed by a school, college, or university. *Mayo Found. for Med. Educ. & Research v. United States*, 131 S. Ct. 704 (2011).

By Jeremy Jones

Enacted by Congress to help fund Social Security, the Federal Insurance Contributions Act ("FICA") requires employers and employees to pay taxes on earned wages. However, Congress has exempt certain individuals from FICA's demands, and, not surprisingly, employers and employees often seek the approval of Congress to qualify for a lawful tax exemption. In *Mayo Foundation for Medical Education and Research v. United States*, the United States Supreme Court addressed "whether doctors who serve as medical residents are properly viewed as 'student[s]' whose service Congress has exempted from FICA taxes under 26 U.S.C. § 3121(b)(10)."

The Mayo Foundation for Medical Education and Research ("Mayo") offers residency programs to doctors who have graduated from medical school and seek additional training in a specialized area of medicine. Although residents complete an educational curriculum consisting of weekly lectures, readings, and written exams, Mayo's residents typically spend fifty to eighty hours per week—the majority of their time—caring for, diagnosing, and treating patients. As a result of their medical services, residents receive paid vacation time and monetary stipends which in 2005 ranged between $41,000 and $56,000 per resident, as well as health insurance and malpractice insurance.

Recognized by Congress as a valid tax exemption under § 3121(b)(10) of the Internal Revenue Code, the student exception exempts from taxation "service performed in the employ of . . . a school, college, or university . . . if such service is performed by a student who is enrolled and regularly attending classes at such school, college, or university." Beginning in 1951, the Treasury Department ("Department") applied the student exception to students who worked for their schools "as an incident to and for the purpose of pursuing a course of study." By comparing the number of hours worked with the number of courses taken, the Department determined on a case-by-case basis whether a student's work was incident to his or her studies and thus tax exempt. Additionally, although the Social

Security Administration ("SSA") similarly applied a case-by-case approach to its "corresponding student exception in the Social Security Act," the SSA categorically excluded medical residents from the benefits of the tax exemption.

However, medical residents soon filled the court system with claims seeking FICA tax refunds when, in 1998, the Eighth Circuit Court of Appeals held that the SSA could no longer categorically, and therefore automatically, exclude residents from the student exception. Fearing continuous litigation, the Department created a new categorical rule—the full-time employee rule— in 2004 to help combat the bombardment of claims. Under the rule, full-time employees (i.e., those individuals working forty hours or more per week) do not qualify for § 3121(b)(10)'s tax exemption. Moreover, the Department advised that "an employee's service is 'incident' to his studies only when '[t]he educational aspect of the relationship between the employer and the employee, as compared to the service aspect of the relationship, [is] predominate.'"

Mayo filed suit in the United States District Court, seeking tax refunds of the money it had withheld from residents' stipends during the second quarter of 2005 and claiming the full-time employee rule was an invalid interpretation of § 3121(b)(10). Relying on the analysis in *National Muffler Dealers Assn., Inc. v. United States* ("*National Muffler*"), the district court concluded that the Department's full-time employee rule was inconsistent with § 3121(b)(10)'s "unambiguous text." The district court interpreted § 3121(b)(10) to mean that "an employee is a 'student' so long as the educational aspect of his service predominates over the service aspect of the relationship with his employer."

The Government appealed and the court of appeals reversed the district court's decision and approved the Department's statutory interpretation regarding § 3121(b)(10). Relying on the opinion in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, the appellate court determined that § 3121(b)(10) "is silent or ambiguous on the question [of] whether a medical resident working for the school full-time is a 'student.'" Mayo's petition for certiorari was granted, and the United States Supreme Court found the Department's full-time employee rule a fair and reasonable interpretation of § 3121(b)(10).

Case law stipulates that *Chevron's* two-part analysis is appropriate in cases where an administrative agency (i.e., the Department) has and exercises the Congressional authority to "engage in the process of rulemaking." Under *Chevron* step-one, the Court asks whether Congress has previously addressed the specific question at issue: whether medical residents are exempt from taxation under § 3121(b)(10). The Court first held that Congress had neither addressed this exact question nor defined the term "student" as used in § 3121(b)(10). Next, the Court applied *Chevron's* second step, which asks whether the Department's full-time employee rule is a "reasonable interpretation" of § 3121(b)(10). Against Mayo's objections, the Court held that, because administrative consistency and efficiency would be better served, the Department's full-time employee rule was a fair assessment of § 3121(b)(10).

The Court was not convinced by Mayo's claim that *National Muffler's* more complex, multi-factored analysis should serve as the benchmark when analyzing an ambiguous portion of the Internal Revenue Code. Unless a contrary reason for applying a "less deferential standard of review" (i.e., *National Muffler*) appears, the United States Supreme Court is compelled to apply the precedents of *Chevron* in a tax case. Additionally, the Court made clear that, although medical residents are not considered students, residents and their families would remain eligible for Social Security coverage and benefits.

The United States Supreme Court's decision to uphold the full-time employee rule should serve as a learning experience to medical residents and residency programs. While the Supreme Court's ruling means that residents working 39.99 hours or less per week are considered students and, therefore, are in compliance with § 3121(b)(10)'s regulations, the vast majority of all medical residents will not meet this criteria, because residents typically spend fifty to eighty hours per week working rather than studying. Transactional attorneys, in particular tax attorneys, should inform their clients of § 3121(b)(10)'s forty hour benchmark and the impact it may have on the residents' annual stipends.

A multistate corporation's capital gains from a one-time acquisition and sale of stock through restructuring activities with its parent corporation represent "business earnings" subject to the Tennessee excise tax. *Blue Bell Creameries, LP v. Roberts*, 333 S.W.3d 59 (Tenn. 2010).

By Caleb Barron

In order to impose an excise tax on a multistate enterprise conducting business in Tennessee, the earnings in question must be "business earnings" as defined by the Tennessee excise tax statute, in addition to satisfying the parallel restrictions imposed by the Due Process and Commerce clauses of the United States Constitution. In *Blue Bell Creameries, LP v. Roberts*, the Tennessee Supreme Court held that, pursuant to the Tennessee excise tax statute, the taxpayer's capital gains from a one-time acquisition and sale of stock represented "business earnings" and that a tax assessment on those earnings did not violate the United States Constitution.

Blue Bell Creameries, LP ("Taxpayer") produced, sold, and distributed Blue Bell ice cream throughout Tennessee and other states. On January 1, 2001, Taxpayer's parent corporation, Blue Bell Creameries, USA, Inc. ("BBC USA") reorganized itself and Taxpayer to decrease their relative tax exposure. To achieve the desired reorganization, 250 stockholders of BBC USA exchanged all of their shares in BBC USA for an equivalent interest in Taxpayer's limited partnership. BBC USA then redeemed the stock transferred to Taxpayer for $142,506,000, and the reorganization was complete. The reorganization allowed BBC USA and its subsidiaries to remove one level of federal income taxation and remain privately held companies, therefore reducing overall expenses.

Taxpayer reported $119,909,317 in capital gains stemming from the Stock Transaction on its 2001 federal income tax return and Tennessee excise tax return. On the Tennessee return, the capital gains were classified as non-business earnings and were therefore exempt from the excise tax. After conducting an audit, the Tennessee Department of Revenue (the "Department") alternatively classified the capital gains as business earnings subject to the excise tax and assessed $146,025.25 against Taxpayer. In response, Taxpayer made the payment in full and filed a complaint against the Department in chancery court for a refund of $128,407 plus interest and attorney's fees. Both parties moved for summary judgment and neither contested any fact in the opposing party's statements.

Taxpayer moved for summary judgment alleging that the imposition of the tax was improper under the Tennessee excise tax statute and alternatively violated the United States Constitution. The Department filed its own motion for summary judgment alleging that the tax assessment was valid under both the Tennessee statute and the United States Constitution. Subsequently, the chancery court granted Taxpayer's motion and awarded Taxpayer a refund of $167,779.07. The court of appeals affirmed the lower court and held that the tax assessment was unconstitutional because there was insufficient evidence showing that the two entities were functionally integrated so as to satisfy the unitary business principle.

In order to determine whether a company's earnings should be classified as "business" or "nonbusiness" earnings, the Tennessee legislature has explicitly adopted the "functional test." The functional test provides that business earnings mean "earnings arising from transactions and activity in the regular course of the taxpayer's trade or business or earnings from tangible and intangible property if the acquisition, use, management or disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations." There is a split among courts on how to properly apply the functional test to investment earnings. One approach, adopted by the North Carolina Supreme Court, considers the ownership or control the company exercised over the property as an additional inquiry and defines the word "integral" as "essential to completeness." The alternative approach, adopted by the California Supreme Court, focuses on the control exerted over the property, instead of actual ownership, and defines the word "integral" as an organic unity between the income-producing property and the taxpayer's business activities.

In addition to the "business earnings" requirement, the attempt to assess excise taxes on the earnings of multistate entities must be constitutional. There are two constitutional limitations placed on a state's ability to tax outside its borders through the requirement of Due Process and the Commerce Clause. The Supreme Court has held that in order to pass constitutional muster there must be a "minimum connection" or "nexus" between the interstate activities and the taxing state. Once such a connection is established, the taxable portion of the earnings is determined through the use of the "unitary business principle." A state may apportion earnings following this principle only if the entity's intrastate and extrastate activities formed part of a single unitary business.

On appeal, the Tennessee Supreme Court held in *Blue Bell Creameries, LP v. Roberts* that, pursuant to T.C.A. § 67-4-2004(1), Blue Bell's capital gains from a one-time acquisition and sale of stock represented "business earnings" subject to the Tennessee excise tax statute, and the tax assessment did not violate the United States Constitution. The court based its holding on the following findings: (1) the earnings from the stock transaction constituted business earnings under the Tennessee excise tax statute following California's interpretation of the functional test; (2) the stock transaction was unitary with Taxpayer's ice cream business in Tennessee; and (3) the tax assessment was valid under the Due Process and Commerce Clauses of the Constitution.

In first determining how to classify the earnings, the court followed the California Supreme Court's less restrictive application of the functional test, which required only that the taxpayer "control, but not necessarily own" the property. By applying this standard the court found that the stock transaction was a "necessary step" in the businesses reorganization because it "reduced expenses that detracted from the earnings arising from the sale of Blue Bell ice cream in Tennessee and elsewhere."

Concluding that the tax assessment was proper, the court then turned to the question of whether the assessment was valid under the Due Process and Commerce Clauses of the United States Constitution. The court first applied the unitary business principle adopted by the United States Supreme Court for determining such constitutional issues. Specifically, the court applied the "operational-function" concept that focuses the unitary business principle on income derived from assets. After a review of Supreme Court cases applying the concept, the court concluded that the stock transaction did indeed serve an operational function, rather than investment function; therefore, the earnings were unitary with the business and apportionable by the state.

The Tennessee Supreme Court's decision in *Blue Bell Creameries, LP v. Roberts* illustrates an expansion of the State's power to assess excise taxes on the earnings of a multistate entity, specifically pertaining to a reorganization involving a subsidiary and its pure holding company parent. Attorneys should be mindful that economic transfers under restructuring, or similar non-income producing or investment activities, may be taxable under this newest standard set forth by the Tennessee Supreme Court. In the endless search for minimal tax liability, Tennessee transactional attorneys should strive to minimize tax exposure by ensuring that earnings from investments not used for operational expenses are clearly shown as such. Under this new standard, attorneys should be more aware of the potential excise tax implications of expense reductions and similar positive effects on the balance sheet resulting from non-income producing activities. If this distinction is not clearly made, such earnings may be taxable by the State of Tennessee.