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TransactionS

The Tennessee Journal of Business Law

A publication of
The Clayton Center for Entrepreneurial Law
of
The University of Tennessee College of Law

- Editorial: Under-Funding Legal Education in Tennessee
- Gary Pulsinelli: New Intellectual Property Professor
- ARTICLES

  Don't Cheat; Escheat! What Every Business Lawyer Ought to Know About Tennessee's Abandoned Property Laws

  Tennessee Nonprofit LLCs -- A New Option for Tax-Exempt Organizations

  Material Adverse Change Clauses Following the *Tyson* Decision

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- Cases and Other Items in the Areas of:

  Antitrust

  Banking

  Bankruptcy/Trademark

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  Partnerships

  Real Estate

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- *Transactions*' Selection of Web Sites for Business Lawyers

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EDITORIAL

UNDER-FUNDING LEGAL EDUCATION IN TENNESSEE

By Kevin M. Howard

Even before the ongoing debate over state tax reform became a major issue, funding problems for public higher education and, more particularly, for legal education in Tennessee began to affect The University of Tennessee College of Law. Arguably, these problems have been responsible for the school's recent drop in the *U.S. News & World Report* Law School Rankings, where Tennessee has moved steadily from 47 to 50 over the last three years. A drop of one more spot would relegate the school to the "second-tier" for the first time in recent years. While some would argue that indexes such as this are inadequate measures of the quality of education, it is indisputable that they have great influence in two major areas: the hiring market for graduates and the prospective student market.

Regardless of which side of the political spectrum one falls on, hopefully we can all agree that public education is one area that deserves to receive our tax dollars. Unfortunately, higher education has not received sufficient support and the UT College of Law has begun to feel the brunt of it. Here are some figures to consider:

• As a result of the lack of state funding increases, tuition and fees hikes for law students at UT have increased a whopping 42% for in-state students and an unconscionable 51% for out-of-state students in the past three years.

• Thanks to these tuition and fees increases, in-state students will pay $6,668 to attend UT this year. This figure does not include books, room or board. Consequently, for the first time ever, an in-state student cannot rely solely on Federal Subsidized Loans to pay for his or her education.

• Out-of-state students will pay around $18,380 to attend UT this year. Recently, as part of University-wide reallocation, the University created seven graduate assistantships at the College of Law. These assistantships include a fee waiver and will very much help us recruit and retain outstanding students. But more remains to be done.

"So what?" you say, "these tuition increases only bring UT in line with its peer institutions in the surrounding states." Not so fast, my friend. Unlike many of our neighboring state institutions, UT as a whole, and especially the College of Law, has made a name for itself as a bargain institution, offering a top-tier education at a second-tier price. But those days have quickly ended, and as a result, the College of Law's rankings have steadily dropped, despite the benefits of enjoying some of the best facilities in the country. Consider these figures:

• In the past, the College of Law had a regional competitive advantage *as one of only four* top-tier public schools in the region (the other three being the University of Georgia, the University of North Carolina, and the University of Virginia). *Now, it is one of eleven* top-tier public schools in the region. The additions are the University of Florida, the University of Alabama, the University of Kentucky, the University of Maryland, George Mason University, the University of Cincinnati, and the University of Houston. Consequently, the College of Law can no longer recruit top students from those states by selling them on the fact that there is no comparable institution in their state.

• Six other top-tier schools are now either less expensive than or the same cost to attend in-state as Tennessee (UGA, Colorado, Arizona, Utah, Alabama, and Kentucky). Even more disturbing, *at least ten top-tier schools now have less expensive out-of-state tuition and fees* than UT. These include Texas, UNC, Washington, Arizona, Utah, Alabama, Florida, Cincinnati, Houston, and Kentucky. Georgia and George Mason are effectively on par with UT. The result is that the College of Law can no longer sell itself to top students from other states on the basis that the school offers a better price than other top-tier law schools. Just three years ago, it could.

• Out-of-state LSAT scores at UT are lower than the in-state LSAT scores. State schools are supposed to be harder to get into for out-of-state students than in-state students. Additionally, state schools have relied upon out-of-state students to raise their test score averages, but the College of Law, for the reasons mentioned above, is having a harder time attracting top students from out-of-state.

• Now, the scariest figure! A quick look at the second-tier schools shows that should UT fall into the second-tier, it could even struggle to stay at the top of the second tier. At least eight second-tier schools have lower in-state tuition than UT including Georgia State, Florida State, Arkansas, and Ole Miss. Even scarier, at least fifteen second-tier schools have less expensive out-of-state tuition than UT, including Georgia State, Florida State, Arkansas, Ole Miss, Louisville and South Carolina. Conceivably, UT would have a hard time staying atop the second-tier because schools of the same perceived caliber would be offering better deals.

Internally, in comparison to other students at the University, the typical law student receives considerably less state dollars for each dollar he or she spends. Take a look at the following table:

	State Appropriation Per Dollar spent by Student
Average UT Student (state-wide)	$1.94
Average UTK Student	$1.27
Average Law Student	**$0.43**

What can a concerned citizen, alumnus, or alumna who cares about the future of the UT College of Law do to help alleviate the funding problem? The answer is *not* merely to donate money to the College of Law. Rather, a concerned citizen should put pressure on State Senators and Representatives to take action to appropriate more money to the law school. A listing of state legislators and the districts they represent, along with a basic form letter addressing these issues can be found at http://www.law.utk.edu/news/legislat.htm. As a concerned citizen, you can cut and paste the letter and representatives' addresses into your own word processor and customize the letter as you see fit.

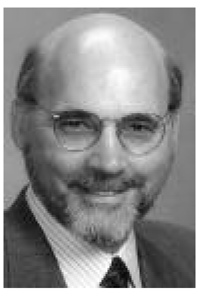
The bottom line is that the quality of education at UT's College of Law is not declining. To the contrary, tuition and fees at UT are rising precipitously while competing schools have been able to keep their respective tuition and fees close to the status quo. Where we once stood relatively alone, other schools are now pressing in. We at *Transactions*, the Clayton Center for Entrepreneurial Law, and The University of Tennessee College of Law urge you to contact senators and representatives, and others, and help us to ensure that the excellence, standing, and reputation of The University of Tennessee's College of Law continues to be recognized nationwide.

Faculty Notes

Prof. **Joan Heminway**, recently elected an officer of Brown University's alumni association, moderated a commencement forum at Brown's commencement exercises in May. The forum, entitled "How Can We Do Right When the Climate Is 'Right'? Standing Up for Social Justice in a Conservative Administration," considered changes that may occur in pro bono and public interest work during the Bush presidency, including challenges facing labor, immigration, child support, and poverty law. This October Prof. Heminway also participated in a seminar presented by the Knoxville Bar Association in conjunction with the Clayton Center for Entrepreneurial Law where she spoke on "Choosing the Right Business Entity." Also, Prof. Heminway recently consulted with a local firm on issues relating to pending and proposed state and federal securities law actions.

Prof. **George W. Kuney's** article "Single Asset Real Estate under 11 U.S.C. § 362(d)(3): A Narrower Construction Than You Might Expect (or, Why Every Hotel Should Have a Gift Shop and Troubled Golf Courses Should Keep their Bars Open)" is being published in Volume 26, Issue 2 of the *California Bankruptcy Journal*. Additionally, Prof. Kuney is serving as a Reviewer and Consultant for CEB's new treatise, "Personal and Small Business Bankruptcy Practice in California," which is scheduled for publication late in 2001. He continues to work with Professor Paula Williams to design and implement an expansion of the College of Law's Legal Clinic to include a program offering students exposure to business law matters.

Prof. **Greg Stein's** book, *A Practical Guide to Commercial Real Estate Transactions: From Contract to Closing*, has just been published by ABA Publishing. The book provides readers with a detailed discussion of the anatomy of a real estate deal. Prof. Stein authored the text, and his two practicing attorney co-authors prepared practice pointers, checklists, and forms. Prof. Stein also has completed a chapter entitled "The Effect of *Palazzolo v. Rhode Island* on the Role of Reasonable Investment-Backed Expectations," which will appear in the book *Takings Perspectives*, to be published later this year. The chapter discusses the impact of the Supreme Court's most recent regulatory takings case. Additionally, Prof. Stein's Land Acquisition and Development Seminar spent the final two class sessions of the spring semester examining the new Knoxville Convention Center as a case study of an ongoing real estate development project. Speakers included Dick Bigler of the Knoxville/Knox County Public Building Authority (PBA), who is the Program Director for the Convention Center; Gordon Knapp, Chief Operating Officer of Denark Construction, which is serving as construction manager for the Center; Douglas H. McCarty, president of McCarty Holsaple McCarty architects; and Michael Kelley, Law Director for the City of Knoxville. The speakers addressed the scope and physical features of the project, land acquisition, public financing, and construction law issues. At the end of this session, the students received a tour of the construction site. The $94 million Convention Center project is scheduled for completion on August 1, 2002.

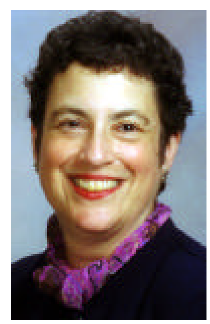


Prof. **Tom Plank** had an article entitled "The Limited Security Interest in Non-Assignable Collateral Under Revised Article 9" published in the *American Bankruptcy Institute Law Review* in June. In July, he gave a presentation on "The Efficiency of Securitization and the Implications for Bankruptcy Law," at the annual meeting of the Southeastern Conference of the Association of American Law Schools. Professor Plank has been invited to make a presentation for the Debtor-Creditor Section presentation at the annual meeting of the Association of American Law Schools in January 2002, and has been solicited by the *Bankruptcy Development Journal* to write a book review, to appear next Spring, on David Skeel's *Debt's Dominion: A History of Bankruptcy Law in America*.

Prof. **Robert M. Lloyd** is continuing to develop new ways of teaching law via the Internet. This summer, more than 30 students took his on-line commercial law class from places as far away as Nairobi, Kenya. An article on the previous summer's on-line course was recently published in the *Journal of Legal Education*. Links to UT's on-line commercial law tutorials may be found at http://www.law.utk.edu/cle/lessons.htm.

Prof. **Colleen Medill** spoke at the Kansas Governor's Conference on Aging in May. Her topic was "What 401(k) Plans Teach Us About Privatizing Social Security." Her articles on pension tax reform and stock market volatility and 401(k) plans are out in print. The citations are: (1) Stock Market Volatility and 401(k) Plans, 34 *Mich. J. L. Reform* 469-545 (2001), and (2) Targeted Pension Reform, 27 *J. Legis.* 1-68 (2001). The UT Board of Trustees granted Prof. Medill tenure at its June meeting. Prof. Medill joined the UT faculty in 1997 after seven years in private practice focusing on tax, corporate and litigation issues arising under the ERISA. She teaches Employee Benefits Law, Gratuitous Transfers, Wealth Transfer Tax, and Property. Prof. Medill's research focuses on the policy ramifications of ERISA.

In addition to his continuing work on the proposed revisions to the Tennessee Rules of Professional Conduct and the American Bar Association Rules of Professional Conduct, Prof. **Carl Pierce** has presented several CLE programs this Fall, including programs for the Mid-South Commercial Law Institute and the Tennessee Federal Tax Institute.



Prof. **Amy Hess** will be a Distinguished Visiting Professor at the University of South Carolina Law School in the Spring. This will be the third time Prof. Hess has visited another school as a professor. Previously, she was a visiting professor at the University of Missouri-Columbia and the University of Texas.

In addition to serving as the chair of the Committee on Affiliated and Related Corporations of the Tax Section of the American Bar Association, Prof. **Don Leatherman** is currently working on a history of the consolidated return Regulations. Prof. Leatherman will be speaking on November 16 at the PLI conference in Los Angeles.

GARY PULSINELLI: NEW INTELLECTUAL PROPERTY PROFESSOR

By Irmie K. Blanton III

The *Transactions* staff extends a warm welcome to Dr. Gary Pulsinelli. Joining the faculty of the College of Law in the Fall of 2001, Dr. Pulsinelli creates a positive learning environment by bringing his experience in intellectual property and the patent process to the classroom.

Originally from Bowling Green, Kentucky, Dr. Pulsinelli received an A.B. from Harvard University, where he was a research associate in the Department of Biology. After his studies at Harvard, he then worked with I.G.B. Products, Ltd. in the East San Francisco Bay Area. After earning a doctorate in molecular biology from the University of Wisconsin, Dr. Pulsinelli became a post-doctoral fellow in the Department of Oncology at the University of Wisconsin at Madison. Soon thereafter, Dr. Pulsinelli embarked on his legal career when he attended the Boalt Hall School of Law at the University of California. Dr. Pulsinelli has a vast array of legal experience including clerking for Judge S. Jay Plager on the U.S. Court of Appeals for the Federal Circuit and working as an associate with the firm of Pennie & Edmonds in Palo Alto, California, in the area of biotechnology patents. His work has been published in the *Santa Clara Computer & High Technology Law Journal* and the *Proceedings of the National Academy of Sciences*.

Dr. Pulsinelli's research interests include pharmacogenetics, interpretation of patent claims, and interaction of law and technology. Pharmacogenetics, which is the tailoring of drugs to the genetics of the patient, requires the balancing of ethics, application of the law, and risk management. For example, if a drug fails overall during the clinical trial phase but works on a certain percentage of people who share a genetic trait, the drug could still be useful for the set of people who share that genetic trait. This practice, however, raises the risk of genetic discrimination. Dr. Pulsinelli would like to understand how we, as a society, view the overall implications and applications of the law in this kind of situation.

With the interpretation of patent claims Pulsinelli feels that there are some strange and unnecessarily complex doctrines employed by both the courts and the claims themselves. He cites the frequent reversals of patent claim interpretation, the confusing structure of one-sentence claims, and near impossibility of determining what an invention is from the claim itself, as areas in need of improvement. Dr. Pulsinelli would also like to research the interaction of law and technology. He believes lawyers and other professionals must look at intellectual property from different perspectives than they normally would. Dr. Pulsinelli would like to further this area of the law by finding a rational interaction and a reasonable fit between how patent law works, with biotechnology in particular, and how the technology fits into the world of law.

In his free time, Dr. Pulsinelli likes to be with his two-year-old daughter. He also enjoys novels, digital movie-making, adventure computer games, and creating mosaics. In fact, he is currently working on a garden bird bath. He has arrived at the College of Law with the desire to assist in expanding the intellectual property offerings, providing outreach to the university through symposiums, and providing intellectual property classes with campus-wide appeal. His teaching style, experience, and desire to build a regimen of intellectual property offerings are a welcome addition to the College of Law.

Don't Cheat; Escheat!

What Every Business Lawyer Ought to Know About Tennessee's Abandoned Property Laws

By: Joan MacLeod Heminway[1]

I. INTRODUCTION

Many business lawyers are unfamiliar with the nature and operation of state unclaimed property (a/k/a "escheat" or "abandoned property") laws.[2] Specifically, many business lawyers may not be aware that their clients are subject to the requirements of applicable state unclaimed property laws, despite the fact that those clients are surely holding abandoned property. Consequently, they may fail to advise their clients to file annual reports and pay or deliver property to the state as required. As a result, their clients may be subject to significant penalties and court proceedings for their failure to comply with applicable unclaimed property laws.

Unclaimed property has recently become a "hot topic" in the State of Tennessee because of an ongoing voluntary compliance plan, the *Tennessee Voluntary Compliance Program for Unclaimed Property* (the "Voluntary Compliance Program"), enacted in May 2001 and effective as of July 1, 2001.[3] The Voluntary Compliance Program may benefit individuals and entities that are not in compliance with the *State of Tennessee Uniform Disposition of Unclaimed Personal Property Act* (the "Unclaimed Property Act").[4] This article (A) summarizes key provisions of the Unclaimed Property Act, (B) illustrates the relevance and importance of the Tennessee abandoned property laws in the business law context, and (C) explains the coverage and operational aspects of the Voluntary Compliance Program. Although compliance programs may not be available to clients with filing and delivery requirements in other jurisdictions, unclaimed property laws are equally important and relevant to business practice in those other jurisdictions.

II. AN EXAMPLE INVOLVING YOUR CLIENT

Your client, a Tennessee corporation with 1,000 employees, acquired another Tennessee corporation in a cash merger about a year ago. Your client acted as paying agent for the merger, and the client's Chief Financial Officer (the "CFO") has just rendered to the client's management a report on its payment activities. The report shows that five former shareholders of the acquired corporation (all of whom have record addresses in Tennessee) have not yet claimed their merger proceeds.[5]

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[1] Professor Heminway is an Associate Professor of Law, The University of Tennessee College of Law. Prior to joining the faculty of the College of Law in the fall of 2000, Professor Heminway was Counsel (specializing in mergers and acquisitions and securities law) in the Boston office of Skadden, Arps, Slate, Meagher & Flom LLP.

[2] As a technical matter, escheat statutes are more limited in scope than unclaimed property statutes and cover only the "[r]eversion of property (esp. real property) to the state upon the death of an owner who has neither a will nor any legal heirs." Black's Law Dictionary 564 (7th ed. 1999). The term "abandoned property" also may be seen to have a more limited meaning than the term "unclaimed property" (implying a voluntary abdication). *Id.* at 1223. In practice, however, unclaimed property statutes are frequently referred to as escheat or abandoned property statutes.

[3] 2001 Tenn. Pub. Acts 231. The Division of Unclaimed Property of the Treasury Department of the State of Tennessee (the "Division") sent written notice of the voluntary compliance program to Tennessee licensed attorneys and certified public accountants by U.S. mail in July 2001.

[4] Tenn. Code Ann. §§ 66-29-101 to -153 (2001).

[5] A shareholder generally would claim merger proceeds by returning to the paying agent a letter of transmittal (distributed to the shareholder by U.S. mail after the effective time of the merger) accompanied by the shareholder's certificate(s) representing shares of the acquired corporation held of record by the shareholder at the effective time of the merger. This article does not cover the way in which paying agent accounts should be established or maintained. Acquirors are well advised to consult with their accountants and counsel on this matter.

Moreover, the CFO reports to you that your client (the same one) routinely receives back, by return mail, uncashed dividend checks (as well as other corporate mail) marked "undeliverable."[6] Some of the intended recipients have record addresses in Tennessee; some have record addresses in other U.S. states (specifically, Florida, North Carolina, Rhode Island, and Virginia). The CFO tells you that the client is in possession of returned checks dated as many as ten years ago. The CFO has good intentions of attempting to find these shareholders, but she has not yet gotten around to it. She also has records that report uncashed dividend checks for other shareholders, with respect to whom or which the client has received no mail returned as undeliverable, for the same ten-year period.

In light of the foregoing, the CFO comes to you with the following questions:

A. *Is it unlawful for the client to continue to hold, in its own account and on an indefinite basis, the unclaimed merger proceeds and the cash underlying the returned and uncashed dividend checks?*

B. *If so, what must the client do with the unclaimed merger proceeds and the cash underlying the returned and uncashed dividend checks to bring them into compliance with applicable unclaimed property laws?*

C. *Regardless of whether it may continue to hold the money in its own account, what obligations does the client have with respect to the unclaimed merger proceeds and the cash underlying the returned and uncashed dividend checks?*

What should your advice be for the CFO? Can a corporation continue to hold unclaimed cash or other property to which a shareholder or other creditor is entitled? To answer these questions, you must know the basic elements of the Unclaimed Property Act[7] and the related regulations.[8]

III. BASIC ELEMENTS OF THE UNCLAIMED PROPERTY ACT

Each business association, as well as other individuals and entities,[9] must file with the Treasurer of the State of Tennessee (the "State Treasurer") an annual report of all abandoned property held by it and, in most cases, simultaneously must pay or deliver to the State Treasurer all unclaimed funds and intangible property set forth in the report.[10] The report must be filed each year before May 1 with respect to property held as of December 31 of the previous year.[11] Prior to submitting the report, the abandoned property holder is required to send written notice to

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[6] This frequently occurs when the recipient shareholder has died (in the case of an individual), liquidated (in the case of an entity), or changed his, her, or its mailing address and has neither filed a forwarding order with the U.S. Postal Service nor filed a change of address with the client. Forced address changes, including those prompted by 911 address change ordinances, also contribute to this problem.

[7] Tenn. Code Ann. §§ 66-29-101 to -153.

[8] Tenn. Comp. R. & Regs. 1700-2-1-.01 to -.37 (2001).

[9] The reporting and delivery requirements of the Unclaimed Property Act apply to any "person," defined to include "any individual, business association, government or political subdivision, public corporation, public authority, estate, trust, two or more persons having a joint or common interest, or any other legal or commercial entity, whether such person is acting in such person's own right or in a representative or fiduciary capacity." Tenn. Code Ann. § 66-29-102(8) (2001). For purposes of the Unclaimed Property Act, a "business association" is a "corporation (other than a public corporation), joint stock company, business trust, partnership cooperative, or any association for business purposes of two or more individuals." *Id.* § 66-29-102(2). The rules promulgated under the Unclaimed Property Act set forth a nonexclusive list of reporting persons, which includes "businesses, corporations, partnerships, associations and other business organizations and firms employing twenty-five (25) or more persons." Tenn. Comp. R. & Regs. R. 1700-2-1-.01(1)(e) (2001). Accordingly, "business organizations and firms" employing less than 25 persons are not required to file abandoned property reports under the Unclaimed Property Act. *Id.*

[10] Tenn. Code Ann. §§ 66-29-113, -115(a) (2001). The property holder also may be required to later deliver tangible property to the State Treasurer. *Id.* § 66-29-115(b). Funds paid or property delivered to the State Treasurer "include[s] all interest, dividends, increments, and accretions due, payable, or distributable . . . ." *Id.* § 66-29-115(d).

[11] *Id.* § 66-29-113(d). Certain holders, including banking or financial organizations, life insurance companies, and utility companies, are required to make a filing with the State Treasurer every year, regardless of whether they held reportable abandoned property at the end of the year for which the report is due. Tenn. Comp. R. & Regs. 1700-2-1-.07 (2001).

the abandoned property owner, at the owner's last known address, notifying the owner that the holder is in possession of abandoned property under the Unclaimed Property Act.[12]

A. TYPES OF UNCLAIMED PROPERTY

Under the Unclaimed Property Act, many types of unclaimed funds and other property held by business associations may be presumed to be abandoned property. Examples of unclaimed property include:

1. refunds ordered by a court or administrative agency that (a) remain unclaimed by the owner for more than two years or (b) are payable to an owner known to the holder to have died and left no legal heirs (by will or by intestate succession);[13]

2. funds or other property (including, without limitation, securities) "held or owing by a business association for or to a shareholder, certificate holder, member, bondholder, or other security holder, or a participating patron of a cooperative" who or which neither claims against nor corresponds with the business association concerning the funds or other property within five years after the prescribed payment or delivery date of those funds or property;[14]

3. funds or other property described immediately above if payable or distributable to an owner known to the holder to have died and left no legal heirs (by will or by intestate succession);[15]

4. intangible personalty distributable in a business association dissolution or liquidation that remains unclaimed by the owner after the final distribution or liquidation date;[16]

5. "property . . . held in a fiduciary capacity for the benefit of another" if the owner has not, within five years of the date on which the property becomes payable or distributable, (a) increased or decreased principal, (b) accepted a principal or income payment, (c) corresponded in writing about the property, or (d) otherwise indicated an interest in the property (as documented in a memorandum on file with the fiduciary);[17] and

6. other property (not including layaway accounts held by retailers) " . . . held or owing in the ordinary course of the holder's business" that (a) remains unclaimed by the owner for more than five years after it became payable or distributable or (b) is payable or distributable to an owner known to the holder to have died and left no legal heirs (by will or by intestate succession).[18]

B. JURISDICTIONAL BASIS

In order for abandoned property to be subject to the custody of the State of Tennessee under the Unclaimed Property Act, as opposed to another jurisdiction's abandoned property laws, Tennessee must have a jurisdictional claim to the property. Among the possible statutory bases for such a claim are:

1. the last known address of the owner being in the State of Tennessee;

2. the holder being a domiciliary of the State of Tennessee, when combined with other facts (*e.g.*, (a) the holder has never made a payment or delivery to the owner in the state of the owner's last known address, (b) the last known

[12] Tenn. Code Ann. § 66-29-113(e) (2001) (written notice must be sent not more than 120 days or less than 60 days before filing the annual report). Effective as of July 1, 2001, holders of unclaimed property must file with each annual report an affidavit stating that the holder has complied with these requirements. *Id.* § 66-29-113(f). No notice is required (i) for property with a value of less than $50 and (ii) unless the property holder has a record address for the property owner that the holder's records do not "disclose to be inaccurate." *Id.* *See also* Tenn. Comp. R. & Regs. 1700-2-1-.19 (2001).

[13] Tenn. Code Ann. § 66-29-106(a)(2) (2001).

[14] *Id.* § 66-29-107.

[15] *Id.*

[16] *Id.* § 66-29-108.

[17] *Id*. § 66-29-109.

[18] *Id.* § 66-29-112.

address of the owner is in a state that has no applicable abandoned property law, or (c) the last known address of the owner is in a foreign nation); and

3. the transaction out of which the property arose occurring in the State of Tennessee, when combined with (a) the fact that the last known address of the owner either is unknown or is in a state that has no applicable abandoned property law and (b) the fact that the holder is a domiciliary of a state that has no applicable abandoned property law.[19]

In addition, Tennessee has reciprocal arrangements with certain other states that allow a holder of unclaimed property to include in its annual Tennessee unclaimed property report all property that is subject to the abandoned property laws of that reciprocal state.[20] Tennessee then forwards the property to the reciprocal state.[21]

Once a holder pays or delivers property to the State Treasurer under the Unclaimed Property Act, the holder no longer is liable for any claim made by the owner in respect to the property, up to the value of the paid or delivered property.[22] Property owners may file claims to recover abandoned property with the State Treasurer.[23] Alternatively, a holder who or which has paid unclaimed funds to the State Treasurer may pay the property owner in settlement of a claim to those funds. If the owner appears to be entitled, the State Treasurer will subsequently reimburse the holder for that payment upon proof of both the payment and the owner's entitlement thereto.[24]

C. THE STATE TREASURER'S RULEMAKING POWER

The State Treasurer has a number of enforcement powers under the Unclaimed Property Act. For example, the State Treasurer may audit an individual's or entity's records, at reasonable times and after reasonable notice, if the State Treasurer has reason to believe the individual or entity has not complied with the Unclaimed Property Act's reporting requirements.[25] In addition, the State Treasurer may bring a court action to compel delivery of abandoned property that a holder refuses to deliver to the State Treasurer as required under the Unclaimed Property Act.[26] The State Treasurer also has the power and authority to assess civil penalties against holders who or which fail to comply with the Unclaimed Property Act's filing or delivery requirements.[27]

In addition to the State Treasurer's enforcement powers, the State Treasurer is authorized by statute "to make necessary rules and regulations to carry out the provisions of [the Unclaimed Property Act]."[28] The State Treasurer has used this authority to adopt rules that, among other things:

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[19] Tenn. Code Ann. § 66-29-103 (2001).

[20] State of Tennessee, *2001 Uniform Disposition of Unclaimed Property Act Reporting Package at 4 instruction III.D. (visited* October 22, 2001*), available at* http://www.treasury.state.tn.us/unclaim.

[21] *Id.* Currently, the Reporting Package indicates reciprocity arrangements with Arkansas, Florida, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, Rhode Island, Virginia, and Washington. *Id.*

[22] Tenn. Code Ann. § 66-29-116 (2001). *Cf.* Tenn. Comp. R. & Regs. 1700-2-1-.19 (2001).

[23] Tenn. Code Ann. § 66-29-123 (2001).

[24] *Id.* § 66-29-116.

[25] *Id.* § 66-29-127(a).

[26] *Id.* § 66-29-128. Subject to certain exceptions (including, without limitation, fraud), the action may not be brought more than 10 years after the holder of the abandoned property files a report for the period in which the property is reportable or gives notice to the State Treasurer of a dispute regarding the property. *Id.* § 66-29-118(b).

[27] The State Treasurer may assess a fine of $25 per day (up to a maximum of $1,000) for each annual failure (after notice) to report any unclaimed property or perform other duties under the Unclaimed Property Act. Tenn. Code Ann. § 66-29-129(a) (2001). The State Treasurer is statutorily obligated (except in the case of a *de minimis* lapse–a failure to pay or deliver property with a value of less than 10% of reportable property–in a particular year) to assess an annual penalty of 10% of the value of any abandoned property not paid or delivered to the State Treasurer as required, with the aggregate penalty amount not to exceed the lesser of 25% of the value of the property or $50,000. *Id.* § 66-29-129(b)(1). Penalties may exceed these caps in circumstances where the state has paid a fee for identifying or collecting the unpaid or undelivered property that exceeds the statutory cap.

[28] Tenn. Code Ann. § 66-29-130 (2001).

1. provide more details on reporting entities, individuals, and procedures;[29]
2. clarify when certain property is considered to be abandoned;[30]
3. identify the "owner" of particular property;[31]
4. define in greater detail the pre-filing "due diligence" duties of holders of abandoned property;[32] and
5. describe with greater specificity the obligation of the holder to deliver unclaimed property to the State Treasurer.[33]

IV. YOUR CLIENT'S UNCLAIMED MERGER CONSIDERATION AND DIVIDEND FUNDS

With this knowledge (and a small amount of additional information that you can obtain from the client), you should be able to answer the questions posed to you by your client's CFO.

A. *Is it unlawful for the client to continue to hold, in its own account and on an indefinite basis, the unclaimed merger proceeds and the cash underlying the returned and uncashed dividend checks?*

Yes, it is unlawful for the client to continue to hold, in its own account and on an indefinite basis, the unclaimed merger proceeds and the cash underlying the returned and uncashed dividend checks. Under the Unclaimed Property Act, if there has been no contact with the apparent recipient of merger proceeds or dividends for five years[34] and the recipient cannot be located after the exercise of due diligence,[35] the unclaimed funds are presumed abandoned. Under these circumstances, the client (a business association which has in excess of 25 employees) would be required to report the unclaimed funds[36] and pay those funds to the State Treasurer.[37] This does not appear to be an issue with respect to the merger proceeds (unless shareholders of the target corporation entitled to those proceeds already have been out of contact with the target corporation for five years, a fact that can be ascertained during acquisition due

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[29] Tenn. Comp. R. & Regs. 1700-2-1-.01 to -.08, 1700-2-1-.16 to -.18, and 1700-2-1-.37(1) (2001).

[30] *Id.* 1700-2-1-.11 (covering the abandonment of rollover certificates of deposit).

[31] *Id.* 1700-2-1-.12 (covering ownership of cashier's checks).

[32] *Id.* 1700-2-1-.19.

[33] *Id.* 1700-2-1-.20, -.37(2).

[34] *See* Tenn. Code Ann. § 66-29-112 (2001) (regarding merger proceeds); *Id.* § 66-29-107 (regarding dividends); Tenn. Comp. R. & Regs. 1700-2-1-.18 (2001) (regarding merger proceeds). Cash merger proceeds are best reported using NAUPA property type code SC07 or SC13; cash dividends are reported using NAUPA property type code SC01.

[35] Before filing its annual report of abandoned property, the holder must exercise due diligence to locate the owner. Tenn. Comp. R. & Regs. 1700-2-1-.19 (2001). "Due diligence" is defined in the regulations as "the degree of care which a reasonably prudent man would exercise in the normal course of business operations." *Id.* 1700-2-1-.19(1). Under the Unclaimed Property Act, no more than 120 days and no less than 60 days before the filing of its annual report of abandoned property, each holder of abandoned property is required to send written notice to the apparent owner of any abandoned property with a value of $50 or more at the owner's last known address (if the holder has a record address for the owner) informing the owner that the holder is in possession of property that is subject to the Unclaimed Property Act. Tenn. Code Ann. § 66-29-113(e) (2001). (Effective as of July 1, 2001, holders of unclaimed property must file with each annual report an affidavit stating that the holder has complied with these requirements. *Id.* § 66-29-113(f).) Return of a first-class or superior mailing sent to the owner's last known address constitutes evidence that the location of the holder is unascertainable. Tenn. Comp. R. & Regs. 1700-2-1-.19(1)(a) (2001). Ordinary business communications sent by first-class or superior mailings that are not returned as undeliverable constitute contact with the owner, and abandonment of the property therefore is not presumed. *Id.* 1700-2-1-.19(1)(b).

[36] Tenn. Code Ann. § 66-29-113 (2001); Tenn. Comp. R. & Regs. 1700-2-1-.01(1)(e) (2001) (clarifying that businesses, including corporations and partnerships employing 25 or more people are required to report abandoned property to the State Treasurer).

[37] Tenn. Code Ann. § 66-29-115(a) (2001).

diligence[38]) since the merger took place about a year ago. Accordingly, the client may continue to hold these funds in its account until they are paid out to the recipients or presumed abandoned. The client should, however, check its contact information with respect to the dividend checks and take any required actions (as described below) with respect to amounts that are presumed abandoned. Like the merger proceeds, unclaimed dividends that are not presumed abandoned may be retained by the client in its own account until they are claimed or become subject to the Unclaimed Property Act.

B. *If so, what must the client do with the unclaimed merger proceeds and the cash underlying the returned and uncashed dividend checks to bring them into compliance with applicable unclaimed property laws?*

To the extent that any of the uncashed dividend checks are presumed to be abandoned (because there has been no contact with the recipient for five years and the recipient cannot be located after the exercise of due diligence)[39] as of December 31, 2001, the client must file an abandoned property report with the State Treasurer before May 1, 2002 reporting the unclaimed dividends (as well as all other property presumed abandoned under the Unclaimed Property Act) held as of December 31, 2001.[40] That report may include any abandoned dividends owed to recipients with last addresses in Florida, North Carolina, Virginia, and Rhode Island, as well as recipients with last addresses in Tennessee.[41] At the same time, the client must pay the State Treasurer the aggregate amount of those unclaimed dividends.[42] Once the State Treasurer assumes custody of the unclaimed dividends, the client is relieved of its liability to pay the dividends to the recipients.[43] If the client pays to any recipient unclaimed dividends earlier paid to the State Treasurer under the Unclaimed Property Act, the State Treasurer is required to refund the client upon proof of payment and entitlement.[44] Otherwise, the recipient may file a claim to the unpaid dividends with the State Treasurer.[45]

C. *Regardless of whether it may continue to hold the money in its own account, what obligations does the client have with respect to the unclaimed merger proceeds and the cash underlying the returned and uncashed dividend checks?*

As to any unclaimed dividends presumed abandoned as of December 31, 2001, the client should send written notice, on or after January 1, 2002, and no later than March 1, 2002, to each dividend recipient with reportable unclaimed dividends of $50 or more, informing the recipient that the client is in possession of unclaimed dividends that are subject to the Unclaimed Property Act.[46] As to all unclaimed funds, including the merger proceeds and any unclaimed dividends not yet presumed abandoned, it is important that the client keep detailed records of the following (at a minimum):

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[38] *See also infra* note 51, regarding acquisition due diligence. This article assumes that none of the recipients of unclaimed merger proceeds have been out of contact with the target corporation.

[39] *See supra* notes 34 and 35.

[40] Tenn. Code Ann. § 66-29-113(d) (2001). Early reporting is permitted. Tenn. Comp. R. & Regs. 1700-2-1-.08 (2001).

[41] Tennessee has a reciprocal arrangement under which Tennessee has agreed to forward property to each of these states. State of Tennessee, *2001 Uniform Disposition of Unclaimed Property Act Reporting Package* at p. 4 instruction III.D. (*visited* October 22, 2001), *available at* http://www.treasury.state.tn.us/unclaim.

[42] Tenn. Code Ann. § 66-29-115(a) (2001). The State Treasurer has statutory authority to bring a court action to compel the required payment if payment is not made as required. *Id.* § 66-29-128.

[43] Tenn. Code Ann. § 66-29-116 (2001).

[44] *Id. Cf.* Tenn. Comp. R. & Regs. 1700-2-1-.23 (2001) (a holder is to be reimbursed for payment made "upon receipt of a photocopy, front and back, of the cancelled check issued to the recipient along with information identifying the type of property and the date it was delivered to the Treasurer"). Because the State Treasurer is only required to reimburse holders for property not previously returned to the owner by the State Treasurer, holders are best advised to ensure that the State Treasurer has not already paid the claiming owner before payment is made directly by the holder to the owner. *Id.*

[45] *Id.* § 66-29-123.

[46] *Id.* § 66-29-113(e). *See supra* note 35 for procedural details.

1. the name and last known address of each person who appears, from the client's records, to be the apparent recipient of the unclaimed funds;[47]

2. the amount and nature of, and any identifying number associated with, the unclaimed funds;[48] and

3. the date when the unclaimed funds became payable and the date of the last transaction with the apparent recipient with respect to the unclaimed funds.[49]

These records will enable the client to know when to report unclaimed funds to the State Treasurer, to know what to report when it is holding funds that are presumed abandoned, and to respond to an audit of its records by the State Treasurer, if necessary.[50]

V. CURRENT NONCOMPLIANCE IS NOT A CAUSE FOR ALARM IF APPROPRIATE ACTION IS TAKEN SOON

Perhaps, before reading this article, you were unfamiliar with abandoned property laws in general, or the Unclaimed Property Act in particular, and have not provided your clients with correct and appropriate legal advice. Do not despair; do not panic. Regardless of whether your client has previously filed any reports with the State Treasurer under the Unclaimed Property Act, your client can still avail itself of a waiver of civil penalties if the client takes *all* of the actions set forth below on or before May 1, 2002.[51]

A. Obtain and review the State Treasurer's official reporting package and follow the included instructions;[52]

B. Comply with all statutory and regulatory due diligence requirements within the statutory period;[53] and

C. Report and pay or deliver to the State Treasurer all unclaimed property required to be reported or delivered in the State of Tennessee.[54]

A holder of abandoned property is best advised to file an accurate and complete report and pay or deliver the reported cash and intangibles as soon as practicable after completing the statutorily required due diligence in order to trigger commencement of a recently adopted 10-year statute of repose.[55] Also, it is important to note that, absent

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[47] *See* Tenn. Code Ann. § 66-29-113(b)(1) (2001) (requiring this information to be reported to the State Treasurer for all property presumed abandoned and having a value of at least $50). A holder may voluntarily submit this information to the State Treasurer for amounts under $50, thereby likely limiting its record keeping responsibilities to 10 years after the property becomes reportable. *Cf. id.* § 66-29-113(h) (requiring a 10-year holding period for property-owner names and last known addresses where reports are required to be filed).

[48] *See id.* § 66-29-113(b)(3) (requiring this information to be reported to the State Treasurer for all property presumed abandoned and having a value of at least $50).

[49] *See id.* § 66-29-113(b)(4) (requiring this information to be reported to the State Treasurer for all property presumed abandoned and having a value of at least $50).

[50] *See id.* § 66-29-127 (permitting the State Treasurer to examine records at reasonable times and upon reasonable notice).

[51] Tenn. Code Ann. § 66-29-129(c) (2001). The State Treasurer has the ability to extend the voluntary compliance period to May 1, 2003. *Id.* It is important to note that a number of acquirors of businesses have become savvy about abandoned property laws. In many cases, significant noncompliance with abandoned property laws, once discovered in due diligence, delays execution of an acquisition agreement or consummation of the transaction. Attuned acquirors do not want to acquire massive liability for abandoned property fines and penalties and, accordingly, often will insist that the target entity settle its abandoned property matters with the relevant state unclaimed property authorities *before* agreeing to acquire, or completing an acquisition of, the target entity.

[52] The 2001 reporting package is available in html format through the Web site for the Unclaimed Property Division of the Treasury Department of the State of Tennessee at http://www.treasury.state.tn.us/unclaim. The package for 2002 is expected to be available in or before December 2001.

[53] *See supra* note 35.

[54] *See supra* notes 13-18.

[55] Tenn. Code Ann. § 66-29-118(b) (2001).

separate action taken by states having reciprocal arrangements with Tennessee, the penalty waiver is not available for property voluntarily surrendered to Tennessee for those reciprocal states.[56]

VI. ADDITIONAL INFORMATION

Frequently, it is difficult to make determinations as to (A) whether particular funds, other intangibles (including securities), or tangible property are presumed abandoned under the Unclaimed Property Act, (B) whether a particular business or organization is subject to the requirements of the Unclaimed Property Act (and, if so, to which requirements of the Unclaimed Property Act it is subject), and (C) how to comply with the procedural requirements for due diligence, filings, and deliveries under the Unclaimed Property Act. Moreover, the Voluntary Compliance Program is newly minted and substantially untested. This article merely touches on a few key points of the law and regulations in these areas.

Fortunately, additional information regarding the Unclaimed Property Act and the Voluntary Compliance Program is available through the Division. The Division has a comprehensive web site at http://www.treasury.state.tn.us/unclaim. When last visited, the front page of the site included links to the most current reporting package, frequently asked questions, applicable laws and regulations (including new legislation) and information regarding the recovery of abandoned property by property owners. In addition, holders of abandoned property can reach the Division by telephone at 615-253-5362 or by U.S. mail at Unclaimed Property Division, P.O. Box 198649, Nashville, Tennessee 37219-8649. These resources will better inform you in handling specific facts regarding your client's retention, reporting, and delivery of unclaimed property.

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[56] *See id.* § 66-29-129(c) (indicating that penalty waiver is available for failures "to render any report or perform other duties required under [the Unclaimed Property Act]"). Tennessee's reciprocity arrangements, which consist of contracts between the State of Tennessee and the reciprocal states, permit holders to comply with certain of their unclaimed property duties and obligations under the laws of the reciprocal states by making filings and deliveries in the State of Tennessee.

Tennessee Nonprofit LLCs—A New Option for Tax-Exempt Organizations

By: James M. McCarten and Kevin N. Perkey[1]

Tax-exempt organizations frequently rely on complex organizational structures to undertake new activities. A tax-exempt parent organization is able to protect its tax-exempt status and shield itself from state law liability claims that may be inherent in the new activity by administering new projects through controlled, but separate, entities. For example, a charitable organization may use a non-charitable, tax-exempt subsidiary when the charitable organization wants to undertake legislative or lobbying activities that cannot be engaged in by a section 501(c)(3) tax-exempt organization.[2] Furthermore, tax-exempt organizations may use controlled subsidiaries when they wish to isolate state law liability or federal unrelated business income risks associated with a particular activity.

For many years, tax-exempt organizations were limited to utilizing the corporate form for their controlled subsidiaries. However, with the advent of the limited liability company (the "LLC"), tax-exempt entities and their Certified Public Accountant (the "CPA") and attorney advisers were given another option with regard to their choice of entity decisions. In fact, LLCs have become a common reorganization vehicle for exempt organizations for many of the same reasons that for-profit activities were placed in LLCs. The LLC, a very flexible organizational structure, offers tax-exempt organizations the pass-through tax treatment of partnerships with the liability protection accorded to corporations. Historically, tax-exempt organizations have found LLCs useful in structuring joint venture arrangements with other exempt organizations, and even with profit-motivated organizations. Now, LLCs also allow for easier insulation of the assets of one or more activities from potential liabilities that might exist in another, completely separate, exempt activity.

The primary advantage of the LLC structure is its tax simplicity. Under the "check-the-box" regulations, a single-member LLC is disregarded as a separate entity from its owner unless the owner affirmatively elects corporate tax treatment.[3] This also holds true in the exempt organization context.[4] Therefore, only one Form 990 (the return required for tax-exempt entities) must be filed, eliminating the time and expense of preparing multiple returns.

A second advantage for a tax-exempt organization considering an LLC subsidiary is that by forming an LLC, the activity placed in the LLC is recognized as a tax-exempt activity by the Internal Revenue Service (the "IRS") without further filings or costs. Alternatively, if the activity is placed in a new nonprofit subsidiary corporation, the new entity must file a Form 1023 or Form 1024 to receive exempt status. The IRS estimates that the time necessary for (i) proper recordkeeping; (ii) familiarizing oneself with the relevant law; and (iii) preparing and filing the required form, may

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[2] *See* 26 U.S.C. § 501(c)(3) (1994).

[3] Treas. Reg. § 301.7701-3(b)(1)(ii) (2001).

[4] *See, e.g.*, Announcement 99-102, 1999-43 I.R.B. 545 (changing the instructions to Form 990, Form 990-EZ, Form 990-T, and Form 990-PF to clarify that an exempt organization's single-member LLC is to be treated as a branch or division of the exempt organization; it is disregarded for federal tax purposes).

exceed eighty (80) hours depending upon the type of tax-exempt organization formed and the category under which the new entity attempts to qualify for exempt status.[5] However, if the activity is placed in a single-member LLC, the exempt organization saves the significant accounting and legal fees involved in filing such an application. The tax-exempt organization further saves money by not paying the user fee charged by the IRS to process the application. The time saved from not filing additional Forms 1023 or 1024, combined with the savings from the accounting, legal, and user fees, easily justifies an exempt organization's decision to create an LLC subsidiary rather than another business entity.

A third advantage for a tax-exempt organization forming a subsidiary nonprofit LLC is the flexibility allowed in structuring the nonprofit LLC. Compared to the rigidity of the corporate form, an LLC offers the tax-exempt parent the opportunity to choose the governance structure that most effectively meets its needs. For example, a tax-exempt organization can choose to (i) retain direct management of the LLC by creating a member-managed LLC; (ii) give up most direct control over the LLC by vesting management in a board of governors; or (iii) select those aspects from either management form that best suits its needs. If the LLC's operations will be relatively small, the parent organization's and the LLC's functions will be relatively similar, or, if the parent organization does not want to yield control, the member-managed form may be the best choice. Because the parent organization would be the single member of the newly formed LLC, the parent's board of directors would have complete control over the LLC's actions. Alternatively, if the LLC's operations will be of a significant size or if the LLC's focus will be substantially different from the parent, such that the parent's board of directors lacks the requisite skill to prudently manage the LLC, the parent organization might choose a board-managed governance form for the LLC. In this case, the parent organization can determine the board's level of independence and appoint governors to bear the majority of management responsibility.

Suppose that a tax-exempt organization client has decided that it would like to take advantage of the opportunity to isolate the liabilities associated with a new endeavor, as well as provide for a less rigid management structure. For example, a tax-exempt organization might wish to pursue a new activity, but it is not sure that the effort can be self-supporting. Does your legal analysis end with the impact of Announcement 99-102? Can that new LLC be organized as a single-member LLC and limit the parent organization's liabilities with regard to these new activities? From a federal standpoint, the answer is a resounding "yes!" Unfortunately, state law consequences must also be considered before the final decision is made to proceed with such a restructuring. Although raising sufficient funds to support its charitable activities is a vital consideration for a tax-exempt organization, one of the most important considerations is the ability to attract and maintain qualified officers, directors and/or governors interested in furthering the tax-exempt organization's mission. When tax-exempt LLCs approach potential governors, the candidates will almost always consider the lack of statutory immunity from personal liability and/or the lack of mandatory indemnification if any claims are brought against them as a significant problem in deciding whether or not to serve. Whereas most state nonprofit corporate statutes provide that directors of a nonprofit corporation are immune from suit except when the director's conduct amounts to willful, wanton, or gross negligence, no such protection exists for governors of LLCs. However, as will be discussed below, the NonProfit Limited Liability Company Act of 2001 (the "Nonprofit LLC Act")[6] provides governors of Tennessee nonprofit LLCs with immunity protection similar to the protection granted to nonprofit corporate directors. A similar concern to potential officers, directors, and governors is whether, and to what extent, the entity can indemnify an officer or governor. In general, the indemnification available to officers, directors and/or governors under nonprofit corporate statutes is much more protective than that found in most states' LLC statutes. This issue will become even more important when the exempt organization using the LLC is moving into a new geographic area and wishes to gain local support by establishing a local governing board.

Another potential issue of concern is the availability of property tax exemptions. Even though a single-member LLC is disregarded for federal tax purposes, and often for state income and franchise tax purposes as well, it remains a separate legal entity under state law, and the LLC's separate existence will be recognized for purposes of other state

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[5] Tenn. Code Ann. § 48-101-701 to -708 (2001).

[6] I.R.S. Form 1023, Instructions (September 1998).

taxes. For example, if a state's property tax laws provide an exemption for nonprofit organizations, and if that state law does not recognize a nonprofit LLC, the tax exemption might not apply and the LLC could be subject to property taxes.

In addition to potential property tax issues, sales tax exemptions must also be considered. Again, because the LLC is a separate and distinct entity for state law purposes, the LLC will most likely be required to separately register for sales and use tax purposes. Whether or not the LLC will qualify for exemption from the sales and use tax will depend on state law. Many state sales tax statutes require that the entity be organized as a "nonprofit" under state law, or have received a determination of exemption under section 501 of the Internal Revenue Code; therefore, the LLC will likely fail to qualify for the exemption because it has neither been organized as a nonprofit nor received its own determination letter from the IRS. Given the current budget crisis facing many states, including Tennessee, it is unlikely that the parent organization's sales tax exemption would be extended to the LLC.

Few states recognize LLCs as nonprofit entities. Thus, if there is no such creature under state law, the advantages to the parent tax-exempt organization as discussed above are all but lost. Fortunately for Tennessee tax-exempt organizations and their counsel, the Tennessee Legislature recently passed legislation permitting the establishment of nonprofit LLCs. The Nonprofit LLC Act allows nonprofit corporations, foreign or domestic, to organize nonprofit LLCs that will provide tax-exempt organizations with simplicity, flexibility, adaptability, and isolation from state law liability claims.

A nonprofit corporation creates a nonprofit LLC by filing articles of organization for the LLC with the Office of the Secretary of State.[7] The LLC must be a single-member LLC and the nonprofit corporation (the parent tax-exempt organization) must be the single member.[8] The articles of organization must prominently designate the LLC as a nonprofit LLC organized under the Nonprofit LLC Act and must provide that the LLC is disregarded as an entity for federal income tax purposes.[9]

In the event that a tax-exempt organization (the "parent nonprofit") has previously formed a nonprofit subsidiary corporation (the "subsidiary nonprofit") as a member organization because nonprofit LLCs were not available at the time that the subsidiary nonprofit was formed, the subsidiary nonprofit may be converted into a nonprofit LLC if certain requirements are met.[10] First, the board of directors of both the subsidiary nonprofit and the parent nonprofit must approve the terms and conditions of the conversion.[11] Second, the subsidiary nonprofit must file articles of conversion with the secretary of state designating the LLC as a nonprofit LLC.[12] The articles of conversion must contain the name and address of the former subsidiary nonprofit, a statement that provides that the subsidiary nonprofit was converted to an LLC, and a statement that the terms and conditions of the conversion have been approved by the board of directors of both the subsidiary nonprofit and the parent nonprofit.[13] Once each of these requirements are met, (i) the conversion of the nonprofit subsidiary to a nonprofit LLC is effective when the articles of conversion are filed or at any later date within ninety (90) days from filing; (ii) the articles of conversion will "be deemed to be a certificate of cancellation for the subsidiary nonprofit[;]" and (iii) the conversion will "be deemed to constitute a dissolution" of the subsidiary nonprofit.[14]

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[7] Tenn. Code Ann. § 48-101-704 (2001).

[8] *Id.*

[9] *Id.*

[10] *Id.* § 48-101-707(a).

[11] *Id.* § 48-101-707(b).

[12] *Id.* § 48-101-707(c).

[13] Tenn. Code Ann. § 48-101-707(c) (2001).

[14] *Id.* § 48-101-707(d) & 708(b).

Generally, a nonprofit LLC is subject to the provisions of the Tennessee Limited Liability Company Act (the "LLC Act").[15] However, the Nonprofit LLC Act contains a significant departure from the LLC Act with regard to its immunity and indemnification provisions. As previously discussed, one of the most important considerations for the officers and/or board members of a tax-exempt organization is the organization's provisions for statutory immunity from personal liability and/or indemnification if any claims are brought against them. In most state LLC statutes, including the Tennessee LLC Act, officers and/or governors of a single-member LLC are afforded very little personal protection for their official acts.[16] Nevertheless, most states have nonprofit corporate statutes providing that directors of nonprofit corporations are immune from suit, except where the director's conduct amounts to willful, wanton, or gross negligence.[17] Rather than apply the immunity and indemnity provisions of the LLC Act, the Nonprofit LLC Act grants the governors and managers of nonprofit LLCs the same immunity and indemnification granted to directors, officers, trustees, and members of nonprofit corporations. This immunity and indemnification increases the likelihood that qualified individuals will be interested in serving as governors of a nonprofit LLC.[18] In addition, the indemnification provisions that apply to directors, officers, employees, and agents of nonprofit corporations apply to the governors, managers, employees, and agents of the nonprofit LLC.[19]

Now that the Tennessee Legislature has created the opportunity for tax-exempt organizations to form a single-member, nonprofit LLC, many Tennessee tax-exempt organizations should explore the potential advantages of this new entity. Nonprofit LLCs offer a simplified form of doing business and significantly reduce the costs associated with ensuring that the activities are treated as tax-exempt for federal tax purposes. However, as with any other business decision, a nonprofit LLC should not be formed without fully exploring the federal and state tax consequences as well as the non-tax, state law consequences of the decision.

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[15] *Id.* §§ 48-201-101 to 48-248-606.

[16] *See, e.g., id.* § 48-239-115 (providing automatic limitation of liability where a governor has acted in good faith or in reliance of reports, but requiring the LLC to affirmatively grant other limitations subject to certain restrictions).

[17] *See, e.g., id.* § 48-58-601 (granting limitation of actions and immunity while recognizing that "the services of nonprofit boards are critical to the efficient conduct and management of the public and charitable affairs of the citizens of this state.").

[18] *See id.* § 48-101-705(c).

[19] *See* TENN. CODE ANN. § 48-101-705(b) (2001).

Material Adverse Change Clauses Following the *Tyson* Decision

By: Bradley D. Peters[1]

I. INTRODUCTION

Material adverse change clauses ("MACs") are an important portion of all merger agreements and should be highly negotiated. These clauses allow the parties to a merger to terminate the merger should a "material adverse change" occur. The recent *Tyson* decision[2] was a landmark case in the field of mergers and acquisitions ("M&A"), raising questions about how MACs should be drafted and about the remedies granted to merger targets that sue to enforce merger agreements. This article discusses the evolving interpretations of MACs and other issues related to mergers. It begins with a discussion of the *Tyson* decision, briefly discusses other related case law, and makes practical drafting suggestions, including ones that have developed following the September 11 attacks on the World Trade Center and the Pentagon.

II. *TYSON* DECISION

A. Brief Facts of *Tyson*

The merger between IBP, Inc. ("IBP"), a leading beef and pork distributor, and Tyson Foods, Inc. ("Tyson"), a leading poultry distributor, was the result of a bidding contest between Tyson and Smithfield Foods, another major meat distributor.[3] Tyson believed an IBP/Tyson merger would produce synergies that would transform the company into the world's leading meat company. Thus, Tyson did not want Smithfield Foods to acquire IBP.[4]

During the bidding process, Tyson learned some troubling facts about IBP.[5] These troubling facts included questions about earnings projections, management credibility, and serious accounting fraud issues with one of its subsidiaries.[6] However, this information did not dampen Tyson's enthusiasm for the merger.[7] In fact, Tyson actually increased its bid by four dollars per share after disclosure of this information and spoke glowingly to its shareholders and the financial community about the merger.[8] The merger agreement was signed on January 1, 2001, and shareholders approved the merger later that month.[9]

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[2] In re IBP, Inc. S'holders Litig. v. Tyson Foods, Inc, Civ. A. No. 18373, 2001 Del. Ch. LEXIS 81, 2001 WL 675330 (Del. Ch. June 18, 2001).

[3] *Id.*, 2001 Del. Ch. LEXIS 81 at *2-3, 2001 WL 675330 at *1.

[4] *Id.*

[5] *Id.*, 2001 Del. Ch. LEXIS 81 at *3, 2001 WL 675330 at *1.

[6] *Id.*

[7] *Id.*, 2001 Del. Ch. LEXIS 81 at *3-4, 2001 WL 675330 at *1.

[8] *IBP*, 2001 Del. Ch. LEXIS 81 at *4, *71-72, 2001 WL 675330 at *2, *23. Tyson's CEO stated the combination of Tyson and IBP would become "the world's premier protein provider." At the same time, the CEO demonstrated that he understood the downside of the acquisition when he stated that his company was purchasing IBP "fully aware of the cyclical factors that affect commodity meat products." *Id.* (emphasis omitted).

[9] *Id.*, 2001 Del. Ch. LEXIS 81 at *4, 2001 WL 675330 at *2.

The first quarter of 2001 proved to be a poor quarter for both companies due to a bad winter.[10] Tyson began having "buyer's regret" and became concerned about the price it had agreed to pay in light of the slow 2001 earnings posted by both companies.[11] Soon thereafter, Tyson attempted to terminate the merger with a letter that cited various theories, none of which involved a MAC argument.[12] Following the attempted termination, IBP initiated litigation to specifically enforce the merger.[13]

New York law governed the merger agreement. The opinion discusses in great depth the different burdens of proof in New York and Delaware, two important states to the M&A field.[14] In specific performance actions, New York law requires the petitioner to prove its claim by a preponderance of the evidence while Delaware requires clear and convincing evidence.[15] Conversely, in rescission actions, New York requires that fraud be proven by clear and convincing evidence, while Delaware requires a less demanding showing of a preponderance of the evidence.[16] This distinction, and the parties' choice of New York law, slanted the playing field in favor of IBP by making it easier to obtain specific performance and more difficult for Tyson to prove fraud.[17]

B. Resolution of the Issues

1. Was Termination Justified on the Basis of a Material Adverse Change?

Tyson argued several theories as justification for the termination of the merger, but this article will focus solely on Tyson's MAC[18] theory.[19] It should be noted that throughout the opinion, "bad facts" plagued Tyson. Many of these "bad facts," however, were products of Tyson's own questionable decisions.

The MAC clause was very sweeping and lacked many seller-friendly exclusions that are typically included in such clauses.[20] The contract allowed Tyson to terminate the merger on the occurrence of "any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect . . . on the condition (financial or otherwise), business, assets, liabilities or results of operations of IBP and its Subsidiaries taken as whole . . . ."[21]

Tyson first argued that IBP's poor first quarter was a material adverse affect.[22] While the clause as drafted would appear to encompass this type of cyclical business downturn, the court chose to read the clause more narrowly.[23] The court discussed materiality in two different contexts. First, the court stated that the average speculator might sell a stock after a bad quarter of earnings.[24] The court then differentiated such speculators from acquirors of companies

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[10] *Id.* "[A] severe winter . . . adversely affected livestock supplies and vitality." *Id.*

[11] *Id.*, 2001 Del. Ch. LEXIS 81 at *5, 2001 WL 675330 at *2.

[12] *Id.*, 2001 Del. Ch. LEXIS 81 at *89, 2001 WL 675330 at *29. The letter stated fraudulent inducement and theories relating to the accounting fraud at the IBP subsidiary. *Id.*

[13] *Id.*, 2001 Del. Ch. LEXIS 81 at *6 n. 1, 2001 WL 675330 at *2.

[14] *See IBP*, 2001 Del. Ch. LEXIS 81 at *93-99, 2001 WL 675330 at *30-31.

[15] *Id.*, 2001 Del. Ch. LEXIS 81 at *94, 2001 WL 675330 at *30.

[16] *Id.*, 2001 Del. Ch. LEXIS 81 at *98, 2001 WL 675330 at *30.

[17] *Id.*, 2001 Del. Ch. LEXIS 81 at *94-98, 2001 WL 675330 at *30-31.

[18] The court in *Tyson* refers to MAC clauses as "Material Adverse Effect" clauses.

[19] *Id.*, 2001 Del. Ch. LEXIS 81 at *91-93, 2001 WL 675330 at *29-30. In addition to the MAC theory, Tyson also argued breach of contractual representations and fraudulent inducement. *Id.*

[20] *IBP*, 2001 Del. Ch. LEXIS 81 at *135-36, 2001 WL 675330 at *41. The clause did not contain exclusions for declines in the economy as a whole, for the livestock sector, or for weather related market conditions. *Id.*

[21] *Id.*, 2001 Del. Ch. LEXIS 81 at *134, 2001 WL 675330 at *40-41.

[22] *Id.*, 2001 Del. Ch. LEXIS 81 at *92, 2001 WL 675330 at *30.

[23] *Id.*, 2001 Del. Ch. LEXIS 81 at *135-36, *141-44, 2001 WL 675330 at *41.

[24] *Id.*

who make purchases based on long-term plans.[25] The court stated that in the M&A setting, even broad MAC clauses are "best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner."[26] This view of material adverse change took the cyclical downturn in IBP's business out of the scope of the MAC clause.

Tyson's second contention regarding why termination was proper was due to the accounting abnormalities in the IBP subsidiary.[27] Tyson argued that these abnormalities, which caused an impairment charge of 50 to 60 cents per share for a total of 60 million dollars, coupled with the IBP earnings slowdown, should trigger the MAC clause.[28] IBP countered with the contention that the one-time, non-cash charge to the IBP subsidiary was insignificant to the transaction as a whole, and that the subsidiary is "but a tiny fraction of IBP's overall business and that a total shut-down of [the subsidiary] would likely have little effect on the future results of a combined Tyson/IBP."[29]

Tyson's own representations and bad decisions undermined its arguments while strengthening IBP's position.[30] First, a Tyson spokesperson stated to analysts that the accounting abnormalities were not a large issue for Tyson.[31] Second, Tyson's in-house counsel wrote a letter of congratulations to IBP after the accounting issues were cleared with the SEC and suggested that the parties move ahead with negotiations.[32] Both of these communications underlined the minor effect of the accounting problems as a whole.[33] Third, the evidence tended to show that Tyson had manufactured the argument in a deliberate attempt to escape its obligation to close the merger. For example, during a meeting of top Tyson officials, Don Tyson announced that "Tyson should find a way to withdraw."[34] Tyson ordered another examination of IBP by Merrill Lynch, this time with very pessimistic projections, yet even this examination still found the price to be fair.[35] The day after Merrill Lynch presented its findings to Tyson, Tyson decided the merger should not proceed.[36] Finally, Tyson's termination letter omitted any discussion of the MAC argument at all, making it appear to be a *post hoc* legal "technicality" drummed up by Tyson's litigation counsel.[37] Taken together, these facts supported enforcement of the merger agreement and a finding of no material adverse change.[38]

2. <u>What Remedy Should be Afforded?</u>

Because the court found that Tyson was unable to sustain its burden of proof under the MAC theory or any of the related theories, it held that the merger agreement was valid and enforceable.[39] The court then turned to the question of remedies.[40] Specific performance under New York law required a showing by a preponderance of evidence that "(1) the Merger Agreement [was] a valid contract between the parties; (2) IBP [had] substantially performed under the contract and [was] willing and able to perform its remaining obligations; (3) Tyson [was] able to perform its [remaining]

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[25] *Id.*

[26] *IBP*, 2001 Del. Ch. LEXIS 81 at *144, 2001 WL 675330 at *43.

[27] *Id.*, 2001 Del. Ch. LEXIS 81 at *92, 2001 WL 675330 at *30.

[28] *Id.*, 2001 Del. Ch. LEXIS 81 at *145-47, 2001 WL 675330 at *43-44.

[29] *Id.*, 2001 Del. Ch. LEXIS 81 at *151, 2001 WL 675330 at *45.

[30] *Id.*, 2001 Del. Ch. LEXIS 81 at *84-91, 2001 WL 675330 at *28-29.

[31] *Id.*

[32] *IBP*, 2001 Del. Ch. LEXIS 81 at *85-86, 2001 WL 675330 at *28.

[33] *Id. See also supra* note 8 for comments of Tyson's CEO that are inconsistent with Tyson's later argument.

[34] *Id.*, 2001 Del. Ch. LEXIS 81 at *88, 2001 WL 675330 at *28.

[35] *Id.*, 2001 Del. Ch. LEXIS 81 at *87-88, 2001 WL 675330 at *28.

[36] *Id.*

[37] *Id.*, 2001 Del. Ch. LEXIS 81 at *185, 2001 WL 675330 at *53.

[38] *IBP*, 2001 Del. Ch. LEXIS 81 at *190, 2001 WL 675330 at *55. Tyson's other theories, breach of contractual representations and fraudulent inducement, failed as well. *See id.*

[39] *Id.*

[40] *Id.*, 2001 Del. Ch. LEXIS 81 at *94, 2001 WL 675330 at *30.

obligations; and (4) IBP [had] no adequate remedy at law."[41] The court answered each of these questions in the affirmative.[42]

3. Lessons Learned from *Tyson*

The *Tyson* decision has lessons for both parties to a merger agreement.

a. Avoid appearance of *post hoc* justifications

If a MAC argument is going to be raised it should be brought up in the initial termination documents. It should also be supported by appropriate evidence formed after reasonable investigation.

b. MAC materiality may be judged by the reasonable acquiror, not speculator

General MACs leave plenty of room for court interpretation. If short-term cyclical factors are important to the buyer, then those issues should be expressly covered in the agreement.

c. Control public remarks

A company's general counsel's office should be involved in screening all public statements by the company and its officials. Although it is not necessary for all exuberant statements to be suppressed, such statements should at least be couched or qualified so that their usefulness as prior inconsistent statements is minimized.

d. The choice of law matters

As *Tyson* shows, the burden of proof can be a very influential factor in court. Counsel for buyers and sellers should consider their client's best interests in these decisions and resist choosing a forum based on convenience. Generally, Delaware is more favorable to buyers and New York is more favorable to sellers.

e. Targets can afford to play hardball once the deal is signed

Tyson illustrates that courts look skeptically at companies who attempt to back out of deals on tenuous grounds. Because of this, target companies have less incentive to negotiate when acquiring companies attempt to use MAC agreements to negotiate lower per-share prices late in the merger game, based on so-called material adverse changes. Thus, the ability to successfully sue for specific performance gives sellers yet another bargaining chip because they are more likely to successfully force the merger in court.

III. OTHER RELEVANT CASES INVOLVING GENERAL MACs

The range of interpretation for general MAC clauses is wide. As shown in the cases below, some courts are reluctant to read the terms as broadly as the terms may appear to be written. Other courts are more willing to pull the plug. This uncertainty provides risk to buyers and sellers that they may agree to live with because they wish to execute the deal, but it is a risk that is difficult to allocate.[43]

A. *Birmingham Steel*

One Delaware chancery court considered a sweeping clause that conditioned a merger on the premise that "no material adverse change occur in the financial condition of Birmingham Steel."[44] In dicta, the court stated that a 50 percent decline in revenues over a two-quarter period would be enough to trip the MAC clause.[45] This is a different

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[41] *Id.*

[42] *Id.*, 2001 Del. Ch. LEXIS 81 at *185-90, 2001 WL 675330 at *53-55. The court put much weight into the fact that Tyson implied it was still interested in IBP, that even though there were harsh words any management concerns could be addressed by Tyson after the merger, that any damages award would be "staggeringly large," and that damages would involve complex valuation issues. *Id.*

[43] Joel I. Greenberg & A. Julia Haddad, *The Material Adverse Change Clause: Careful Drafting Key, But Certain Changes May Need to Be Addressed Elsewhere*, 225 N.Y. L.J. 77 (2001).

[44] Raskin v. Birmingham Steel Corp., Civ. A. No. 11365 1990 Del. Ch. LEXIS 194, at *4, 1990 WL 193326, at *1 (Del. Ch. Dec. 4, 1990).

[45] *Id.*, 1990 Del. Ch. LEXIS 194 at *14-15, 1990 WL 193326 at *5.

approach than the one taken in *Tyson*, and it illustrates the range of enforcement opportunities for judges examining MAC clauses that have broad coverage.

B. *Pine State Creamery*

The Fourth Circuit Court of Appeals took yet another view in a case decided under North Carolina law.[46] The MAC was general and provided an escape if there was "any material adverse change in the [b]usiness . . . ."[47] After a lengthy discussion of whether profitability was a material factor in the acquisition, the court decided that financial activity should be included within the term "[b]usiness."[48] In August, the target's financial reports showed a year-to-date profit of $44,000.[49] It was later revealed that the profit totals were wrong and that the August number should have indicated a year-to-date *loss* of more than $150,000.[50] The company finished the year with a loss of more than $700,000.[51] In reversing and remanding the district court's summary judgment motion, the court determined that there was not enough evidence to conclude that there had been a material adverse change.[52]

While a jury still may have found a material adverse change, it would have been preferable for the MAC to include additional language as to durational profitability expectations. It would have helped even more to have an objective materiality threshold or other objective standard that would allow summary judgment.[53]

IV. RELEVANT CASES INVOLVING SPECIFIC MACs

When MACs state specific terms, those terms will generally be enforced. One example of a specific term that has been added to some MACs recently is a "terrorist attack" term.[54] Practitioners are divided on the wisdom of such a term. On one side is Ron Howard of Brobeck Phleger & Harrison who said that his firm would be pushing for the term in deals.[55] On the other is Dennis Block of Cadwalader, Wickersham, & Taft who said that such a term is "probably unnecessary" and that opposing parties would be "unlikely to accept it."[56] This is just one example of the difficult drafting choices facing drafters of MACs today.

An additional worry for stating specific terms is that unmentioned items will carry less weight because they were not significant enough to be mentioned. In specific term-type MACs, drafters need to make it absolutely clear that specific references to items do not imply that other unmentioned items are excluded. Consider the *Borders* and *Goodman* cases, which are discussed below.

A. *Borders*

The *Borders* case involved a merger of two Texas radio stations.[57] In *Borders*, the Texas Court of Appeals dealt with a detailed MAC, with specific terms that did not include a 50 percent drop in Arbitron Ratings, which is a dramatic

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[46] Pine State Creamery Co. v. Land-O-Sun Dairies, Inc., Civ. A. No. 98-2441 1999 U.S. App. LEXIS 31529, 1999 WL 1082539 (4th Cir. Dec. 2, 1999).

[47] *Id.*, 1999 U.S. App. LEXIS 31529 at *10, 1999 WL 1082539 at *1.

[48] *Id.*, 1999 U.S. App. LEXIS 31529 at *10-16, 1999 WL 1082539 at *1-2.

[49] *Id.*, 1999 U.S. App. LEXIS 31529 at *5, 1999 WL 1082539 at *1.

[50] *Id.*

[51] *Id.*, 1999 U.S. App. LEXIS 31529 at *6, 1999 WL 1082539 at *1.

[52] *Pine State Creamery*, 1999 U.S. App. LEXIS 31529 at *5-6, 1999 WL 1082539 at *1.

[53] Objective materiality thresholds help to allocate risk by narrowing litigable matters due to black and white objective criteria. In this instance, the MAC could have stated dollar thresholds that were *deemed* material.

[54] Richard B. Schmidt & Robin Sidel, *'Terrorism' Clauses Surface in Deals Extra Protection Is a Focal Point*, Wall St. J., Oct. 10, 2001 at C1.

[55] *Id.*

[56] *Id.*

[57] Borders v. KRLB, Inc., 727 S.W.2d 357 (Tex. App. 1987).

drop in listeners.[58] The court held that since the terms of the MAC were specific, if the parties were concerned about the Arbitron Ratings, the MAC should have mentioned the ratings.[59]

B. Goodman

Goodman addressed prospective material adverse changes.[60] In this New York case, the plaintiff's theory was that the defendant suffered a material adverse change before the deal closed and did not disclose the change, in violation of the merger agreement.[61] The defendant argued that it was under no duty to disclose *prospective* or forward-looking material adverse changes.[62] Once again, the MAC contained detailed terms, but the definition of "business condition" was silent on the issue of *future* business prospects. The plaintiff argued that "there is no reasonable meaning of a material adverse change in 'business' or its 'financial condition' that does not involve a business's future prospects."[63] The court was not moved and refused to read in a future earnings or prospects provision.[64]

One option for balancing broad versus specific MAC clauses is to draft a broad coverage MAC clause, and then take specific items out of the scope of the MAC definition and include them as separate conditions to closing.[65] In the Warner Lambert / American Home Products (Wolverine subsidiary) merger agreement, the key issue was pending phen-fen litigation.[66] Instead of glossing over the issue in the MAC clause, Warner-Lambert chose to discuss that issue in another part of the agreement and excluded the phen-fen litigation from the definition of material adverse change.[67] Thus, Warner-Lambert did not risk being too narrow with the MAC because the phen-fen litigation was addressed in detail in another section.[68]

Specific MAC clauses can also feature objective materiality thresholds. For example, a material adverse change that can reasonably be expected to affect less than three percent of a company's quarterly earnings could be excluded from the category of *material* adverse change.

V. CONCLUSION

If the decision in *Tyson* is followed, sellers will benefit significantly. Counsel for buyers and sellers alike should think about the implications of *Tyson* and the other cases and heavily negotiate MAC clauses that suit their client's individual needs. M&A lawyers should consider using objective materiality thresholds, or perhaps the belt and suspenders lawyering style of a broad MAC combined with closing conditions, as a way of allocating risk. Adverse changes, whether material or not, can happen rather unexpectedly for a wide variety of reasons. At such times it is good to be prepared with a well-negotiated MAC clause that allocates risk predictably.

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[58] *Id.* at 358.

[59] *Id.* at 359.

[60] Goodman Mfg. Co. v. Raytheon Co., No. 98 Civ. 2774 1999 U.S. Dist. LEXIS 13418 at *39-40, 1999 WL 681382 at *13 (S.D.N.Y. Aug. 31, 1999).

[61] *Id.*, 1999 U.S. Dist. LEXIS 13418 at *39-40, 1999 WL 681382 at *13. This involved a dispute over the defendant's ready-for-volume production status. *Id.*

[62] *Id.*, 1999 U.S. Dist. LEXIS 13418 at *40-41, 1999 WL 681382 at *13-14.

[63] *Id.*, 1999 U.S. Dist. LEXIS 13418 at *42, 1999 WL 681382 at *14.

[64] *Id.*

[65] Greenberg & Haddad, *supra* note 43.

[66] *Id.*

[67] *Id.*

[68] *Id.*

Covenants Not To Compete in Tennessee

By: Mark Rettinger[1]

I. INTRODUCTION

A covenant not to compete is a "contractual provision – typically found in employment, partnership, or sale-of-business agreements – in which one party agrees to refrain from conducting business similar to that of the other party."[2] This article analyzes the law of covenants not to compete in Tennessee and details the applicable legal principles to enable transactional attorneys to draft covenants not to compete for employment agreements.

II. GENERAL RULES

Covenants not to compete are restraints of trade and are therefore disfavored in Tennessee.[3] Because these covenants are disfavored, they are strictly construed in favor of the employee.[4] However, as long as the covenant's restrictions are reasonable under the circumstances, the agreement will be enforced.[5] The reasonableness of the restrictions is viewed as of the time the agreement was signed.[6]

The relevant factors in determining the reasonableness of the restrictions are: (A) the consideration supporting the agreement; (B) the threatened danger to the employer if the agreement is not enforced; (C) the economic hardship the employee would have to endure if the agreement is enforced; and (D) whether the covenant is contrary to the public interest.[7] If the restrictions are deemed reasonable under the above analysis, it will be enforced as written as long as the time and geographical restrictions are no greater than necessary to protect the interests of the employer.[8]

III. CONSIDERATION

A covenant not to compete must be supported by reasonable consideration.[9] If the agreement was signed before employment began, shortly after employment began, or as a part of the employment contract, the consideration is *per se* reasonable as long as the employee worked for the employer for any length of time after signing the agreement.[10] A mere promise of employment without actual employment is insufficient consideration for a covenant not to compete.[11]

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[2] Black's Law Dictionary, 370 (7th ed. 1999).

[3] Hasty v. Rent-A-Driver, Inc., 671 S.W.2d 471, 472 (Tenn. 1984).

[4] *Id.*

[5] *Id.*

[6] *Id.*

[7] Allright Auto Parks, Inc. v. Berry, 409 S.W.2d 361, 363 (Tenn. 1966).

[8] A court may modify the agreement to restrict the time or geographical scope. *Id.*

[9] Cent. Adjustment Bureau, Inc. v. Ingram, 678 S.W.2d 28, 33 (Tenn. 1984).

[10] *Id.*

[11] Associated Dairies, Inc. v. Ray Moss Farms, Inc., 326 S.W.2d 458 (Tenn. 1959); Ramsey v. Mut. Supply Co., 427 S.W.2d 849 (Tenn. Ct. App. 1968).

If the covenant was not signed at one of the above times, the court will determine the reasonableness of the consideration on a case-by-case basis.[12] If an agreement was not signed near the beginning of the employment relationship, the consideration will generally be deemed reasonable if employment continued for an "appreciable amount of time" after the employee signed the agreement.[13] A court is also likely to find that the consideration is reasonable if the employee signed the agreement at the time of a pay raise, or if the employee was a well-paid worker.[14] However, if the employee was fired shortly after signing the agreement, or if the employee was fired in an arbitrary and capricious manner, a court is likely to find that the consideration was not reasonable.[15]

IV. DANGER TO THE EMPLOYER

If the court finds reasonable consideration for the agreement, the court must next determine whether the employer has a legitimate business interest that needs to be protected by the covenant not to compete.[16] The employer must present special facts, over and above ordinary competition, which show that the employee would have an unfair advantage in future competition with the employer if the covenant were not enforced.[17]

In deciding whether the employee would have an unfair advantage, courts consider whether: (A) the employee received specialized training from the employer; (B) the employee had access to confidential information such as business secrets; and (C) the employer's customers tended to associate the business with the employee because of repeated contacts with the employee.[18] These factors are typically combined to find a protectable interest.[19]

1. Specialized Training

The employer does not have a protectable interest in the general knowledge and skill that the employee either brings to, or learns during, the employment relationship.[20] This is true even if that general knowledge and skill is learned through expensive training provided by the employer.[21]

In *Selox, Inc. v. Ford,*[22] the Supreme Court of Tennessee held that a former industrial gas salesman had not been given any specialized training. The employee had previously worked in the industry as a quality control manager and shop supervisor, but never as a salesman.[23] The employee's training consisted of traveling the sales route with

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[12] *Cent. Adjustment Bureau*, 678 S.W.2d at 33. *See id.* at 35 (seven years and two years of employment were sufficient consideration); Ark. Dailies, Inc. v. Dan, 260 S.W.2d 200, 205 (Tenn. Ct. App. 1953) (sufficient consideration where the employee worked for six years and then quit); Flying Colors of Nashville, Inc. v. Keyt, No. 01-A-019103CH00088, 1991 Tenn. App. LEXIS 634, at *14, 1991 WL 153198, at *4 (Tenn. Ct. App. Aug. 14, 1991) (six months of employment is enough).

[13] *Cent. Adjustment Bureau*, 678 S.W.2d at 34.

[14] *Id.* at 35 (pay raise); Turner v. Abbott, 94 S.W. 64, 69 (Tenn. 1906) (well-paid employee).

[15] *Cent. Adjustment Bureau*, 678 S.W.2d at 35.

[16] Vantage Tech., LLC v. Cross, 17 S.W.3d 637, 644 (Tenn. Ct. App. 1999).

[17] Hasty v. Rent-A-Driver, Inc., 671 S.W.2d 471,473 (Tenn. 1984).

[18] *Id.*

[19] *Vantage Tech.*, 17 S.W.3d at 646.

[20] *Hasty*, 671 S.W. 2d at 473. *See also* Associated Dairies, Inc. v. Ray Moss Farms, Inc., 326 S.W.2d 458, 460 (Tenn. 1959) (delivering milk did not require any peculiar skill); Amarr Co. v. Depew, No. 03A01-9511-CH-00412, 1996 Tenn. App. LEXIS 660, at *5, 1996 WL 600330, at *2 (Tenn. Ct. App. Oct. 16, 1996) (training course that taught general skills was not specialized training, no protectable interest especially because employee did not possess any trade secrets).

[21] *Hasty*, 671 S.W.2d at 473.

[22] 675 S.W.2d 474 (Tenn. 1984).

[23] *Id.* at 475.

another salesman and attending sales meetings.[24] The court held that because the job could be performed by any employee of average competence there was no specialized training that deserved protection.[25]

The employer does have a protectable interest in any unique knowledge or skill that an employee acquired through specialized training during the employment relationship.[26] The skill that the employee learned from the training must be specialized enough to make it unfair for the employee to use it in future competition with the employer.[27] A court is much more likely to uphold a covenant when specialized training can be combined with other factors that tend to show a protectable interest, such as access to confidential information or special customer relationships.[28]

2. Confidential Information

An employer has a protectable interest in prohibiting an employee from using the employer's trade secrets or confidential information in competition with the employer.[29] To be properly protectable, the trade secrets or confidential information must not be well known or easily ascertainable.[30] Customer lists, profit and loss statements, and pricing and credit information are generally not considered confidential information.[31] As with specialized training, a court is more likely to find a protectable interest if confidential information or trade secrets can be combined with other legitimate interest factors.[32]

3. Customer Relationships

Special relationships between customers and the employee may also be protectable.[33] Covenants are often upheld "where the employee closely associates or has repeated contact with the employer's customers so that the customer tends to associate the employer's business with the employee."[34]

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[24] *Id*.

[25] *Id*. The court also noted that the list of employer's customers could be ascertained by looking in the phone book.

[26] *Hasty*, 671 S.W.2d at 473.

[27] Vantage Tech., LLC v. Cross, 17 S.W.3d 637, 645 (Tenn. Ct. App. 1999).

[28] *Hasty*, 671 S.W.2d at 473. *See also* Flying Colors of Nashville, Inc. v. Keyt, No. 01-A-019103CH00088, 1991 Tenn. App. LEXIS 634, at *15, 1991 WL 153198 at *5 (Tenn. Ct. App. Aug. 14, 1991) (training in specialized techniques and processes of paint-mixing, together with a special relationship with the employer's customers gave rise to a properly protectable interest); *Vantage Tech*., 17 S.W.3d at 646 (employee spent first 241.5 hours in training and had a special relationship with customers).

[29] *Hasty*, 671 S.W.2d at 473. Hickory Specialties, Inc. v. B & L Laboratories, Inc., 592 S.W.2d 583, 586 (Tenn. Ct. App. 1979), defined "trade secret" as any secret "formula, process, pattern, device or compilation of information that is used in one's business and which gives him an opportunity to obtain an advantage over competitors who do not use it." (quoting Allis-Chambers Mfg. Co. v. Cont'l Aviation & Eng. Corp., 255 F. Supp. 645, 653 (E.D. Mich. 1966)). The burden is on the plaintiff to show something was a trade secret. *Ark. Dailies*, 260 S.W.2d at 204.

[30] *Hickory Specialties*, 592 S.W.2d at 587.

[31] Heyer-Jordan & Assoc's, Inc. v. Jordan, 801 S.W.2d 814 (Tenn. Ct. App. 1979) (holding that the identities of an employer's customers are not confidential when they are generally available in the trade); *see also* Amarr Co. v. Depew, No. 03A01-9511-CH-00412, 1996 Tenn. App. LEXIS 660, at *13-14, 1996 WL 600330, at *4-5 (Tenn. Ct. App. Oct. 16, 1996) (holding that profit and loss statements, customer credit information, customers lists, and pricing information were not confidential information.); *Heyer-Jordan*, 801 S.W.2d at 821 (customer relationships are not confidential information.). *But see* AmeriGas Propane, Inc. v. Crook, 844 F. Supp. 379 (M.D. Tenn. 1993) (knowledge of customer lists and pricing was a properly protectable interest especially where employees did not have experience in the propane industry before working for employer); William B. Tanner Co. v. Taylor, 530 S.W.2d 517, 522-23 (Tenn. Ct. App. 1974) (customer lists and pricing information were a properly protectable confidential information where employee was hired at considerable expense and knowledge of the confidential information was an important factor in employee getting job with competitor).

[32] *See, e.g.*, Matthews v. Barnes, 293 S.W. 993, 993-94 (Tenn. 1926) (knowledge of unique business method plus acquaintance of customers added up to a properly protectable interest.); *Ark. Dailies*, 260 S.W.2d at 672-73 (knowledge of customers' likes and dislikes plus knowledge of contract expiration dates and percentage of compensation added up to a properly protectable interest).

[33] *Hasty*, 671 S.W.2d at 473.

[34] *Id. See Ark. Dailies*, 260 S.W.2d at 204 (employee "during his employment was 'Mr. Good Will' himself to the customers, because he alone had all the dealings with them for his employer.")

A court will almost always find a protectable interest in customer relationships when a person sells a business and agrees not to compete with the buyer.[35] Similarly, a court is likely to find a protectable interest if the employee was a salesman.[36] On the other hand, a court is not likely to enforce the covenant if the employee held a lower-level job.[37]

In *Vantage Technology v. Cross*, the Tennessee Court of Appeals found that a former medical technician had a properly protectable relationship with customers.[38] Vantage was a mobile service provider of specialized equipment used in cataract eye surgeries.[39] Cross' job was to transport and set up equipment at different hospitals.[40] Vantage was interested in developing good relations with physicians at the different hospitals, and encouraged its technicians to cultivate such relationships.[41] To maintain good relations with physicians, the technicians tracked and recorded the physicians' machine setting preferences, hobbies, interests, and other personal and professional information.[42] The court upheld the Vantage covenant because the special relationships that Cross developed with the physicians were based on Vantage's goodwill, and the logbooks were a type of confidential information.[43]

V. EMPLOYEE'S ECONOMIC HARDSHIP

Once a court finds a properly protectable interest, the court will weigh the danger to the employer that might result if the agreement is not enforced against the economic hardship that the employee might endure if the agreement is enforced.[44] The Tennessee Supreme Court has said that "[p]ost-employment restraints are scrutinized with particular care because they are often the product of unequal bargaining power and because the employee is likely to give scant attention to the hardship he may later suffer through the loss of his livelihood." This is especially so where the restraint is imposed by the employer's standardized printed form.[45]

In most instances, a court will decline to hold that an employee's prospective economic hardship will outweigh the possible danger to the employer's protectable interest.[46] This is especially true where the agreement only restricts the

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[35] This is true as long as goodwill is included in the sale. Greene County Tire & Supply, Inc. v. Spurlin, 338 S.W.2d 597 (Tenn. 1960); Hogan v. Coyne Int'l Enters., 996 S.W.2d 195 (Tenn. Ct. App. 1998); Butts v. Birdwell, 503 S.W.2d 930 (Tenn. Ct. App. 1973). *But see* Allright Auto Parks, Inc. v. Berry, 409 S.W.2d 361, 364-65 (Tenn. 1966) (court found it was important that seller was later hired by the buyer in a much different capacity than he occupied as owner).

[36] *See* Powell v. McDonnell Ins., Inc., No. 02A01-9608-CH-00176, 1997 Tenn. App. LEXIS 642, at *14, 1997 WL 589232, at *5 (Tenn. Ct. App. Sept. 24, 1997) (insurance salesman); *Ark. Dailies*, 260 S.W.2d at 204 (newspaper advertising salesman, trade journal advertising salesperson). *But see Amarr,* 1996 Tenn. App. LEXIS 660, 1996 WL 600330 (garage door salesman who was not popular with customers); Kaset v. Combs, 434 S.W.2d 838, 841 (Tenn. Ct. App. 1968) ("sales" position where employee drove vehicle and served coffee and snacks to factory employees did not result in any special customer relationships).

[37] *See, e.g., Hasty*, 671 S.W.2d at 473 (truck driver who went to work for one of employer's customers and thereafter customer stopped doing business with employer); *Associated Dairies*, 326 S.W.2d at 460 (milk deliveryman). *But see* Flying Colors of Nashville, Inc. v. Keyt, No. 01-A-019103CH00088, 1991 Tenn. App. LEXIS 634, at *15, 1991 WL 153198, at *5 (Tenn. Ct. App. Aug. 14, 1991)(employee whose main job duty was to apply touch-up paint to cars; it was important to the court that the employee had significant contact with customers); AmeriGas Propane, Inc. v. Crook, 844 F. Supp. 379, 385-86 (M.D. Tenn. 1993) (propane delivery and serviceman).

[38] Vantage Tech., LLC v. Cross, 17 S.W.3d 637, 637 (Tenn. Ct. App. 1999).

[39] *Id.*

[40] *Id.*

[41] *Id.*

[42] *Id.* The technicians were also given expense accounts to entertain the physicians.

[43] *Id.* at 646-47.

[44] *Vantage Tech.*, 17 S.W.3d at 647.

[45] *Selox, Inc. v. Ford*, 675 S.W.2d 474, 475-76 (Tenn. 1984) (quoting Restatement (Second) of Contracts § 188 cmt. g).

[46] *See, e.g.,* Ark. Dailies, Inc. v. Dan, 260 S.W.2d 200, 205 (Tenn. Ct. App. 1953) ("It is further insisted that the contract is oppressive because Dan is a family man who has to work for a living and this is the only line of work for which he is fitted; it may be remarked that he has lots of company in this respect").

employee from competing for the employer's customers, as opposed to restricting the employee from competing for any customers in the area.[47] A court is also more likely to enforce the agreement if it feels that the employee possesses general skills applicable to many different fields of work.[48]

In *Greene County Tire & Supply, Inc. v. Spurlin*, the Supreme Court of Tennessee was not swayed by the economic hardship argument even where the restricted party was of limited education.[49] There, Spurlin sold his business to the buyer and agreed not to compete with the buyer for five years within a 100-mile radius of Greeneville.[50] Spurlin argued that the agreement should not be enforced because his life work had "been in the recapping business, and this [was] his only means of livelihood, since he [had] only had limited educational opportunities."[51] The court upheld the restriction, pointing to the consideration that Spurlin had received in exchange for his promise not to compete.[52]

VI. PUBLIC POLICY CONCERNS

The public interest must also be considered in determining whether the covenant is reasonable.[53] The public policy analysis in covenant not to compete cases usually involves balancing different public interests.[54] A court rarely finds that an otherwise valid covenant is unenforceable because of public policy concerns.

VII. TIME AND TERRITORY RESTRICTIONS

Finally, a covenant will be deemed reasonable only if its time and geographical restrictions are not greater than what is necessary to protect the interests of the employer.[55] If the time and geographical limits are reasonable, the covenant will be enforced.[56] If the limits impose an unnecessary burden on the employee, the court will modify the covenant to the extent necessary to reasonably protect the employer's interest without imposing undue hardship on the employee.[57] To prevent employers from drafting covenants that are extremely restrictive in an attempt to scare employees from leaving the company, a court will invalidate an entire covenant not to compete if credible evidence shows that the agreement is deliberately oppressive and unreasonable.[58]

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[47] *Id.* at 205; Thompson, Breeding, Dunn, Creswell & Sparks v. Bowlin, 765 S.W.2d 743, 745-46 (Tenn. Ct. App. 1987).

[48] William B. Tanner Co. v. Taylor, 530 S.W.2d 517, 523 (Tenn. Ct. App. 1974). *But see* Dabora, Inc. v. Kline, 884 S.W.2d 475 (Tenn. Ct. App. 1994) (employee's hardship discounted where employer offered to find the employee a temporary job).

[49] 338 S.W.2d 597, 600 (Tenn. 1960).

[50] *Id.* at 599.

[51] *Id.* at 600.

[52] *Id.* at 601.

[53] Vantage Tech., LLC v. Cross, 17 S.W.3d 637, 647 (Tenn. Ct. App. 1999).

[54] *See, e.g.*, Di-Deeland, Inc. v. Colvin, 347 S.W.2d 483, 484-85 (Tenn. 1961) ("freedom of alienation" cited in enforcing a covenant not to compete against an employee, as opposed to a seller of a business); Green County Tire & Supply, Inc. v. Spurlin, 338 S.W.2d 597, 601 (Tenn. 1960) (discussing the public's interest in convenience as opposed to the public's interest in promoting honesty and freedom of alienation); Medical Educ. Assistance Corp. v. State *ex rel* E. Tenn. State Univ. Quillen Coll. of Med., 19 S.W.3d 803, 815 (Tenn. Ct. App. 1999) (discussing the public's interest in having access to highly trained doctors like Mehta vs. the public's interest in helping ETSU's medical school to recruit qualified physicians); *Vantage Tech.*, 17 S.W.3d at 647 (discussing the public's interest in keeping medical costs down vs. the public's interest in not creating a disincentive for employers to train their employees); Flying Colors of Nashville, Inc. v. Keyt, No. 01-A-019103CH00088, 1991 Tenn. App. LEXIS 634, at *16, 1991 WL 153198, at *5 (Tenn. Ct. App. Aug. 14, 1991) (discussing the public's interest in not having monopolies).

[55] Allright Auto Parks, Inc. v. Berry, 409 S.W.2d 361, 363 (Tenn. 1966).

[56] *Vantage Tech.*, 17 S.W.3d at 647.

[57] *Id.*

[58] Cent. Adjustment Bureau, Inc. v. Ingram, 678 S.W.2d 28, 37 (Tenn. 1984).

Geographic limitations are viewed in terms of the scope of protection that the employer actually needs. Unless an employee possesses an employer's trade secrets, covenants restricting the employee from working in an area where the employee never before performed services for the employer will usually be modified by a court.[59] However, employers may restrict an employee from contacting any customer that the employer had during the employment relationship, even if the employee did not personally do business with that customer.[60]

In *Dabora, Inc. v. Kline*, the Tennessee Court of Appeals refused to modify an agreement that prohibited the employee from competing against the employer anywhere in the country.[61] The agreement in *Kline* prohibited the employee from working for any other Saddlebred or Morgan horse publication in the country for three years.[62] The court upheld the restriction because it found that the territorial question had more to do with the type of breed than geography.[63]

Time limits of up to five years have been deemed reasonable in Tennessee.[64] Two and three year restrictions are more common.[65] In *Turner v. Abbott*, the Tennessee Supreme Court upheld an agreement that prohibited the employee from competing with the employer as long as the employer remained in business.[66] In *Turner*, a dentist hired an assistant, who agreed not to open his own practice in the same town so long as the dentist remained in business.[67] The court found that the time restriction was reasonable, especially because the assistant was well paid.[68] Today, courts are more likely to uphold time restrictions of that type only in sale-of-business situations.[69]

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[59] *Allright Auto Parks*, 409 S.W.2d at 364 (covenant restricting employee from competing with employer for five years in forty-six cities in the United States, Canada and Mexico deemed unreasonable where employee had been employed in only three of the cities); *Vantage Tech.*, 17 S.W.3d at 648 (fifty-mile restriction limited so that it only applied to hospitals that were customers when employee left, fifty miles based on shortest driving distance); *Flying Colors of Nashville*, 1991 Tenn. App. LEXIS 634, at *16-17, 1991 WL 153198, at *5 (agreement that restricted employee from competing in a seven-county area restricted to the one county where the employee worked the most).

[60] *Cent. Adjustment Bureau*, 678 S.W.2d at 36 (covenant that restricted employee from contacting any client of the employer during entire employment term limited to parties who were clients three months prior to employees leaving); Powell v. McDonnell Ins., Inc., No. 02A01-9608-CH-00176, 1997 Tenn. App. LEXIS 642, at *16-17, 1997 WL 589232, at *6; Ark. Dailies, Inc. v. Dan, 260 S.W.2d 200, 205 (Tenn. Ct. App. 1953) (the court did note that there was no evidence that the employee was trying to solicit clients that may have stopped doing business with the employer eight or nine years before the employee left).

[61] 884 S.W.2d 475 (Tenn. Ct. App. 1994).

[62] *Id.* at 476 (very few of these types of publications in existence).

[63] *Id.* at 478. *See also* William B. Tanner Co. v. Taylor, 530 S.W.2d 517, 522 (Tenn. Ct. App. 1974) (agreement with national scope enforced as written).

[64] *See, e.g.*, Greene County Tire & Supply, Inc. v. Spurlin, 338 S.W.2d 597, 597 (Tenn. 1960) (five-year, one-hundred-mile restriction reasonable where defendant sold his business including goodwill); Matthews v. Barnes, 293 S.W. 993 (Tenn. 1927) (five-year, one-county restriction reasonable where employee rented out cars and was a manager); Medical Educ. Assistance Corp. v. State *ex rel* E. Tenn. State Univ. Quillen Coll. of Med., 19 S.W.3d 803, 803 (Tenn. Ct. App. 1999) (five-year, seven-county restriction reasonable where employee was a physician).

[65] *See* AmeriGas Propane, Inc. v. Crook, 844 F. Supp. 379 (M.D. Tenn. 1993) (two years); *Cent. Adjustment Bureau*, 678 S.W.2d 195 (two-year limitation modified to one year); Di-Deeland, Inc. v. Colvin, 347 S.W.2d 483 (Tenn. 1961) (six months); Associated Dairies, Inc. v. Ray Moss Farms. Inc., 326 S.W.2d 483 (Tenn. 1959) (one year); *Vantage Tech.*, 17 S.W.3d 637 (three years); *Powell*, 1997 Tenn. App. LEXIS 642, 1997 WL 589232 (two-year restriction reasonable where employee was an insurance salesman); Amarr Co. v. Depew, No. 03A01-9511-CH-00412, 1996 Tenn. App. LEXIS 660, 1996 WL 600330 (Tenn. Ct. App. Oct. 16, 1996); Dabora, Inc. v. Kline, 884 S.W.2d 475 (Tenn. Ct. App. 1994); Flying Colors of Nashville, Inc. v. Keyt, No. 01-A-019103CH00088, 1991 Tenn. App. LEXIS 634, 1991 WL 153198 (Tenn. Ct. App. Aug. 14, 1991); *William B. Tanner Co.*, 530 S.W.2d 517; Federated Mut. Implement & Hardware Inc. v. Johnson, 382 S.W.2d 214 (Tenn. Ct. App. 1964) (two-year, six-county restriction reasonable where employee was an insurance salesman); *Ark. Dailies, Inc.*, 260 S.W.2d 200.

[66] 94 S.W. 64 (Tenn. 1906).

[67] *Id.* at 65.

[68] *Id.* at 69.

VIII. COVENANTS NOT TO COMPETE IN THE "NEW ECONOMY"

The Internet has altered the way that most companies do business, and is also beginning to change the way courts look at covenants not to compete. Because of the Internet's worldwide presence, courts are taking a second look at agreements containing extensive geographic restrictions.

In *National Business Services, Inc. v. Wright*, an employee was in charge of NBS's Internet marketing efforts and had contact with customers nationwide.[70] The employee's covenant not to compete restricted her from competing with NBS anywhere in the country.[71] The District Court for the Eastern District of Pennsylvania held that the geographic restriction was reasonable because NBS was an Internet-related business.[72] The court reasoned that because the Internet is not constrained by state boundaries, Internet-related companies need not limit the territorial restrictions in their covenants not to compete.[73]

The Internet has also begun to affect how courts examine an agreement's time restrictions. In *Earthweb, Inc. v. Schlack*, the employee was the vice president in charge of content on the employer's Web site.[74] The District Court for the Southern District of New York held that a one-year restriction was unreasonably long "given the dynamic nature of this [Internet] industry . . . [and] its lack of geographical borders."[75]

IX. CONCLUSION

The task of drafting an enforceable covenant not to compete is often daunting. To draft a reasonable and enforceable covenant, an attorney must consider several factors, including the consideration supporting the agreement, the relative effect of the covenant on the employer and employee, and whether the covenant is contrary to the public interest. An understanding of the legal principles presented in this article should increase the ability of an attorney in Tennessee to draft an enforceable covenant.

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[69] *See, e.g.*, Butts v. Birdwll, 503 S.W.2d 930 (Tenn. Ct. App. 1973).

[70] 2 F. Supp. 2d 701 (E.D. Pa. 1998).

[71] *Id.* at 708.

[72] *Id.*

[73] *Id.*

[74] 71 F. Supp. 2d 299 (S.D.N.Y. 1999).

[75] *Id.* at 313. *See also* Sprint Corp. v. DeAngelo, 12 F. Supp. 2d 1188 (D. Kan. 1998) (three-year restriction unreasonable because of the "explosion of technology").

Synopses

Antitrust

Standing in Antitrust Cases. *RSA Media, Inc., v. AK Media Group, Inc.*, 260 F.3d 10 (1st Cir. 2001).

By Johnnie D. Bond, Jr.

When does a plaintiff have standing to bring an antitrust suit against a competitor for unfair trade practices? The Supreme Court has previously determined that the antitrust claimant must show (1) that there was a causal connection between alleged antitrust violation and harm to plaintiff; (2) an improper motive on behalf of the defendant; (3) that the nature of the plaintiff's alleged injury was of a type that Congress sought to redress with antitrust laws; (4) a direct causal connection between the alleged market restraint and the asserted injury; (5) non-speculative damages; and (6) an absence of risk of duplicative recovery or complex apportionment of damages. This test is filled with express and implied causation requirements and factual determinations that are difficult to overturn on appeal. In *RSA Media*, the 1st Circuit upheld the district court's finding that a billboard company lacked standing to claim an antitrust violation by a competitor.

RSA Media ("RSA"), a new participant in the Massachusetts billboard advertising industry, sought to increase the number of billboards that it operated in the Greater Boston area. In doing so, RSA faced several obstacles. For example, the billboard industry in the Greater Boston area was heavily regulated by federal, state, and local laws. State law required a prospective billboard owner to obtain a license from the Massachusetts Outdoor Advertising Board ("OAB"). Local zoning laws had grandfathered many of the existing billboards in Boston, but did not allow a new billboard to be built in its place. Although there were billboard locations that would allow the construction of a replacement billboard, it was extremely difficult, if not impossible, to obtain approval for a replacement billboard from both the OAB and local zoning authorities.

In addition to the legal obstacles RSA faced, it also suffered from a minority ownership of local billboards in an area dominated by a giant competitor. AK Media Group ("AK"), controlled approximately 2200 of the 2400 billboards in the Greater Boston area. AK maintained its position in the market by preserving leases with property owners and by maintaining control of its licenses and permits. As part of this policy, AK refused to sell or transfer its billboards or permits, even when its rights to the property had lapsed.

In its antitrust suit against AK, RSA argued that by enforcing this policy, AK excluded it from the billboard market and violated antitrust laws. RSA also argued, more significantly, about the "drill" that AK gave its landlords. This consisted of telling landlords that it would be foolish on their part to end their tenancy relationship with AK and negotiate a new lease with RSA. According to RSA, AK told landlords that if a landlord chose to negotiate a lease with RSA, AK would tear the billboard down and that it would be very difficult to get a permit to construct a new one. RSA claims that this drill was the exclusionary conduct of a monopolist actionable under Section 2 of the Sherman Act.

In a largely fact-based decision, the district court held that RSA's alleged injury was a byproduct of the regulatory scheme rather than AK's conversations with landlords. The 1st Circuit affirmed. After listing the six factors of the Supreme Court's antitrust standing test, the court discussed which of the six factors were most critical to achieving standing. Although it technically analyzed all six elements, it generally emphasized the causation requirements of the test. Elements one and four expressly require causation between the alleged violation and the alleged harm. While element three does not explicitly raise the causation issue, it requires a showing of "antitrust injury," which has been defined as "injury of the type the antitrust laws were intended to prevent and that flows from that which makes the defendants act unlawful." Based on RSA's inability to meet this requirement, the appellate court affirmed.

RSA Media emphasizes the challenges that prospective plaintiffs face when seeking to bring antitrust claims against competitors. In order to bring a claim, a plaintiff must first have standing and, as this case illustrates, standing can be difficult to achieve. Unless the plaintiff can demonstrate that the defendant's actions were the sole cause of its injuries, the plaintiff will lack standing.

Retail Price Maintenance Agreements: A "50% rule" That is Not an Antitrust Violation. *Ezzo's Inv., Inc. v. Royal Beauty Supply, Inc.*, 243 F.3d 980 (6th Cir. 2001).

By Chris Raybeck

Retail price maintenance ("RPM") agreements are a popular method of control for manufacturers who sell products via independent retailers. The Sixth Circuit Court of Appeals held that a manufacturer's particular RPM agreement, which contained a "50% rule" without a specific pricing element, did not violate the Sherman Antitrust Act.

Ezzo Ebeido d/b/a Ezzo's Investments, Inc. ("Ezzo's"), owner of a beauty salon, contracted with Matrix Essentials, Inc. ("Matrix"), a manufacturer of hair care products, to sell Matrix products. At the time of contract, Matrix sold its salon products according to its "Professional Salon Policy," Matrix's version of an RPM agreement. With the agreement, Matrix sought assurance that its products were associated with professional support by requiring that Matrix retailers derive the majority of their revenue from hair care services and not from product sales.

Although Ezzo's never met Matrix's requirement, it purchased and sold Matrix products at discount prices for almost a year. After warning Ezzo's on several occasions to comply with the agreement, Matrix's distributor eventually terminated Ezzo's account. Ezzo's subsequently brought suit under Section 1 of the Sherman Act.

Under the Act, restraints that are "manifestly anticompetitive" in that they "always or almost always tend to restrict competition and decrease output" are illegal *per se*. Ordinarily, such restraints are horizontally structured and affect inter-brand competition. Alleged violations that are not illegal *per se* are examined under a rule-of-reason analysis, which evaluates a restraint by analyzing (1) the market structure and power of the particular business, (2) the history of the restraint, and (3) the reason for imposing the restraint. Typically, vertical restraints without an agreement on price or price levels are examined under the rule of reason.

The thrust of Ezzo's claim was that Matrix's "50% rule" was a *per se* violation because the rule "restrict[ed] aggressive merchandising, including discounting, and coerced adherence to retail prices." However, Matrix's RPM agreement, which was a vertical restraint, lacked an explicit pricing element, and Ezzo's failed to show that the agreement produced a negative effect on sales of other hair care brands. Therefore, the court ruled that the "50% rule" in Matrix's RPM agreement was not a *per se* violation of the Sherman Act.

Because the agreement was not illegal *per se*, the Court of Appeals held that the district court appropriately applied the rule-of-reason analysis to determine whether Matrix's policy violated the Sherman Act. The court concluded that Ezzo's failed to demonstrate that Matrix itself had sufficient market power to affect competition within the hair care market or effectively counter Matrix's purpose for the agreement, which was quality control. The agreement did not, therefore, violate the Sherman Act.

Ezzo's illustrates an acceptable method of drafting RPM agreements. The court ruled that a "50% rule" that is silent on price arrangements and employs a vertically integrated structure is not *per se* illegal. In addition, drafters of RPM agreements should be mindful of the rule-of-reason analysis and avoid any arrangements that may affect inter-brand competition or that seem to lack a legitimate purpose.

Banking

Usurious Interest is a Federal Question When a National Bank is Involved. *Anderson v. H & R Block, Inc.*, 132 F. Supp. 2d 948 (M.D. Ala. 2000).

By Rowlett Sneed

In *Anderson v. H & R Block*, the U.S. District Court for the Middle District of Alabama ruled that a state law claim against a national bank for charging usurious interest on a loan is a federal question subject to removal from state to federal court.

When parties to a lawsuit are not diverse, removal of the dispute to federal court requires a federal question. The presence of a federal question usually is determined according to the well-pleaded complaint rule, in which the court looks to the face of a complaint to see whether there is a federal question. The rare exception to the well-pleaded complaint rule is the complete preemption doctrine, which bars state courts from ruling in areas of law that concern federal matters. Complete preemption is rare, and when finding it, the Supreme Court has primarily relied upon a strong showing of congressional intent to occupy the field.

The National Banking Act ("NBA") regulates national banks, and as such, was the relevant statute in *Anderson*. The Supreme Court has never ruled on whether claims under the NBA fall within the complete preemption doctrine. Other federal courts, however, have found that similar claims against national banks are completely preempt from state law claims.

In *Anderson v. H.R. Block*, the court looked to case law and the language of the NBA and concluded that Congress intended to give an advantage to national banks over state banks and, therefore, claims against national banks should be brought at the federal level. In addition, the court determined that an action stating a claim of usury is a new right, which is regulated under federal law. Therefore, the court ruled that the Plaintiffs' state law claim was completely preempted and removable to federal court.

The decision in *Anderson* clarifies the jurisdictional boundaries of claims brought under the NBA. While there may have been some confusion on this matter after the Eleventh Circuit's *BLAB T.V. v. Comcast Communications, Inc.*, 182 F.3d 851 (11th Cir. 1999), decision, *Anderson* clearly states that all usurious interest claims are preempted and are to be brought in federal court since the intent of Congress in the creation of the NBA was the protection of national banks.

Bankruptcy/ Trademark

Prepetition Assignments of Trademarks Invalidated as Assignments in Gross. *In re Impact Distributors, Inc.*, 260 B.R. 48 (Bankr. S.D. Fla. 2001).

By Raney L. Irwin

When a soon-to-be debtor assigns away valuable trademarks as part of a pre-petition transfer, those transfers may later be invalidated by a trustee or debtor in possession in bankruptcy if those assignments are held to be "in gross." The key is the use of the mark, and not its registered owner. As *In re Impact Distributors, Inc.* illustrates, bankruptcy courts will likely characterize those assignments in name but not substance as 'assignments in gross' and invalidate them.

Impact Distributors, Inc. (the "Debtor"), was a Florida-based beverage distributor within the United States and the Caribbean. The Debtor manufactured a particular soft-drink called Cuzcatlan that was registered with the U.S. Patent & Trademark Office (PTO) in April 1992 (trademark registration #1,699,307). As part of an investment transaction, the Debtor executed a document entitled "Assignment of Trademark from Impact Distributors, Inc. to Impact Food & Beverage, LLC." Impact Food & Beverage never actually used the Cuzcatlan trademark. Presumably the assignment was meant to keep the valuable trademark from becoming part of Impact's estate should a bankruptcy case ensue.

United States trademark laws are based upon the concept of use, rather than registration. Ownership of a trademark depends upon usage. Therefore, a party that registers or owns the mark but does not use it has no trademark rights under U.S. trademark laws. The Debtor had begun using the Cuzcatlan Trademark in May 1988 and did so until immediately prior to filing the bankruptcy petition on September 7, 1997. The bankruptcy court held that where the Debtor had continued to use the trademark, in the absence of a license-back agreement, nothing other than a bare assignment of the trademark had occurred and the trademark rights remained property of the Debtor's estate. *In re Impact Distributors, Inc.* demonstrates that bare assignments of trademarks without use are likely to be invalidated as "assignments in gross" in subsequent bankruptcy cases. Lenders and other sources of capital should properly perfect a security interest in the mark rather than take an assignment of the mark in order to protect the mark in later bankruptcy proceedings.

Employment/Employee Benefits

Employee's Falsification of Cash Tips on Federal Income Tax Return may not Inhibit Employee's Effort to Receive Back Pay Award Based on Actual Earnings. *Atl. Limousine, Inc. v. NLRB*, 243 F.3d 711 (3d Cir. 2001).

By Kenneth A. Corum

The Third Circuit Court of Appeals held that employees' intentional failure to accurately report the amount of cash tips on federal income tax returns could not limit a National Labor Relations Board ("NLRB") award of back pay following a wrongful discharge suit where other credible evidence supported the award's correctness.

On March 4, 1995, the NLRB found that Atlantic Limousine had engaged in unfair labor practices by discharging two employees for union activity, and the NLRB reinstated the employees to their former jobs at Atlantic with back pay. In a subsequent hearing to determine the amount of back pay due, the aggrieved employees testified that they had falsified their time sheets and their federal income tax returns in order to avoid paying taxes. Indeed, one employee provided a copy of his time sheet, which he claimed reflected the actual amount of cash tips he received the week before his discharge. However, Atlantic argued that even if the employees had not accurately reported their cash tips, the back pay award should be based on the amount of tips they had claimed on their federal income tax returns. Ultimately, the NLRB's back pay award was in excess of the amount the employees had claimed on their time sheets and federal income tax returns. Atlantic appealed to the Third Circuit.

Affirming the award, the Third Circuit Court of Appeals found the employees' testimony credible because their admission that they falsified their tax returns subjected them to the very real possibility of criminal prosecution for tax fraud and perjury. The Court stated that the goal of the NLRB, in awarding back pay, is not to punish the employees for evading taxes, but rather to deter future violations of the National Labor Relations Act by the offending employer and to return the employees to the position they would have been in had the violation of the act never occurred. Therefore, the burden was on Atlantic to provide sufficient evidence to prove that the employees had not underreported their income. Ultimately, the court concluded that Atlantic did not meet its burden.

Atlantic demonstrates the evidentiary problems that face an employer who is attempting to challenge a back pay award in a wrongful discharge case, especially where the award is based on cash tips. *Atlantic* establishes that federal income tax returns are not conclusive on the issue of the employee's actual income if there is other credible evidence to the contrary. Employers are well advised to keep detailed records of employees' cash tips even if they must approximate the amounts they suspect employees are actually receiving. Such record keeping would allow employers to decide, *before* a back pay hearing, whether it is worth their time and expense to challenge a back pay award.

State Law Revoking Divorced Spouse's Interest in ERISA Plan is Preempted by Federal Law. *Egelhoff v. Egelhoff*, 532 U.S. 141, 121 S. Ct. 1322 (2001).

By Jennifer R. Pearson

The United States Supreme Court held that where a state statute directly affects the administration and payment of ERISA benefits by revoking the interest of a named beneficiary in an ERISA benefit plan, the state statute has a "connection with" ERISA plans and is therefore preempted.

In 1988, the deceased, David A. Egelhoff, designated his second wife, Donna, as the beneficiary of both a life insurance policy and pension plan provided by his employer and governed by the Employee Retirement Income Security Act of 1974 ("ERISA"). Mr. and Mrs. Egelhoff divorced in 1994. A few months after the divorce, Egelhoff died intestate. As Mrs. Egelhoff was still listed as the beneficiary under both the life insurance and the pension plan, the life insurance proceeds were paid to her.

Egelhoff's children by a previous marriage filed suit against Mrs. Egelhoff in Washington state court to recover the life insurance proceeds and pension plan benefits that were about to be paid to her. The children relied on a Washington statute that provides that if a marriage is dissolved or invalidated, a prior transfer of the decedent's interest in a nonprobate asset in favor of the decedent's former spouse is revoked. The statute defines "nonprobate asset" specifically to include a life insurance policy or employee benefit plan. The children argued that the statute disqualified Mrs. Egelhoff as a beneficiary and that the insurance proceeds should pass to them as Egelhoff's heirs.

The trial court concluded that both the insurance policy and the pension plan had a connection with an ERISA plan and, therefore, the Washington statute was preempted by ERISA. The Washington Court of Appeals reversed, concluding that the state statute was not preempted and that the children were entitled to the proceeds of both the insurance policy and the pension plan because Mrs. Egelhoff was disqualified as a beneficiary. The Supreme Court of Washington affirmed, holding that although the state statute applies to employee benefits plans in general, the statute does not alter or conflict with the nature of the plan itself or the administration of the plan. Because several courts had disagreed about whether ERISA preempted statutes of this same sort, the United States Supreme Court granted certiorari.

The Supreme Court reversed, holding that the Washington statute governs the payment of benefits out of an ERISA plan, and because the payment of benefits is a central matter of plan administration, ERISA works to preempt application of the Washington statute. If state statutes can interfere with plan administration, they frustrate the national uniformity ERISA seeks to create. Therefore, the beneficiary designation of the life insurance and pension plan was valid and the children were not entitled to the proceeds.

Egelhoff establishes that any state statute that affects the way an ERISA plan will process claims or pay benefits will be preempted. Of course, non-probate assets not governed by ERISA plans remain unaffected by this ruling.

Partnerships

Failure to Enter Into a Partnership Agreement May Not Negate Partnership Status and Excuse Business Liabilities. *Harrell Oil Co. of Mount Airy v. Case*, 543 S.E.2d 522 (N.C. Ct. App. 2001).

By Ginny T. Hsiao

Although the owners of a business do not file a formal partnership application, the owners may still be considered partners if their business activities are conducted as a partnership.

Albert and Brenda Case purchased the Lowgap Grocery & Grill in November of 1991 with the intention that their daughter Elizabeth Case Stanley would operate and eventually own the business. In December of 1992, Elizabeth and Harrell Oil entered into an oral agreement that the business would sell gas purchased from Harrell, and Harrell would receive the cost of the gas plus one half of the profits. By June 1993, the business fell behind on payments to Harrell. In September of 1994, Brenda sold the business and offered Harrell $8,000 to settle all outstanding debts. Harrell declined and brought suit against the co-owners.

The trial court held that the co-owners of Lowgap Grocery were partners and therefore jointly and severally liable for the obligations of the partnership and entered judgment for all outstanding amounts plus the statutory maximum service charge of 1.5 % per month plus costs of collection. The North Carolina Court of Appeals affirmed. Under the Uniform Partnership Act ("UPA"), a partnership is defined as "an association of two or more persons to carry on as co-owners a business for profit." The defendants had cited several factors they claimed indicated the absence of a partnership. These factors included the lack of an agreement on profit-sharing, the filing of a tax return defining the business as a proprietorship rather than a partnership, the continuing personal ownership of property used by the business, and the opening of a bank account for the business.

However, several factors countered these contentions. First, Brenda took out an insurance policy for the operation of the Lowgap Grocery & Grill which identified her as the policy's owner. Second, Albert appointed Elizabeth as his "attorney-in-fact" and gave her the authority to sell the business. Albert and Brenda signed the closing statement for the sale of the business and received the profits. Albert and Brenda's testimony pointed to their status as "silent" and "sleeper" partners. After reviewing these factors, the appellate court concluded that the co-owners' partnership and ownership did not terminate simply because they intended for their daughter to manage the business, but rather the appellate court concluded that they invited her to participate in the management of the business, which they continued to own as partners.

The decision illustrates that business owners cannot avoid liabilities simply by not filing a partnership application, by filing a tax return defining the business as a proprietorship, or by not having any formal agreement on profit-sharing if they conduct their business with partnership tendencies. Courts will review the substance of the business to determine the nature of the arrangement and apportion liability according to substance, not form.

Real Estate

Diminution in Fair Market Value of a Shopping Center is the Correct Measure of Damages when an Anchor Tenant Breaches an Implied Covenant of Continuous Occupancy. *BVT Lebanon Shopping Ctr., Ltd. v. Wal-Mart Stores, Inc.*, 48 S.W.3d 132 (Tenn. 2001).

By Joshua R. Walker

The Tennessee Supreme Court held that when the anchor tenant of a shopping center breaches the implied covenant of continuous occupancy, the proper measure of damages is the diminution in fair market value of the shopping center. This amount is appropriate because it takes into account both economic loss and lost future percentage rents sustained by the shopping center.

The parties in this case entered into a 20-year agreement in 1985 that provided for a guaranteed rent supplemented by a percentage rent based upon Wal-Mart's gross receipts in excess of a specified figure. In 1994, BVT Lebanon Shopping Center, LTD ("BVT") filed for anticipatory breach, claiming that Wal-Mart intended to replace its store with a Bud's Discount City ("Bud's"), thus breaching the implied covenant of continuous occupancy and the express "permitted use" clause of the lease. Bud's did replace Wal-Mart in the shopping center, and although Wal-Mart continued to pay the minimum rent, Bud's never collected gross receipts sufficient to warrant any percentage rent as provided in the lease.

The trial court found that Wal-Mart breached the contract and awarded BVT damages based solely on the present value of lost future percentage rent. On appeal, however, the Court of Appeals adopted the diminution in market value of the shopping center as the proper measure of damages. The Supreme Court, facing an issue of first impression, upheld the Court of Appeals because the diminution in market value test compensated for both lost future rent and the non-breaching party's expectation interest. Included in the diminution in market value analysis are such factors as stability of the center, attraction of customers and other tenants, and long-term financing. The court further held that the diminution in value is to be determined by expert testimony and remanded the case for consideration of each party's expert's opinion.

Remedy for Loan With Inconsistent Lien Provisions is Limited to Overlap Absent Clause Indicating Which is Controlling. *Foothill Capital Corp. v. East Coast Bldg. Supply Corp.*, 259 B.R. 840 (Bankr. E.D. Va. 2001).

By Eric C. Lane

Applying general principles of contract law, the United States District Court for the Eastern District of Virginia held that a deed of trust that included a lien limitation provision limited the remedy of a secured creditor under an inconsistent but concurrently executed loan agreement that lacked a lien limitation provision.

Foothill Capital Corporation ("Foothill") entered into a loan agreement with East Coast Capital Building Supply Corporation ("East Coast") that included a grant of a blanket security interest in all of East Coast's personal property. Simultaneously, the parties also executed a deed of trust ("DoT"), granting Foothill a security interest in both the real and personal property of a particular East Coast holding, the Greentree Site ("Greentree"). The DoT included a clause limiting the lien to $1,400,000 of value. As such, the terms of the loan agreement and the deed overlapped each other in relation to East Coast's personal property. Neither agreement indicated which document was controlling.

Subsequently, East Coast sought relief under Chapter 11 of the United States Bankruptcy Code. East Coast initially arranged to sell Greentree to a third party for $1,850,000 and to direct all proceeds to Foothill. However, the Unsecured Creditor's Committee objected, claiming Foothill's amount of recovery was capped at $1,400,000. Foothill argued that the true intent of the parties was for the loan agreement to supercede the DoT. Nevertheless, both the United States Bankruptcy Court for the Eastern District of Virginia and the District Court held that the terms of the deed controlled. Accordingly, Foothill's recovery was limited to the amount of the $1,400,000 lien limitation.

In reaching its decision, the District Court relied on general principles of contract interpretation. Courts usually "uphold the intent of the contracting parties as expressed through contractual language." When the contractual language is "clear, subject to only one reasonable interpretation," and does not contradict the express terms of the contract in interpreting the intent of the parties, the "plain meaning rule" controls and evidence relevant to contract interpretation is limited to the "four corners of the document." Where multiple agreements are executed collectively, those agreements are to be considered together when deciphering the parties' contractual intent. The absence of words excluding the lien limitation clause on Greentree personal property from applying to the loan agreement precluded any personal property rights under the loan agreement.

The decision in *Foothill* illustrates the importance of drafting precise contracts and the use of clear and unambiguous language. The case underscores the importance of using clear, consistent terms throughout *all* the documents involved in a deal. It is likely that evidence of parties' intent will be limited to the four corners of their documents; therefore, the drafter must ensure that the parties' intent is clearly expressed within the document.

Securities

Stock Valuation in Buyout: Oppressive Conduct Towards Minority Shareholder Invalidates Stock Purchase Agreement. *Hayes v. Olmsted & Assoc., Inc.*, 21 P.3d 178 (Or. Ct. App. 2001).

By Mark W. Aaron

The Oregon Court of Appeals held that the majority shareholders breached their fiduciary duty to the plaintiff, a minority shareholder. This constituted oppressive conduct sufficient to invalidate a previously negotiated Stock Purchase Agreement ("SPA"). Instead, a fair value approach to the valuation of the plaintiff's stock was imposed as the measure of damage.

In *Hayes*, plaintiff Dan Hayes was an employee, officer, director, and shareholder of Olmsted & Associates, Inc. ("O & A"), a food brokerage firm. Hayes was terminated a year before his planned retirement date, and offered a severance package that included the purchase of his shares at $64 per share. Hayes filed suit against O & A for judicial dissolution and other remedies, alleging oppressive conduct, misapplication of corporate assets, breach of fiduciary duty, and interference with prospective economic advantage. A settlement agreement provided for the purchase of Hayes' shares at a value to be determined by the court.

Although the trial court found that Hayes had been the victim of oppressive conduct, this had little effect on its judgment as to the value of the shares. A previously negotiated SPA provided that the parties would set the share value of the stock at least annually. The value was set at $64 per share three years prior to Hayes' termination, and had not been updated since.

At trial, Hayes argued that the price per share should be set at $171.35 per share, which his expert witness testified was the fair value of the stock. The trial court rejected Hayes' argument, valuing the shares at $67 per share, and finding that the SPA was a fair basis for valuing the stock since it took into account the interests of all parties involved.

On appeal, the Court of Appeals upheld the trial court's finding of a breach of fiduciary duty constituting oppressive conduct. The Court of Appeals observed that among the remedies available under Oregon law to a victim of oppressive conduct is a court order requiring the corporation to purchase the minority shareholder's stock at a "fair and reasonable price," based upon case-specific factual inquiries. The Court of Appeals, therefore, reversed the trial court on the measure of damages and held that Hayes' formula for fair market value was the correct approach, stating that the SPA was not an accurate measure of the stock's fair value because the agreement reflected a contractual compromise between the interests of the shareholders and the corporation. The agreement obviously did not take into account shareholder oppression.

Courts have great latitude when faced with fact-specific inquiries as to what constitutes oppressive conduct and fair value. The opinion in this case carefully avoids bright-line rules, leaving future courts the ability to decide these issues on a case-by-case basis.

Court Denies Corporate Representation by Current Shareholder in Class Action Settlement of Alleged Securities Violations. *In re Cendant Corp. Litig.*, 264 F.3d 286 (3d Cir. 2001).

By Scott P. Dill

The Third Circuit Court of Appeals (the "Court") upheld a district court's approval of a class action settlement for alleged securities violations. The Court principally held that a current shareholder of the defendant corporation could not object to the settlement because he was not a member of the class and his claims were best addressed in a shareholder derivative suit.

On December 17, 1997, CUC International, Inc. ("CUC"), merged with HFS, Inc. ("HFS"), to form Cendant Corporation ("Cendant"). After a four-month investigation into CUC accounting irregularities, Cendant reported to the SEC that CUC had materially misstated revenue and income in 1995, 1996, and 1997. Over this four-month investigation, Cendant's stock dropped 67 percent. Consequently, former shareholders of CUC, HFS, and Cendant sued, seeking damages for violations of the Securities Act and the Securities Exchange Act. The lawsuits were consolidated in a class action lawsuit and transferred to the U.S. District Court for the District of New Jersey. The plaintiffs included any person or entity that purchased or acquired certain CUC or Cendant securities from May 31, 1995, to August 28, 1998. The defendants included Cendant, 12 former officers and directors of CUC, and former officers and directors of HFS (the "HFS Individual Defendants").

On March 29, 2000, the District Court granted preliminary approval of a settlement agreement. Under the settlement, Cendant would pay $2.85 billion to the class and make certain changes to its corporate governance. In addition, Cendant and the HFS Individual Defendants would pay 50 percent of their recovery from claims brought against Ernst & Young, CUC's independent premerger accountant. Cendant would lose its contribution claims available through the Private Securities Litigation Reform Act ("Reform Act") and any federal or state law, but it would keep the right to assert claims against any defendant in future litigation.

Marvin Deutch objected to the settlement. Although he was not a class member, he moved to intervene as a current shareholder and a derivative action plaintiff. When the District Court rejected Deutch's objections and approved the settlement. Deutch appealed the decision on seven counts.

The Third Circuit rejected Deutch's three procedural arguments. First, the court stated that Federal Rule of Civil Procedure 23(e) required the court to consider the fairness, reasonableness, and adequacy of the settlement *to the class*, not Cendant. If Deutch wanted to argue that Cendant's board of directors breached their fiduciary duty of loyalty by agreeing to settlement terms that were unfair to Cendant, he should sue Cendant's board in a shareholder derivative action. Second, the Court rejected Deutch's argument that the notice of settlement was insufficient because Rule 23(e) requires a plaintiff to notify class members, not current shareholders. Third, the court stated that Deutch could not intervene as of right because Rule 24(a) requires intervention only when party interests are not represented. Because Cendant was represented in the lawsuit, Rule 24(a) did not apply.

The Third Circuit also rejected Deutch's four substantive arguments. First, the Court found that the Reform Act did not require the District Court to determine whether the HFS Individual Defendants paid their fair share in the settlement before Cendant released potential contribution claims, particularly when Cendant preserved its claims against the HFS Individual Defendants in the settlement. Second, the Court found that the HFS Individual Defendants had an implied duty to make a good faith effort under the settlement to seek recovery from Ernst & Young. Third, the Court held that neither Rule 23(e) nor the Reform Act required the District Court to determine the amount of the settlement attributable to Section 11 of the Securities Act. Fourth, and finally, the court used cases that defined indemnification as a corporation's reimbursement to its officers to hold that Cendant's payment to class members did not constitute an indemnification of the HFS Individual Defendants.

The Court rejected Deutch's objections to the class action settlement principally because Deutch, a current shareholder, could appropriately address his objections in a shareholder derivative suit. Practitioners representing plaintiffs in similar situations should determine whether a potential plaintiff qualifies for a particular class and, if not, which cause of action would best address the plaintiff's claims. Alternatively, practitioners representing defendants in similar situations should determine whether a current shareholder can join a particular class and, if not, should argue that non-class members cannot object to proposed settlements.

Fraudulent Intent Must Be Alleged with Particularity for Each Individual Defendant in Securities Fraud Litigation. *In re Envoy Corp. Sec. Litig.*, 133 F. Supp. 2d 647 (M.D. Tenn. 2001).

By Nathan A. McCoy

In an action for securities fraud against multiple defendants, the Private Securities Litigation Reform Act ("PSLRA") requires a complaint to state with particularity facts giving rise to a strong inference that each defendant acted with scienter or reckless behavior.

A class of common stock shareholders of Envoy Corporation ("Envoy") filed suit against Envoy, Envoy co-CEOs Goad and Kever, and CFO McNamara for securities fraud. Before the suit, Envoy engaged in a series of acquisitions that lead to an investigation of Envoy's accounting methods by the SEC. When Envoy purchased National Electronic Information Corporation ("NEIC"), it allocated a disproportionate amount of the purchase price to in-process research and development ("R&D"). As a result, Envoy avoided periodic amortization treatment because R&D must be written-off immediately. Envoy continued this pattern of making acquisitions and large one-time write-offs twice more, purchasing Diverse Software Solutions ("DSS") and Healthcare Data Interchange Corporation ("HDIC").

Envoy issued several public announcements regarding its financial status in connection with the acquisitions of NEIC, DSS, and HDIC. Each financial report indicated that Envoy experienced a consistent trend of steady growth and increased revenues. In addition, each report contained the assertion that Envoy's financial statements were prepared in accordance with generally accepted accounting principles ("GAAP"). Following the release of Envoy's financial statements, its common stock steadily increased in value, and reached $46 per share by February of 1998. In February, Envoy acquired three additional companies ("Expressbill Companies") for 3.5 million shares of stock. The defendants continued to release favorable financial reports until a press release on August 18, 1998 disclosed that the SEC was investigating its accounting practices. Finally, in November of 1998, Envoy revealed that it had overstated the funds allocated to R & D in several of its acquisitions. In addition, Envoy disclosed that it understated net losses from the fourth quarter of 1996 to the fourth quarter of 1997 and overstated net income for the first two quarters of 1998.

In their complaint, the plaintiffs alleged that the defendants were guilty of securities fraud for knowledge-able and reckless misrepresentations that affected the price of Envoy common stock. Specifically, the plaintiffs argued that the large one-time write-offs to R & D from Envoy's acquisitions of NEIC, DSS, and HDIC were unjustified, excessively high, and in violation of GAAP. The Court noted that a mere allegation of GAAP violations alone is not enough to state a valid claim for securities fraud; however, excessively large write-offs to R&D to disguise acquired assets indicates sufficient scienter for a securities fraud claim. The court determined that a reasonable person could consider Envoy's write-offs reckless, but the plaintiffs had failed to plead with particularity that the defendant CEOs had acted with scienter. However, the allegations against the CFO were sufficient because he was listed as Envoy's contact person and was responsible for all information disseminated to the public from the financial departments. Thus, a sufficient complaint alleging securities fraud against multiple defendants requires more than pleading the circumstances, it requires pleading facts specifically for each defendant that give rise to a strong inference of scienter.

Incentive Agreements at Time of Acquisition Held in Violation of the 1934 Act. *Katt v. Titan Acquisitions, Ltd*., 133 F. Supp. 2d 632; (M.D. Tenn. 2000).

By Stacey A. Terral

The United States District Court for the Middle District of Tennessee held that incentive agreements presented to officers of a target corporation were integral components of the acquiring corporation's tender offer and served primarily as an inducement to support the offer, thereby constituting additional consideration to some shareholders in violation of the "best price" rule of Section 14(d)(7) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78n(d)(7), and Rule 14d-10. In enacting this legislation, Congress sought to "assure fair treatment of those persons who tender their shares at the beginning of the tender period, and to assure equality of treatment among all shareholders who tender their shares." S.Rep. No. 550, 90th Cong., 1st Sess., at 10 (1967).

Titan Acquisitions, Ltd. ("Titan") and United Technologies Corp. ("UTC"), sought to acquire International Comfort Products ("ICP"). Titan made a tender offer for all outstanding ICP shares at $11.75 per share with a total consideration of $479 million. Titan also agreed to pay select ICP executives as much as $30 million in additional compensation upon the sale of the company. Plaintiff Katt, a non-officer ICP shareholder, filed a private class action alleging a violation of the best price rule.

Employing the criteria established in *Cort v. Ash*, 422 U.S. 66, 78 (1975), the court first determined that Katt had a right to bring a private class action pursuant to the 1934 Act, because, as a stockholder in ICP, he was a member of the class Section 14(d)(7) was intended to protect.

The court then turned to whether the additional consideration offered by the defendants to the ICP executives was offered "during the tender offer period." Section 240.10b-13 of the Federal Code of Regulations provides technical guidelines that define when a tender offer period begins or ends. The Seventh Circuit has established a "Bright Line" rule that uses the time limits in Rule 106-13 to define "during the tender offer" in Section 14(d)(7). *Lerro v. Quaker Oats Co.*, 84 F.3d 239, 242-43 (7th Circuit 1996). The Ninth and Second Circuits have declined to use the standard of Rule 10b-13, instead adopting functional tests to determine whether the additional consideration is an "integral part of the tender offer." *Epstein v. MCA, Inc.*, 50 F.3d 644, 654-56 (9th Cir. 1995); *Field v. Trump*, 850 F.2d 938, 943-44 (2d Cir. 1988).

While the court in *Katt* noted that "incentive contracts between a company and its key officers and executives are not [generally] subject to Section 14(d)(7)," it also pointed out that Titan's agreements were "executed solely in the context of . . . Titan's tender offer . . . and could be found to have been induced by Titan as part of its tender offer for ICP and not as contracts solely between ICP and its officers."

The decision in *Katt* may significantly affect the practice of mergers and acquisitions law in Tennessee. This case indicates that incentive contracts that are selectively offered and are dependent upon the success of an acquisition are made to induce shareholders to tender their shares and will likely be held to have been made within the tender offer period if they are "inextricably linked" with the tender offer. Consequently, acquisitions lawyers should advise their corporate clients to avoid offering incentives or other consideration to target corporation officers and executive shareholders as a precondition to a successful acquisition, unless the same consideration is offered to all the shareholders.

Transactions' Selection of Web Sites for Business Lawyers

Matt Wimberley, Senior Research Editor of *Transactions*, has updated and augmented the *Transactions'* Selection of Web sites for Business Lawyers as a service to our readers. If you have favorite or useful websites to business lawyers that did not make the list, please e-mail the specifics to the editors of *Transactions* at transact@justice.law.utk.edu for consideration.

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