
By Catherine Huie

The Eleventh Amendment to the United States Constitution precludes suits “in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State.” The Court has also interpreted the Eleventh Amendment to preclude suits against “an unconsenting State . . . by its own citizens.” However, in *Tennessee Student Assistance Corporation v. Hood*, the Supreme Court held that “a bankruptcy court’s discharge of a student loan debt does not implicate a State’s Eleventh Amendment immunity.”

Tennessee Student Assistance Corporation (“TSAC”) is a government corporation that was created to “administer student assistance programs” and guarantee student loans of Tennessee residents and qualified Tennessee students. Hood was a recipient of such student loans. In *TSAC v. Hood*, Hood filed a bankruptcy petition, and the United States Bankruptcy Court granted her a general discharge of all her debts. Because she did not list her student loans in the bankruptcy proceeding, they were not covered in the general discharge. Thus, Hood petitioned to have her case reopened and sought “a determination by the Bankruptcy Court that her student loans were dischargeable as an ‘undue hardship’ pursuant to” the bankruptcy code.

TSAC filed a motion to dismiss for lack of jurisdiction on the grounds of Eleventh Amendment sovereign immunity. The Bankruptcy Court denied the motion on the grounds that the Bankruptcy clause “was a valid abrogation of TSAC’s sovereign immunity” in 11 U.S.C. § 106(a). TSAC took an interlocutory appeal and the Bankruptcy Appellate Panel of the Sixth Circuit affirmed unanimously. TSAC appealed the panel’s decision and the United States Court of Appeal for the Sixth Circuit affirmed, “holding that the States ceded their immunity from private suits in bankruptcy in the Constitutional Convention, and therefore, the Bankruptcy Clause, provided Congress with the necessary authority to abrogate state sovereign immunity in 11 U.S.C. § 106(a).”
The United States Supreme Court affirms the Court of Appeal's judgment but on different grounds. The Court did not reach what the Court of Appeals considered to be the determinative issue because discharge of a student loan in a bankruptcy proceeding “does not implicate a State’s Eleventh Amendment immunity.”

TSAC “argue[d] that the particular process by which student loan debts are discharged unconstitutionally infringes its sovereignty.” Student loan debts are discharged only after a debtor secures a hardship determination in a separate action. To commence the hardship determination, the debtor must file a complaint and serve it with a summons on the creditor. TSAC argue[d] that “[b]y making a student loan debt presumptively nondischargeable and singling it out for an ‘individualized adjudication,’” Congress has permitted an action against a State. The Court rejected this argument by noting, “the bankruptcy court's jurisdiction is premised on the res, not the persona.”

The Court stated, “the States’ sovereign immunity did not prohibit in rem admiralty actions in which the state did not possess the res.” Similarly, the Court found that a bankruptcy action is also “an in rem proceeding.” It pointed out that a bankruptcy proceeding is “one against the world” and because the bankruptcy court has in rem jurisdiction, it is permitted to determine any claim that anyone has against the property in question, “whether named in the action or not.” Where the bankruptcy court’s “jurisdiction over the res is unquestioned,” precedent “indicate[s] that the exercise of its in rem jurisdiction to discharge a debt does not infringe state sovereignty.”

The bankruptcy court had in rem jurisdiction over the case and had “not attempted to adjudicate claims outside that jurisdiction.” The Court stated that “[t]o conclude that the issuance of a summons, which is required only by the Rules, precludes Hood from exercising her right to an undue hardship determination would give the rules an impermissible effect.” Thus, the Court did not decide whether a bankruptcy court’s exercise of personal jurisdiction over a State would be valid under the Eleventh Amendment. The Court did note, however, that “[i]f the Bankruptcy Court on remand exceeds its in rem jurisdiction, TSAC . . . would be free to challenge the court’s authority.”

Practitioners should take note that a bankruptcy proceeding involving the discharging of loans which a State made or guaranteed is a proceeding in rem and does not implicate that State’s Eleventh Amendment sovereignty. However, this case does nothing to settle the question of whether adversary proceedings within a


bankruptcy proceeding that implicate the need for in personam jurisdiction are a violation of a State's sovereignty.


By Meredith Adams Mallard

When a Chapter 13 debtor selects the “cram down option,” by choosing to satisfy his secured creditors’ interests through deferred installments, the interest rate applied to the future payments must take into account the opportunity costs to the creditor, the possibility of inflation, and the risk of nonpayment. Of the available methods for determining the appropriate interest rate, the United States Supreme Court found that the formula approach best reflects the principles of the bankruptcy system in Till v. S.C.S. Credit Corporation.

The debtors financed the purchase of a vehicle with a retail installment contract that was assigned to the creditor. Approximately a year later, the debtors, behind in their payments to the creditor, filed for bankruptcy under Chapter 13. Having promptly asserted a secured interest, 11 U.S.C. § 1325(a)(5)(B) entitled the secured creditor to receive the “value, as of the effective date of the plan,” that equals or exceeds the value of the creditor’s secured claim.” The debtor’s debt adjustment plan provided that the debtor would satisfy the creditor’s interest with monthly payments.

The debtor proposed that the formula rate, using the national prime rate as its base, determine the interest rate for the future payments. Although the creditor argued that the formula rate was insufficient to cover the risk of the debtor’s nonpayment, the Bankruptcy Court applied the formula rate, recognizing that a higher interest rate would make it too difficult for the debtor to complete his Chapter 13 plan. The District Court reversed the decision of the Bankruptcy Court, supporting the coerced or forced loan approach. The Seventh Circuit modified this approach with the presumptive contract rate, holding that the court should base the interest rate upon the parties’ initial loan contract and allow the parties to rebut the presumptive rate. The dissenting opinion to the appellate court’s decision asserted that the “cost of funds” method, which takes into account the value that the creditor has received, should apply when determining the appropriate interest rate.
The United States Supreme Court held that bankruptcy courts should use the formula approach when determining the appropriate cram down interest rate. The Court recognized that this approach for determining the interest rate is superior, because it best reflects the present value of the debtor's payments, reduces the need for costly litigation, and does not overcompensate creditors. Moreover, it provides for an objective examination of the creditor and the loan transaction by focusing on the appropriate value of the debtor's payments instead of on the individual creditor's status. In addition, the formula rate permits the bankruptcy courts to modify the terms of the parties' initial loan contract to reflect the bankruptcy system's positive impact on the risk of nonpayment.

A hearing may be held to determine the appropriate risk adjustment to the national prime rate. The adjustment will depend on “the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan.” Because the national prime rate is modest in value, the burden is on the creditors to increase the interest rate. The adjustment of the interest rate is limited in that it should not be so high that it incapacitates the debtor's ability to complete the plan.

This decision resolves the disparate views of how cram down interest rates should be calculated and informs bankruptcy attorneys that the formula rate approach will be applied to future property distributions. Creditors' attorneys must be prepared to present evidence to raise the national prime interest rate to an amount that will fully compensate creditors for the present value of their secured interests.

**Attorneys Beware! A lawyer may be denied fees if a Chapter 11 bankruptcy is converted to a Chapter 7.** Lamie v. United States Trustee, 540 U.S. 526 (2004).

By Patrick C. Woodside, Jr.

Affirming the United States Court of Appeals for the Fourth Circuit, the United States Supreme Court held that even though 11 U.S.C.S. § 330(a)(1) was awkward and ungrammatical, the statute was not ambiguous and did not authorize compensation awards to debtors’ attorneys from estate funds, unless the awards were authorized by 11 U.S.C.S. § 327. Therefore, the petitioner was not entitled to legal fees for work done after the Chapter 11 bankruptcy was converted to a Chapter 7.

Petitioner, a bankruptcy attorney for the debtor, applied for compensation for legal services that he provided to the debtor after the proceeding was converted to a chapter 7 bankruptcy. However, the Bankruptcy Court, the District Court, and
the United States Court of Appeals summarily denied petitioner’s application for fees for the Fourth Circuit. Furthermore, each court held that in a Chapter 7 proceeding, § 330(a)(1) does not authorize payment of attorney’s fees unless the attorney has been appointed pursuant to § 327 of the Bankruptcy Code.

Congress amended the Bankruptcy Code in 1994. The Bankruptcy Reform Act of 1994 addressed the subject of professional fees and serious changes were made. Prior to the 1994 Act, § 330(a) provided:

“(a) After notice to any parties in interest and to the United States trustee and a hearing, and subject to sections 326, 328, and 329 of this title, the court may award to a trustee, to an examiner, to a professional person employed under section 327 or 1103 of this title, or to the debtor’s attorney –
“(1) reasonable compensation for actual, necessary services rendered by such trustee, examiner, professional person, or attorney. . . .”

However, the 1994 Act changed the language of the statute considerably. The Court stated, “As can be noted, the 1994 enactment’s principal, substantive alteration was its deletion of the five words at the end of what was § 330(a) and is now § 330(a)(1): ‘or to the debtor’s attorney.”’

In the present case, Equipment Services, Inc. (“ESI”) hired petitioner to prepare, file, and prosecute the chapter 11 proceeding. However, three months into the proceeding, the United States trustee filed a motion to convert the action into a chapter 7 liquidation proceeding, and the Court subsequently granted the motion. This ceased ESI’s status as debtor-in-possession and so terminated petitioner’s service under § 327 as an attorney for the debtor-in-possession. Nevertheless, petitioner proceeded to supply legal services to the debtor, despite the fact that the petitioner did not obtain the trustee’s authorization to do so.

The petitioner argued that the statute is ambiguous. However, the Court disagreed and stated that “[t]he starting point in discerning congressional intent is the existing statutory text . . . not the predecessor statutes.”

The Supreme Court’s decision is clear: If the attorney expects to be paid from the bankruptcy estate under § 330(a)(1) in a chapter 7 case, the attorney must seek employment from the trustee and approval by the court. This case should not cause consternation for bankruptcy attorneys as long as they are familiar with the requisite steps to secure payment in a Chapter 7 case.
It's Just a Box: Sixth Circuit forces Tennessee to open up the casket market. 
*Craigmiles v. Giles*, 312 F.3d 220 (6th Cir. 2002).

By Courtney M. Rogers

The Sixth Circuit held that limiting entry into the casket market to licensed funeral directors violates the 14th Amendment’s Due Process and Equal Protection Clauses in *Craigmiles v. Giles*.

The plaintiffs were small business owners within the casket industry. They sold caskets, urns, gravemarkers, monuments, and flower holders, but not embalming or funeral services. The plaintiffs brought suit in the United States District Court for the Eastern District of Tennessee alleging that the Tennessee Funeral Directors and Embalmers Act (“TFDEA”)\(^1\), as applied to them, violated the 14th Amendment.

TFDEA requires all people involved in selling “funeral merchandise” to hold a funeral director’s license. None of the plaintiffs held such licensure. The plaintiffs alleged, and the district court found, that this restriction violated both the Due Process and Equal Protection Clauses of the 14th Amendment for lack of a rational basis.

On appeal, the Sixth Circuit considered whether restricting casket sales to licensed funeral directors bore a rational relationship to a legitimate state purpose. The state argued that this restriction promoted two state goals: public health and safety and consumer protection. The Sixth Circuit found that no such relationship existed.

Hoping to support its public health and safety goal, the state argued that requiring licensure assures that dead bodies are disposed of safely and that communicable diseases are not spread. The court highlighted the inadequacy of this claim; casket retailers would never be in contact with a dead body. The plaintiffs merely sold caskets and delivered them to the appropriate funeral homes. Next, the state proposed that casket quality is important and only licensed funeral directors are capable of making this determination. The court disposed of this argument by citing

\(^1\) The Tennessee Funeral Directors and Embalmers can be found at Tenn. Code Ann. § 62-5-101, *et seq.*
that no casket standards exist – indeed caskets are not even required when burying a person.

Furthermore, the district court found and the Sixth Circuit affirmed that a casket is nothing more than a box. No regulations exist to sell a box, and none should exist for a casket. Thus, the court concluded that no rational relationship existed between TFDEA’s provisions regarding casket retailers and the state’s stated goal of public health and safety.

The state then unsuccessfully argued its goal of consumer protection, positing that licensed funeral directors are specifically trained to deal with grief-ridden people and that TFDEA protects casket consumers from fraud and misrepresentation. The court was unconvinced and rebutted the state’s consumer protection argument by finding that TFDEA actually “harms consumers in their pocketbooks.” Market-place competition would alleviate this by lowering casket prices.

Although the court concedes that public health and safety and consumer protection are legitimate state interests, they found no rational relationship existed between the goals and the means in place to achieve them. Noting that it is rare for a regulation to be struck down by rational basis review, the court found that “[t]his case should be among this handful.”

In conclusion, the court noted that the only protection afforded by this regulation is to state funeral directors. TFDEA was the legislature’s “naked attempt to raise a fortress protecting the monopoly rents that funeral directors extract from consumers.”

This case shows that rational basis review is still alive and that state regulations are not impenetrable. Additionally, this case reinforces that “protecting a discrete interest group from economic competition is not a legitimate government purpose.” Business lawyers around the country should rejoice. One more case is in the books against regulations with monopolistic effects. Everyone else should rejoice, too. If anyone can sell a box, and a casket is just a box, then that ever-needed box will be dropping in price soon.
CONTRACTS

**Note:** The Tennessee Supreme Court granted permission to appeal in the case of *Murfreesboro Med. Clinic, P.A. v. Udom*, No. M2003-00313-COA-R9-CV, 2004 WL 193049, 2004 Tenn. LEXIS 743 (Tenn. Ct. App. 2004), on September 7, 2004. This case involved buy-out provisions that barred injunctive relief where the parties have agreed upon such provisions in a non-compete agreement and was the subject of a commentary in the Fall 2004 Issue.

Statute of Frauds does not apply where parties did not specifically agree that contract would absolutely last more than one year. *Birdwell v. Psimer*, 151 S.W.3d 916 (Tenn. Ct. App. 2004).

By Tracy Dry Clevenger

Applying Tennessee law, the Tennessee Court of Appeals held that where there was no proof that the parties specifically agreed that a loan would “absolutely not be repaid within one year,” the statute of frauds did not apply.

Plaintiff Birdwell sued defendant Psimer on a loan where plaintiff loaned defendant $30,000. The loan was secured by a note owed to defendant by a third party, which defendant had assigned to plaintiff. Defendant denied that the transaction was a loan and instead asserted that plaintiff purchased the note at a discount. Defendant also pled the statute of frauds as an affirmative defense. Defendant asserted that the contract could not be performed in one year and that no writing that complied with the statute existed to commemorate the transaction.

Plaintiff testified that the parties never discussed the transaction as a sale and produced extrinsic evidence that the transaction was indeed a loan. Plaintiff also produced the note used as collateral, which included an acknowledgment of the loan and an assignment of the note as collateral for the loan. Plaintiff’s secretary, who witnessed the transaction, testified and corroborated plaintiff’s assertions. Defendant testified that the transaction was a sale and that although the writing for the assignment of the note mentioned that the note was collateral for a loan, he was unsure what loan was referred to. The trial court found that plaintiff did not prove a loan, that the statute of frauds applied, and that the requirements of a note were not satisfied by the acknowledgment.
The Court of Appeals stated that when time is an issue, the parties must agree that the contract will not be performed within one year. That agreement must be demonstrated in the contract or in the words or actions of the parties at the time of the contract. The contract must require that it not be performed within one year. Unless a court can say that it is reasonably probable that the contract could not be performed within one year, the court should uphold the contract. The Court found “no proof that the parties agreed that the loan would absolutely not be repaid within one year.” Therefore, the Court found that the statute of frauds did not apply and that because the defendant signed the acknowledgment of the loan, the defendant could not argue that the contents of the document he signed were incorrect.

This case is important to business practitioners because it demonstrates when a writing is necessary to satisfy the statute of frauds. If a client has entered into a contract that is not properly documented, the practitioner should determine whether there is evidence that demonstrates that the contract absolutely could not be performed within one year before advising the client that the contract fails to satisfy the statute of frauds.


By Jason Gast

Exculpatory clauses—contractual clauses that relieve a party from a specified degree of liability—are valid tools in Tennessee, according to the recent case of Ouzts v. Womack. What makes this case noteworthy is that the Court of Appeals decided that properly drafted and executed exculpatory clauses can protect a party from liability—even for their own potentially fraudulent statements.

Husband and wife Michael Womack and Victoria Raub (“Sellers”) put their Memphis home up for sale in April 2000. When they did so, the Sellers wrote a residential disclosure statement that stated that their property was not subject to flooding. Steven Ouzts (“Ouzts”) became interested in the property but was concerned about the possibility of flooding, so he directed his real estate agent to ask the sellers about any history of flooding. The Sellers’ agent stated that the Sellers had not experienced any flooding problems.
Ouzts was satisfied and made an offer on the house. The Sellers counter-offered and also added an exculpatory clause that said, in part: “[g]rantor has not made and does not hereby make . . . any representations or warranties of any kind . . . with respect to the property, its condition . . ., uses or fitness for any particular purpose.” Additionally, the clause disclaimed any past representations by the Sellers and discharged the Sellers from responsibility for any representations they had made. Finally, the clause stated that it would survive the closing and be binding upon the parties and their successors. Ouzts accepted and purchased the house.

Predictably, flooding damaged the property two years later. Ouzts sued the Sellers as well as their agent, alleging that the Sellers fraudulently misrepresented their knowledge that the property was prone to flooding. He sought compensatory and punitive damages, as well as rescission of the contract. The Sellers filed motions for summary judgment, arguing that the exculpatory clause protected them from any liability. The trial court granted the motion, stating that the exculpatory clause “clearly states that the defendants did not make any representations as to any of the conditions [of] which the plaintiff is complaining.”

The Court of Appeals agreed. Citing the common law rule that contract clauses must be interpreted according to their plain meaning whenever possible, the court then found that the exculpatory clause was unambiguous. Accordingly, Ouzts’ statement that his acceptance of the exculpatory clause was based directly on the Seller’s earlier representations that were disclaimed by that very clause was inherently unreasonable. The court went on to add that “even assuming that [the Sellers] knowingly misrepresented the Property’s susceptibility to flooding, this would not be a material fact” that would prohibit summary judgment.

Ouzts v. Womack illustrates how powerful exculpatory clauses can be. The Court of Appeals found that even if the Sellers had purposefully lied to Ouzts about the possibility of flooding, Ouzts could not complain about that lie because he knowingly agreed to the exculpatory clause that disavowed any previous representations by the Sellers. Transactional attorneys should take note of this case, both when they are using exculpatory clauses and when those clauses are being used against them. Exculpatory clauses are read literally in Tennessee, even when there are potentially compelling reasons not to do so.

By Gennie Gieselmann

An arbitration clause remains valid and enforceable in the absence of duress or a contract of adhesion. Absent a sufficient showing that the agreement is not valid, Tennessee courts will enforce the arbitration clause.

Vickery Transportation, Inc. and Grammer Industries, Inc. (collectively referred to as “Vickery”) operate a hazardous waste transportation business. In May of 2002, a driver for Vickery was transporting hazardous waste from Helena, Arkansas to Vickery, Ohio, and made a stop in Haywood County, Tennessee. After pulling over, the driver noticed that the hazardous chemicals were beginning to react and spill out of the truck onto the ground. Vickery called Spill Center, a company that maintains a database of companies who perform hazardous waste cleanups. Through Spill Center, Vickery contacted HEPACO, Inc. and contracted with them to clean up the spill. HEPACO began cleaning the spill only after a Vickery manager signed HEPACO’s standard service agreement.

Vickery became concerned with HEPACO’s method and standard of cleaning and asked HEPACO to sign an indemnity agreement. When HEPACO refused, Vickery terminated the agreement. HEPACO filed a complaint to compel arbitration for breach of contract in accordance with the service agreement. In response, Vickery filed for declaratory judgment to stay arbitration and compel litigation by finding the contract, including the arbitration clause, unenforceable because it was a product of duress or a contract of adhesion. The trial court granted Vickery’s motion to compel litigation and stay arbitration. The Tennessee Court of Appeals reversed.

The Tennessee Court of Appeals found that the agreement was not signed under duress even though HEPACO waited until moments before the clean-up was to begin to inform Vickery that a service agreement would need to be authorized in order to start cleaning. The court stated that requiring a signed agreement before performing services is not “unlawful, wrongful, or coercive.” See Flynt Eng’g Co. v. Cox, 99 S.W.3d 99 (Tenn. Ct. App. 2002). Moreover, according to 28 Samuel Williston, Treatise on the Law of Contracts § 71:23, at 522-23 (Richard A. Lord ed., 4th ed. 2003), duress does not occur when the other party is not responsible for the
circumstances creating the urgency to enter the agreement. The court found that Vickery could not claim duress because HEPACO did not create the situation that required urgent attention.

The Tennessee Court of Appeals ruled that the agreement was not a contract of adhesion. The court based its ruling on the fact that Vickery could obtain the same service from other companies because the Spill Center had a database of several companies that provided the same services as HEPACO. In fact, Vickery made several attempts to secure the services of another spill removal company. The court ruled that the agreement was not a contract of adhesion, therefore the agreement and arbitration clause were enforceable.

_Benton v. Vanderbilt Univ.,_ 137 S.W.3d 614 (Tenn. 2004).

Third-party beneficiaries are bound by arbitration provisions contained in contracts when they sue to enforce the contract. In general, parties to a contract are bound by the agreed terms of a contract, regardless of whether the terms are favorable or unfavorable. Similarly, third-party beneficiaries with standing to enforce favorable terms must also accept unfavorable terms. The Supreme Court of Tennessee reaffirmed this principle by holding that third-party beneficiaries must adhere to arbitration provisions of a contract even if the third-party beneficiary considers the provision unfavorable.

The plaintiff, Larry Eugene Benton ("Benton") received medical treatment in The Vanderbilt University Medical Center ("Vanderbilt") after being injured in a car accident. Benton's insurance carrier, Blue Cross and Blue Shield of Tennessee ("Blue Cross") had a contract with Vanderbilt stating that Vanderbilt would provide medical services for a reduced rate and that Vanderbilt would not charge the Blue Cross members the difference. Blue Cross paid Vanderbilt according to their fee agreement. However, when Benton filed a lawsuit for personal injuries against the negligent driver, Vanderbilt tried to recover the difference between Blue Cross' reduced rate and the normal rate by filing a hospital lien against any monetary recovery Benton might receive.

Benton filed a complaint against Vanderbilt for abuse of process, breach of contract, and violation of the Tennessee Consumer Protection Act. Vanderbilt responded by filing a motion to compel arbitration and stay litigation based on the fact that Benton was a third-party beneficiary to the contract at issue and should be

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2 The Tennessee Consumer Protection Act of 1977 can be found at Tenn. Code Ann. § 47-18-101, _et seq._
bound by the arbitration provision. The trial court denied Vanderbilt’s motion by finding that Benton was not bound by the arbitration provision because he was not a party to the contract. The Court of Appeals reversed and held that Benton’s status as a third-party beneficiary required him to adhere to the arbitration provision. The Tennessee Supreme Court affirmed.

The Tennessee Supreme Court noted that, according to Tennessee statute and existing case law, arbitration is a preferred mode of dispute resolution. Tenn. Code Ann. § 29-5-302(a) (2000); Buraczynski v. Eyring, 919 S.W.2d 314, 317 (Tenn. 1996). In addition, Tennessee courts have recognized that when a beneficiary accepts favorable terms of a contract, the beneficiary must also accept unfavorable terms. Applying these general principles, the Tennessee Supreme Court concluded that arbitration provisions could be enforced against third-party beneficiaries.

The court emphasized the narrowness of their holding by finding that in order for the arbitration provisions to be enforceable against a third-party beneficiary; the third-party beneficiary must bring an action to enforce certain rights found in that contract.

**Conclusion**

These two recent Tennessee decisions emphasize the judiciary’s preference towards enforcing arbitration provisions. If an arbitration provision is part of a sound and enforceable contract, the courts will bind the parties to their agreement. Further, transactional attorneys should be aware that a contractual provision to arbitrate will be enforced against third-party beneficiaries when that party files suit to enforce the contract. The courts are sending a message to Tennessee attorneys: Arbitration provisions will be enforced.
EMPLOYMENT


By Jason Robert Whitler

Although under Tennessee law, employees are employed on an at-will basis, the employer-employee relationship is often complicated by the employer's issuance of an employee handbook. The employee often considers the handbook a contract of employment governing the employer-employee relationship. This was the situation in *McCarthy v. UT-Battle, LLC*.

In *McCarthy v. UT-Battle, LLC*, Oak Ridge National Laboratory (“ORNL”) terminated John F. McCarthy’s employment on August 24, 2001, for misconduct in allegedly directing an employee to falsify her time record. One month later, McCarthy asked for a peer review of his termination, which was denied as untimely. He then initiated another appeal which was also denied as untimely.

McCarthy then sued ORNL for wrongful termination, claiming that ORNL did not follow the procedure prescribed in its handbook (“Handbook”). The circuit court granted summary judgment in favor of ORNL because the Handbook that McCarthy was relying on was not a contract of employment.

The issue on appeal was straightforward: did the Handbook create a contractual right for a peer review hearing?

Under Tennessee law, ORNL did not have to give a reason to discharge McCarthy because his employment was at-will. Under the at-will doctrine, the employee or the employer can terminate the employment relationship at any time for any reason not prohibited by law. Since McCarthy’s employment was at-will, the Handbook clearly did not govern the employer-employee relationship of the parties.

McCarthy argued that he was entitled to a peer review appeal based on the holding in *Williams v. Maremont Inc.*. Williams addressed the issue of whether an

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3 776 S.W.2d 78 (Tenn. Ct. App. 1988) (Permission to appeal denied by Tennessee Supreme Court on April 17, 1992).
employee handbook gave laid-off employees a contractual right to be recalled based on their seniority. The handbook in that case provided provisions that indicated that the employer intended to create a binding commitment between the employer and its employees.

However, the Handbook at issue explicitly provided that it “neither implies nor establishes an employment contract” and “is intended as an informational guideline only.” Furthermore, it explicitly stated, “the contents of this handbook do not constitute the terms of an employment contract.” Having concluded that Williams was inapplicable to the case at bar, the court affirmed the lower court’s grant of summary judgment to ORNL.

As McCarthy demonstrates, an employee handbook issued by the employer generally does not govern the employer-employee relationship. In the absence of language indicating the employer’s intent to create a binding commitment, the handbook does not establish an employment contract and merely operates as an informational guide. Employment attorneys in the future should scrutinize the terms of employee handbooks to see the employer has indicated any intent to create a binding commitment.


By Megan Jane Wilson

The standard of review for an arbitration award “is one of the narrowest standards of judicial review in all of American jurisprudence.” As long as the arbitrator’s award “draws its essence from the collective bargaining agreement,” a court will not overturn the decision even if the court believes the arbitrator committed a serious error. As Way Bakery v. Truck Drivers Local illustrates, employers are unlikely to be able to convince a court to invalidate an arbitration award.

Way Bakery employed union member James Zentgraf as a truck driver. In February of 2000, Zentgraf, who is white, told his African-American coworker to “relax Sambo.” Way Bakery fired Zentgraf for violating the Company’s Equal Employment Opportunity (“EEO”) policy. He filed a grievance in protest, which was submitted to arbitration. The arbitrator reinstated Zentgraf’s employment at Way Bakery subject to a six-month suspension and five year probation period. Way
Bakery sued to get the arbitration award vacated. When the district court granted the Union’s and Zentgraf’s motion for summary judgment, Way Bakery appealed.

On appeal, Way Bakery argued two issues: (1) the arbitrator exceeded the scope of his authority under the Collective Bargaining Agreement (“CBA”), and (2) the award violated public policy. The court developed a four-prong test to determine whether the arbitration award failed to draw its essence from the CBA. “An award so fails when: (1) it conflicts with express terms of the agreement; (2) it imposes additional requirements not expressly provided for in the agreement; (3) it is not rationally supported by or derived from the agreement; or (4) it is based on general considerations of fairness and equity instead of the exact terms of the agreement.

The court did not find any evidence to suggest that the award was in conflict with the provisions of the CBA. Because the EEO policy stated that discipline could be “up to and including discharge,” Way Bakery could – but was not required to – discharge Zentgraf. Thus, under the CBA, the arbitrator was authorized to review Way Bakery’s termination of Zentgraf, and the award did not conflict or add to the express terms of the CBA.

Additionally, Way Bakery argued that the Zentgraf’s reinstatement violated public policy, because it impedes the employer’s effort to comply with Title VII and to end harassment in the workplace. When deciding whether an award violates public policy, “the court must determine whether the arbitrator’s interpretation of the contract jeopardizes a well-defined and dominant public policy, taking the facts as found by the arbitrator.” The central issue is not whether Zentgraf’s conduct violated some public policy, but instead whether the award granting reinstatement of employment violated some overt public policy.

The court distinguished Zentgraf’s reinstatement from two prior workplace harassment cases that had been found to violate public policy where an employee was reinstated without the arbitrator even determining whether sexual harassment had even occurred, and the employee was reinstated even though he had a history of sexually harassing his female coworkers and had been disciplined previously for the same misconduct. Zentgraf did not have a record of past workplace harassment. The court also pointed out that even though Zentgraf was reinstated, the arbitrator still acknowledged that a serious offense had occurred and subjected Zentgraf to a six-month suspension without pay and a five year probation, during which time he would be terminated immediately if he was involved in a similar incident. Zentgraf also had to acknowledge in writing that he understood he could remain employed with Way Bakery only if he abided by the EEO policy. The court said that the
arbitration award did not condone Zentgraf’s racially offensive remark, rather it
disciplined him by suspending him without pay and placing him on probation. Thus,
the court held that the award did not violate any public policy.

As Way Bakery illustrates, the court has a very limited review of decisions
made by an arbitrator, and as long as there is some basis for the arbitration award in
the CBA, the court will uphold the award. Also, in order to prove that a
reinstatement award violates public policy, an employer will need to prove more than
reprehensible conduct. In order to violate public policy, the reinstatement award
must follow past similar conduct or fail to punish the employee so that future
misconduct would be deterred.

PROPERTY

The State cannot hold a subsequent owner of land strictly liable under the
Tennessee Water Quality Control Act without proof of violation. Furthermore, judgment liens against land are not enforceable against
subsequent owners absent strict compliance with statutory requirements.

By Chris Harris

The Tennessee Court of Appeals held in State ex rel. Summers v. B&H
Investments, Inc., that (1) the Tennessee Water Quality Control Act4 does not impose
strict liability on landowners without proof of violation, and (2) judgments against
previous owners of land do not “run with the land” against subsequent owners
unless specific statutory requirements are met pursuant to Tenn. Code Ann. § 25-5-
101(c).

The main issues on appeal were (1) Did the Water Quality Control Act impose strict liability on B&H to abate a condition of pollution caused by the

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4 The Tennessee Quality Water Control Act of 1977 can be found at Tenn. Code Ann. § 69-3-101, et seq.
previous landowner? (2) Did judgments against the previous landowner run with the land pursuant to Tenn. Code Ann. § 25-5-101(c)?

In its address of the first issue, the Tennessee Court of Appeals noted that the Tennessee Water Quality Control Act was developed from the Federal Water Pollution Control Act. The court also noted that the federal statute had also been construed as a strict liability statute. However, the court pointed out that the Federal Water Pollution Control Act did not “impose liability without proof of any violation by the owners.” The court also went on to explain that “strict liability relieves the government of the obligation to show mens rea, not the actus reus.” Therefore, strict liability cannot hold a subsequent owner liable for a violation by a prior owner.

From its interpretation of Allegheny, the Tennessee Court of Appeals vacated the trial court’s judgment that B&H was strictly liable under the Act and remanded the issue for further review to determine from the facts whether B&H had committed any actual deeds that violated the Act.

The Court of Appeals also dealt with the issue of whether the previous judgments against the prior owner “ran with the land” and were enforceable against B&H. The court explained “a judgment obtained in Tennessee becomes a lien on the debtor’s real property when the judgment is recorded in the register’s office of the county where the land is located.” The court also explained that in order for the judgments rendered against the previous owner to be effective against B&H (i.e., to “run with the land”), the judgment on file must contain the parties’ names, case number, court, date entered, and a description of the property.

The court noted that in this case, the abstracts did not mention the island by name, nor did they describe the property. Therefore, there was no notice that a lien was intended to be placed on the island. Because statutory requirements are strictly construed in Tennessee, the court held that the judgments against the previous landowner did not run with the land and therefore did not affect B&H.

B&H Investments, Inc. demonstrates that an owner of land can be held strictly liable under the Tennessee Water Quality Control Act only if the owner has actually committed a violation. Therefore, a subsequent owner who has purchased land cannot be held strictly liable for the previous owners’ violation. The subsequent owner must have committed some violation of his own. B&H Investments, Inc. also demonstrates that judgments against previous owners of land only “run with the

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land” if the judgments have been recorded according to the strict requirements of certain Tennessee statutes.

Transactional lawyers should pay close attention to whether the actus reus element of the Tennessee Water Quality Control Act has been satisfied if there is an attempt to hold their client strictly liable under the Act. They should remember that there has to be a violation of the Act by their client in order for strict liability to apply. Transactional lawyers should also note that if they have a client that has purchased land, judgments against the property do not “run with the land” unless specific statutory requirements are met that give their client notice of the judgments.


By Emily S. Kaderly

In Creech v. Addington, the Tennessee Court of Appeals held that a summary judgment ruling was inappropriate when the issue of agency between independent land brokers and landowners was a disputed issue of fact. The court of appeals decision vacated and remanded the trial court’s summary judgment ruling in favor of the defendant landowners.

The plaintiffs in Creech v. Addington were investors who leased land from the defendant landowners. The land, located in Tunica, Mississippi was expected to become highly developed because of casino boats that were moving into the area. The plaintiffs planned to build multi-million dollar motels on the leased land.

The plaintiffs learned of the investment opportunity at an investment meeting headed by Lloyd and Betty Link. The Links had an understanding with the landowners that if the Links found the leases, they could retain any amount obtained above the defendant landowners’ asking price. From the time of the investment meeting until the plaintiffs purchased the leases, the plaintiffs were assured by the Links that financing to build the motels was already in place. However, the financing the plaintiffs were promised never materialized, and the deal collapsed. The plaintiffs brought suit against multiple parties, including the landowners and the Links. The Links were dismissed from the suit based on the statute of frauds. The trial court, finding there was no issue of material fact, granted summary judgment in
favor of the landowners on the grounds that there was no proof that the landowners made any misrepresentations to the plaintiffs.

The Tennessee Court of Appeals found that the trial court did not properly address the plaintiffs’ claim that the Links were agents of the landowners and that, therefore, the landowners were liable for their agents’ misrepresentations. The appellate court noted that, should an agency relationship be proven, the landowners could be held liable for the acts of the agents performed on the landowners’ behalf, depending on the circumstances and the amount of control exercised by the landowners. The court of appeals held that the question of whether the Links were acting as agents for the landowners was a disputed question of fact to be determined by the trial court.

_Creech v. Addington_ illustrates that landowners using independent parties to find investors could be liable for the actions of those independent parties under an agency theory. In determining whether agency exists, courts will look at the principal’s right to control the acts of the agent as well as the amount of actual control exercised by the principal over the agent. Landowners cannot rely on summary judgment simply because they themselves did not make misrepresentations to investors.

_A plaintiff can prove an ongoing or recurring dangerous condition in order to establish notice in a premises liability case, but a layperson property owner does not have notice when the condition is only recognizable by an expert absent an agency relationship with such expert (a two case analysis)._ Blair _v. West Towne Mall_, 130 S.W.3d 761 (Tenn. 2004); Shipwash _v. Meadowood Apts._, No. E2003-01528-COA-R3-CV, 2004 WL 690008, 2004 Tenn. App. LEXIS 191 (Tenn. Ct. App. Mar. 31, 2004).

By Darsi M. Newman

In _Blair v. West Towne Mall_, the Tennessee Supreme Court held that a plaintiff in a premises liability action may establish constructive notice of a dangerous condition by showing a continuing condition or a recurring incident indicating the condition’s existence. Shortly after that decision, the Tennessee Court of Appeals held in _Shipwash v. Meadowood Apartments_ that a layperson property owner does not have imputed constructive notice of a dangerous condition merely because he hires an expert to inspect for such a condition. In order for the expert’s knowledge to be imputed to the property owner, there must be an agency relationship between the property owner and the expert.
Blair slipped and fell on an oil spot as she was exiting West Town Mall. She claimed that the Mall repeatedly allowed buses to drop off passengers at that spot and that the Mall knew or should have known that those vehicles, while stopped at the mall entrance, would leak fluids that could create slick spots. The Tennessee Supreme Court had previously held that a plaintiff could establish constructive notice by proving that the dangerous condition had existed for such a length of time that the property owner should have become aware of it. However, the Court in *Blair* relieved plaintiffs of the difficult task of showing the duration of a particular condition as long as they can show that the dangerous condition was a recurring incident or a continuing condition such that the property owner could have reasonably foreseen its existence.

In the *Shipwash* case, the plaintiff sued Meadowood Apartments to recover for damage done when a tree near the apartment’s parking area fell on her vehicle during a severe storm. At trial, her expert testified that the tree should have been removed because it exhibited signs of decay before the storm. In particular, the tree had large holes and white spots on its trunk, and its leaves were brown. Meadowood contracted with a tree service to inspect all of its trees each spring. The tree service reported no problems with the tree in its most recent inspection, which was eight months before the tree fell. The court found that the signs of decay plaintiff’s expert noted were not sufficient to alert a layperson that the tree was dead. Because the tree fell in late fall, it was common at that time for trees to have brown leaves. The court also found that the presence of a visible hole in the tree was not enough to constitute notice of a dangerous condition. Because Meadowood only hired the tree service to conduct annual inspections and did not dictate how the tree service should perform its work, the court held that the tree service was an independent contractor rather than an agent of Meadowood. Therefore, the tree service’s expert knowledge was not imputable to Meadowood. Because Meadowood had no knowledge of the dangerous condition caused by the dead tree, the court held that it was not liable for the damage to Shipwash’s vehicle.

The *Blair* decision aids a plaintiff in establishing a prima facie case of premises liability by providing an easier way to prove the crucial element of notice. The *Shipwash* case narrows the *Blair* decision somewhat by saying that, even if the plaintiff can prove an ongoing dangerous condition, the condition must be apparent to a layperson property owner if the property owner has neither expert knowledge of his own nor an agency relationship with an expert. Attorneys representing property owners should encourage their clients to hire experts to inspect the property for dangerous conditions so that those conditions can be corrected before they become recurring or continuous. However, the client should be advised how to avoid the
appearance of an agency relationship with the expert so that a court will not later charge the client with the expert’s knowledge in the event of the expert’s negligence.


By Elizabeth Saxton

A trial court, when ruling in equity, may grant an injunction to halt a major construction project if the court is merely enforcing a previous agreement for consideration between the predecessors of both parties. The Court of Appeals of Kentucky was presented with this case in Home Depot U.S.A., Inc. v. Saul Subsidiary I L.P.

Home Depot U.S.A., Inc. (“Home Depot”) and Saul Subsidiary I Limited Partnership (“Saul”) own abutting tracts of land in Lexington, Kentucky. Lexington Mall arose on these properties in the 1970’s, after the parties’ predecessors in title agreed in 1969 to mutual restrictive covenants that allowed only for the development of a mall-type center on the properties. This agreement acknowledged that each property owner would develop his or her property separately from the other owner.

Before Home Depot gained title to its tract, Saul initiated litigation to prevent Home Depot from constructing a freestanding store on Home Depot’s tract of land. Despite knowledge of the original restrictive covenants, Home Depot purchased the property, destroyed a portion of the mall on its property, and constructed a freestanding Home Depot store on the property.

The trial court found that the covenants only bound Saul, therefore the court did not grant Saul its desired injunction. However, the Court of Appeals of Kentucky reversed, holding that both parties were equally bound by the restrictive covenants and remanded to the trial court for a determination of the proper remedy. At trial, the judge found that monetary damages were not proper because of the difficulty in calculating damages. Also, Kentucky decisions require covenant enforcement and therefore required destruction of the Home Depot store and replacement of the original structure within one year.
In upholding the decision requiring demolition of the Home Depot store, the Kentucky Supreme Court stated a rule of equity from the *Marshall v. Adams* decision: “If parties for valuable consideration, with their eyes open, contract that a particular thing shall not be done, all that a court of equity has to do is to say, by way of injunction, that the thing shall not be done.” Home Depot’s predecessor in title agreed to the 1969 agreement. Home Depot was aware of the agreement and its covenants, and Home Depot violated the covenants. In other words, Home Depot’s punishment was self-inflicted.

If an entity purchases a tract of land, and the entity has knowledge of restrictive covenants in place on the land but chooses to ignore the covenants, the entity will likely be faced with an injunction remedy if an adjoining landowner objects to the entity’s use of the tract.


By Adam G. Smith

In *Ruffin Building Systems, Inc. v. Varner*, the Tennessee Court of Appeals held that “for purposes of complying with Tenn. Code Ann. § 66-11-115, a materialman’s contract expires on the last date of delivery of materials rather than on the date payment is due.”

In *Ruffin*, the defendants contracted with Timberline Construction Company (“Timberline”) for the construction of a building on property owned by the defendants. Subsequently, Timberline contracted with plaintiff, Ruffin Building Systems (“Ruffin”), for Ruffin to supply a portion of the materials necessary for the construction of the building. The contract between Ruffin and Timberline provided for payment “net 30 days.” Ruffin delivered all materials required under its contract with Timberline to the defendants’ property on December 13, 2000.

Although the defendants made their requisite payments to Timberline, Timberline failed to make payment to Ruffin. Consequently, Ruffin sent the

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defendants a notice of nonpayment. Ruffin sent the notice of nonpayment on March 14, 2001, ninety-one (91) days after the date Ruffin delivered all materials to the defendants’ property and sixty-one (61) days after the date payment was due under Ruffin’s contract with Timberline. Furthermore, Ruffin recorded a notice of lien on March 16, 2001 and later sued the defendants in June 2001 in an attempt to foreclose a materialman’s lien pursuant to section 66-11-126(3) of the Tennessee Code Annotated.

Section 66-11-115(a) of the Tennessee Code Annotated provides material suppliers with a statutory materialman’s lien, while section 66-11-115(b) provides the notice requirement associated with claiming such liens. In order to satisfy section 66-11-115(b)’s notice requirement, a materialman must provide notice to the owner(s) of property upon which a building or improvement is being constructed that the materialman is claiming a lien within ninety (90) days after the building or improvement is completed, the materialman’s contract expires, or the materialman is discharged. In Ruffin, the court of appeals was faced with the issue of when a materialman’s contract expires for purposes of providing timely notice under Tenn. Code Ann. § 66-11-115(b).

The court of appeals began by noting that out of deference to the legislature, “Tennessee generally requires strict compliance with its lien statutes.” In rejecting the plaintiff’s argument that the supply contract could not expire until the date payment was actually due—thirty days after all materials were delivered—the court relied on the common law rule providing that “when one furnishe[s] material to a building site, payment [is] due at the time of delivery.” The supply contract expires at the time of delivery as well.

In support of its holding, the Court of Appeals stated the legislature is presumptively aware of the common law interpretation of when a materialman’s contract expires and has chosen not to amend or revise Tenn. Code Ann. § 66-11-115 to expressly displace the common law interpretation, despite several opportunities to do so. The court also stated that if a materialman’s contract did not expire until the date payment was due under the contract, property owners could potentially be subjected to continuous liability if a materialman chose unilaterally to “postpone the time for payment or keep extending such time indefinitely.” In conclusion, the court further opined that it would be imprudent to surmise that the legislature intended to allow contractors and subcontractors to contract around Tenn. Code Ann. § 66-11-115’s specific statutory requirements, essentially exposing a property owner to liability when the property owner may not be aware of such contractor-subcontractor contracts.
In light of the *Ruffin* decision, transactional attorneys should advise their clients that in order to claim a materialman’s lien against an owner of improved real property, a materialman should give the owner notice of the claimed lien within ninety (90) days after the date the last delivery of materials is made. Additionally, transactional attorneys should also note that in order to protect property owners, the Tennessee courts may require strict compliance with *all* statutory requirements before finding that a materialman is entitled to a lien under Tenn. Code Ann. § 66-11-115.

**SEcurities**


By Edward W. Collins

Analyzing the Securities Act of 1933 and the Securities Exchange Act of 1934, the United States Supreme Court found that the term “investment contract” encompasses virtually all schemes that promise individuals a financial return in exchange for the use of their capital.

The respondent, Edwards, was the chairman, CEO, and sole shareholder of ETS Payphones, Inc (“ETS”). The company sold payphones to investors and then leased back the phones. Investors were promised a fixed 14% return on their investments. After ETS declared bankruptcy, the SEC brought a civil enforcement action against the company for violating the registration and antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.

An investment system qualifies as an “investment contract” if “the scheme involves an investment of money in a common enterprise with profits to come solely from the effort of others.” The Court stressed that this definition of “investment contract” encompasses a wide-range of schemes that seek the use of other people’s money in return for the promise of future returns. The Court rejected Edwards’ attempt to differentiate schemes promising fixed rates of return from those offering variable rates. In fact, the Court stressed that schemes promising fixed returns are likely more attractive to unsophisticated investors and thus lend themselves to the potential of even greater abuse and fraud. As a result, ETS’ sale-leaseback agreements were “investment contracts” subject to SEC regulation. The purpose
behind securities regulation is to regulate all investments, regardless of their individual packaging.

The overriding lesson for transactional attorneys from this case is that the term “investment contract” includes schemes promising a fixed rate of return. Consequently, merely offering a fixed rate of return to investors does not remove an investment scheme from the realm of SEC oversight – even payphones may be securities.

Mere personal friendship, standing alone, is insufficient to raise a reasonable doubt regarding a director’s independence. *Beam v. Stewart*, 845 A.2d 1040 (Del. 2004).

By Ryan Russell

In *Beam v. Stewart*, the Supreme Court of Delaware held that “[a]llegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director’s independence” for purposes of a demand futility inquiry. This is true even if the non-interested director’s relationship is with an interested co-director who owns a controlling percentage of the corporation’s stock. A relationship renders a director unable to consider a presuit demand only if the relationship is “of a bias-producing nature” such that “the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director.” This holding ensures that professional and social relationships that naturally develop among members of a board do not cause an entire board to be tainted by the membership of a few interested directors.

Monica Beam, an owner of shares of Martha Stewart Living Omnimedia, Inc. (“MSO”), filed a derivative action in the Court of Chancery against Martha Stewart, the other members of the MSO board, and one former board member. Beam alleged that Stewart violated her fiduciary duties to MSO by illegally selling ImClone stock and mishandling the resulting media attention. Prior to filing this action, Beam did not demand that the MSO board pursue this claim. At the time Beam filed suit, the MSO board consisted of six members: (1) Stewart, MSO’s chairman, CEO, and controlling shareholder; (2) Sharon Patrick, MSO’s president and Chief Operating Officer; (3) Arthur Martinez, an outside director and former Sears Roebuck CEO; (4) Darla Moore, an outside director and investment banker; (5) Naomi Seligman, an outside director and e-commerce consultant; and (6) Jeffrey Ubben, a MSO director whose independence was undisputed. All of these directors received valuable
benefits as a result of their board positions. Stewart could have easily removed each due to her voting power.

The Court of Chancery would excuse Beam’s failure to make a presuit demand upon MSO’s board if three of the directors were interested or lacked independence. The court found that Stewart was an interested party due to her potential civil and criminal liability. The court also found that Patrick lacked independence because her position as an officer and inside director when combined with her substantial compensation from MSO raised a reasonable doubt as to her independence. Beam argued that Martinez and Moore lacked independence because they were long-time personal friends of Stewart and Patrick. The Court of Chancery disagreed; Beam’s claim was dismissed for failure to demonstrate the futility of presuit demand. Beam appealed.

The Supreme Court of Delaware noted that under Aronson “a stockholder may not pursue a derivative suit to assert a claim of the corporation unless: (a) she has first demanded that the directors pursue the corporate claim and they have wrongfully refused to do so; or (b) such demand is excused because [at least half of] the directors are deemed incapable of making an impartial decision regarding the pursuit of the litigation.” The court explained that a director is deemed incapable of making an impartial decision if he or she is interested in the outcome of the litigation or lacks independence. A director lacks independence if there is “a reasonable doubt that a director is not so ‘beholden’ to an interested director (in this case Stewart) that his or her ‘discretion would be sterilized.’” At issue in this case was “the quantum of doubt about a director’s independence that is ‘reasonable’ in order to excuse a presuit demand.”

Beam argued that Stewart’s personal friendships with other directors were sufficient to create a reasonable doubt as to the independence of those directors. The Supreme Court of Delaware disagreed and held that a relationship renders a director unable to consider a presuit demand only if the relationship is “of a bias-producing nature” such that “the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director.” The court further stated that “[m]ere allegations that [Stewart and other directors] move in the same business and social circles, or a characterization that they are close friends, is not enough to negate independence for demand excusal purposes.” This is true even if those allegations are combined with Stewart’s 94% voting power. The Delaware Supreme Court concluded that presuit demand was not excused. Therefore, the judgment of the Court of Chancery dismissing Beam’s suit was affirmed.
This case is important because it ensures that professional and social relationships that naturally develop among members of a board do not cause an entire board to be tainted by the membership of a few interested directors. These relationships are inevitable and exist among the members of most, if not all, corporate boards. An opposite holding would effectively eviscerate the presuit demand requirement because the futility exception would apply to nearly all corporate boards.

**TAX**


By Ted Morrissey

The following describes a private letter ruling from the IRS regarding a hospital’s attempt to structure a joint venture and maintain its non-profit status.

The non-profit, tax-exempt hospital proposed to form a new joint venture to create a freestanding diagnostic imaging center, but wanted to ensure that such a venture would not endanger its non-profit status. The IRS ruled that the proposed group of transactions would not adversely affect the hospital’s status as an exempt organization for the purposes of federal income taxation under I.R.C. § 501(a) and (c)(3). Additionally, neither the hospital’s distributive share of income from neither the partnership, nor the rents received from the partnership would result in unrelated taxable income under § 512 of the Code.

First, the hospital formed a limited liability company to serve as the general partner in a limited partnership. The hospital was the only member of the limited liability company, and the company would be treated as a disregarded entity for federal income tax purposes. Thus, the limited partnership that the hospital created had as its two partners the hospital (holding 99 per cent ownership) and the limited liability company (holding 1 per cent ownership). The hospital would then offer for sale units of the limited partnership to physician investors and related physician groups. If the offering were fully subscribed, the hospital would own fifty-four partnership units, physician investors would own forty partnership units, and an independent management company would own the remaining 5 limited partnership units.
In order to maintain the hospital’s tax-exempt status, the proposed venture must be operated solely for charitable, scientific, or educational purposes (see I.R.C. § 501(c)(3)). However, the limited partnership would have for-profit partners.

The IRS used the community benefit standard to determine whether the purpose of the partnership would affect the hospital’s non-profit status. The community benefit standard determines whether the hospital will continue to promote health in a charitable manner. The hospital qualified under this standard prior to this proposed group of transactions, so the question is whether participation in the aforementioned partnership changes how the hospital operates. The standard focuses on a number of factors, but is generally met if the operations of the hospital benefit the community rather than serving private interests.

The IRS noted that the hospital would continue to be operated for charitable purposes, but went further to analyze the hospital’s participation in the partnership. Because the partnership activities are considered to be hospital activities for the purpose of evaluating the hospital’s exempt status, the partnership agreement cannot prevent the hospital from operating exclusively in furtherance of its exempt purpose. Thus, the agreement can only incidentally benefit for-profit partners.

The hospital specifically addressed this issue in its proposed partnership agreement and its structure. Specifically, the partnership has a duty to operate in a manner promoting the charitable purposes of the hospital; this duty overrides any duty of the partnership to operate for the financial benefit of its members. Since the limited liability company created by the hospital will be the general partner, it will have effective control over the major decisions of the partnership. In addition to these factors, the managing company will have a duty to operate the imaging center for charitable purposes. Finally, all allocations of profit and losses of the partnership will be in proportion to the ownership interests of the partners. The IRS determined that these factors established that the participation in the joint venture would further the hospital’s charitable purposes and allow the hospital to act in furtherance of those purposes without unduly benefiting the for-profit partners.

Additionally, the IRS noted that any distributive share of the partnership’s profits would not be considered unrelated business taxable income under I.R.C. § 512(c). The hospital will receive a distributive share of the profits of the partnership through the general partner (the hospital’s disregarded entity). Therefore, the activities of the partnership must be substantially related to the hospital’s exempt purposes, or in other words, must further the charitable purpose of the hospital. The IRS stated that the imaging center would provide expanded and improved
health care to the community and that this purpose would override any duty to maximize profits, thus satisfying the substantially related requirement.

Finally, the hospital will rent space to the partnership for the imaging center and will receive rents from this venture. The IRS stated that the rents received from the lease would be excluded from unrelated business taxable income. The rental agreement stated that the space would be rented on a fixed square footage amount rather than on the basis of the profits of the imaging center, thus meeting the requirements of I.R.C. § 512(b)(3).

The hospital demonstrated to the IRS that its control over the partnership (as determined under the partnership and management agreements) would enable the hospital to maintain its charitable purposes, and thus retain its tax-exempt status.
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