CASE COMMENTARIES

ARBITRATION

Choosing Tennessee Law May Prohibit Arbitration of Fraud in the Inducement. *Whisenant v. Bill Heard Chevrolet, Inc.*, No. W2004-01745-COA-R3-CV, 2005 Tenn. App. LEXIS 418, 2005 WL 1629991 (Tenn. Ct. App. July 12, 2005).

By Melissa Hunter

Parties who enter into an arbitration agreement are usually required to resolve disputes with arbitration. However, when a party alleges that the transaction was fraudulently induced, the party may be entitled to a judicial resolution of the claim. Recently, the Tennessee Court of Appeals denied a motion to compel arbitration when a party alleged fraud in the inducement in *Whisenant v. Bill Heard Chevrolet, Inc.*

In *Whisenant*, Whisenant and Bill Heard Chevrolet entered into a contract for the sale of a vehicle. The contract contained an arbitration provision; the provision stated that all issues regarding the transaction, including issues involving the formation of the agreement, were to be submitted to an arbitrator. The provision also stated that Tennessee law governed the transaction. Soon after the transaction was completed, Whisenant's vehicle began malfunctioning. Whisenant filed suit against Bill Heard Chevrolet under several theories, including fraud in the inducement. Bill Heard Chevrolet responded by filing a motion to require arbitration, which was denied by the trial court.

Bill Heard Chevrolet argued that since the Federal Arbitration Act grants a presumption of arbitrability when arbitration clauses are present, this dispute should be submitted to the arbitrator in accordance with the mutually agreed upon terms of the contract. Bill Heard Chevrolet noted that the agreement explicitly states that fraudulent inducement is arbitrable since the agreement includes issues involving representations made in connection with the sale of the vehicle.

The Tennessee Court of Appeals acknowledged that fraud in the inducement is an issue involving contract formation, and this agreement implies that the parties have agreed to arbitrate such issues. After examining Tennessee case law, the court rejected Bill Heard Chevrolet's arguments and affirmed the trial court based on two considerations.

First, the appellate court noted that the arbitration agreement did not explicitly state that fraud in the inducement was arbitrable. Second, the parties agreed that Tennessee law would govern the transaction. Tennessee case law holds that, when parties to an arbitration agreement select Tennessee state law to govern disputes, issues of fraud in the inducement are not arbitrable. Tennessee courts recognize that this approach is a "minority view," but have asserted that it is the "better view."

Transactional lawyers should advise clients who utilize arbitration clauses of the ramifications of selecting Tennessee law to govern transactions. As *Whisenant* illustrates, parties to an arbitration agreement who select Tennessee law to govern will not be compelled to arbitrate allegations of fraudulent inducement, absent language in the agreement to the contrary. In light of *Whisenant*, a lawyer may suggest that clients re-draft arbitration provisions. Clients may choose to select another jurisdiction in which to resolve issues or may explicitly state in the agreement that parties agree to arbitrate all issues involving contract formation, including fraud in the inducement.

BUSINESS ENTITIES

Limited Partnerships Do Not Dissolve on Their Own. *Barton v. Gilleland*, No. E2004-01369-COA-R3-CV, 2005 Tenn. App. LEXIS 187, 2005 WL 729174 (Tenn. Ct. App. Mar. 30, 2005).

By Daniel French

The dissolution of a limited partnership is more complicated when the initial agreement or provisions within the agreement creating the partnership have been amended or supplemented by subsequent agreements. The partners, whether limited or general, must carefully review subsequent agreements to assure that their desired intent is expressed in a plain and unambiguous way. Further, partners must act in accordance with that expressed intent to prevent an ambiguous interpretation. Otherwise, partners will find themselves bogged down in difficulties like those considered by the Tennessee Court of Appeals in *Barton v. Gilleland.*

On September 18, 1978, the limited partnership of Henry Manor, Ltd., ("the Partnership") was formed to acquire, develop, and manage a rent-subsidized apartment complex ("the Property"). On February 26, 1979, a "Restated Agreement" was executed, which, among other things, stated the following: (1) Roy Gilleland and Cleve Smith ("Defendants") would serve as administrative general partners for the first three years the Property was available for occupancy; (2) Defendants were entitled to 20% of the net proceeds from any sale of the Property; (3) Glen Claiborne would serve as managing general partner; (4) Claiborne would also be entitled to 20% of the net proceeds from any sale of the Property; and (5) Claiborne could not transfer or sell "all or any part" of his interest without written consent of the Partnership. These five provisions were re-stated by a "Companion Agreement" executed the same day.

In 1982, the Partnership executed a "Supplemental and Amended Agreement" that expressly stated that defendants would resign as administrative general partners. In 1992, Claiborne and his wife created the G & P Claiborne Trust ("the Claiborne Trust"), to which Claiborne transferred his interest in the Partnership – a violation of the "Restated Agreement." Claiborne continued to serve as managing general partner until his death in 1997, upon which Stanley Roy – the trustee for the Claiborne Trust – began undertaking certain duties within the Partnership, including the negotiation and sale of the Property in 2000. Following the sale of the Property, the limited partners – the plaintiffs – filed suit against Defendants and the Claiborne Trust to prevent the Defendants from obtaining 20% of the net proceeds as agreed under the "Restated Agreement."

The plaintiffs' argument for declaratory judgment was two-fold: (1) Defendants were not entitled to any of the net proceeds from the sale of the Property because they resigned from the Partnership in the 1982 "Supplemental and Amended Agreement" and (2) even if they are, the Partnership was essentially dissolved in 1992 when Claiborne violated the "Restated Agreement" by transferring his interest into the Claiborne Trust, thus creating a tenancy in common between the Claiborne Trust and the plaintiffs. The trial court, noting that no facts surrounding the initial and subsequent agreements were disputed, found that the defendants were entitled to 20% of the net proceeds of the sale of the Property and that the Partnership was not dissolved in 1992 by Claiborne's interest transfer. However, the trial court did hold that the Partnership was dissolved in 1997 due to the partners' failure to appoint another managing general partner upon Claiborne's death, despite the participation of Claiborne's trustee in the negotiation and sale of the Property.

The Court of Appeals examined three issues. The first issue was whether the 1982 "Supplemental and Amended Agreement" expressly stated that Defendants resigned from the Partnership as a whole, thus forfeiting their 20% interest in the net proceeds of the sale under the previous "Restated Agreement." The court, noting that a plain and unambiguous contract must be interpreted according to its plain terms, concluded that the 1982 "Supplemental and Amended Agreement" never expressly purported to amend or supplement the prior "Restated Agreement" providing Defendants with the 20% interest. Furthermore, the 1982 agreement expressly stated that Defendants resigned as administrative general partners, not as partners all together. Therefore, despite their near lack of involvement in the Partnership from 1982 to its eventual dissolution in 2000, Defendants were still partners and thus, privy to all their contractual rights under the "Restated Agreement."

The second issue the court considered was whether Claiborne's transfer of his interest in the Partnership to the Trust dissolved the Partnership, resulting in a tenancy in common and a forfeiture of Claiborne's 20% interest in the net proceeds of a sale under the "Restated Agreement." The court noted that under Tennessee Code Annotated Section 61-2-702(a) (2002), a partner may assign an interest in the Partnership without dissolving the Partnership, unless the partnership agreement states otherwise. Clearly, Claiborne's transfer violated the express language of the "Restated Agreement," which prevented the transfer of "all or any part" of his interest. Nevertheless, the court concluded that the "Restated Agreement" failed to state whether a violation of the agreement resulted in the Partnership's automatic dissolution. Furthermore, the court noted that following the transfer to the Claiborne Trust, the partners continued to treat Claiborne and, upon his death, his trustee, as members of the partnership. Because this dissolution consequence was not expressly stated and the partners' conduct counters dissolution, the court held that the Partnership did not dissolve in 1992.

Finally, the court considered the third issue of whether the death of Claiborne in 1997 and the partners' failure to appoint another managing general partner resulted in dissolution of the Partnership and a forfeiture of Claiborne's 20% interest under the "Restated Agreement." The court noted that the "Restated Agreement" specifically provided that upon the death of the managing general partner, the partnership should either appoint another managing partner or wind up. The Agreement, however, expressly stated that the partners would continue to share in the profits and losses during the liquidation in the same proportions as *before* the dissolution. Therefore, the Claiborne Trust, upon Claiborne's death, had a contractual right to the 20% interest of the net sale proceeds under the "Restated Agreement."

Barton v. Gilleland illustrates the need for transactional attorneys to attempt to account for every detail in executing an initial, amended, or supplemental limited partnership agreement, whether or not the partners orally agree to a general understanding or interpretation. Intent and interpretation, if not expressly stated in an agreement, are subject to the court's interpretation. The court, as demonstrated in *Barton*, is then reduced to an "after the fact" interpretation of the so-called plain meaning of words on a page, and transactional attorneys must take great care in choosing their words. Transactional attorneys should also note the court's unwillingness to dissolve the partnership, even in light of a blatant violation of the partnership agreement – an unwillingness motivated not only by the lack of express intent but also somewhat by principles of equity.

The Corporate Shield is Not Bulletproof: Piercing the Corporate Veil. *Boles v. National Development Co.,* 175 S.W.3d 226 (Tenn. Ct. App. 2005).

By Lori Lott

Boles v. National Development Co., was brought to the Tennessee Court of Appeals after an individual principal of a corporation was found liable for diminution in value damages for failing to complete a lake in a lake community development. The Tennessee Court of Appeals held that the corporate veil can be pierced and the individual principal held responsible where the corporation is an insolvent dummy corporation.

In the late 1990s, Hidden Valley Lakes Development in Hickman County, Tennessee, seemed to be an attractive investment. The developer, National Development Company ("NDC"), promised to provide a centerpiece for the development—Crystal Lake ("the lake")— which would span thirty acres. The lake would accommodate boating, skiing, and fishing. The lake was the primary draw for purchasers of the 3,876 lots. However, because the lake was not properly constructed and would not hold water; it was, in essence, nothing but a thirty-acre hole in the ground.

In *Boles*, the plaintiffs claimed breach of contract against the developer NDC, as well as its parent company and its principle, Charles Engle ("Engle"), for failing to uphold the portion of the contract holding the developer responsible for the lake's construction. The suit sought recovery for the diminution in value of plaintiffs' properties due to the incomplete lake.

The trial court bifurcated the trial. The first trial determined the damages. The second trial asserted that Engle was the alter ego of NDC, and thus liable for the damages assessed. The trial court awarded compensatory damages and held Engle liable. An appeal followed.

On appeal, the main issue was whether piercing the corporate veil and finding Engle liable for the damages of the whole corporation was appropriate. Typically the corporation is distinct and separate from the shareholders, officers, and directors; however, piercing the corporate veil may become appropriate when the corporation is liable for a debt but is without funds to pay it and the lack of funds is due to some misconduct on the part of the corporate authorities. Piercing the corporate veil may also be appropriate where there is a showing that it is a sham or dummy corporation or where it is necessary to accomplish justice. All of the companies owned by Engle were insolvent. To allow Engle to use the corporate entity as a shield to avoid satisfying the judgment would be an injustice. The appellate court found that the evidence supported the conclusion that NCD was a dummy corporation used to shield Engle from liability. Therefore the corporate entity was disregarded and liability was imposed on Engle.

The question of when an individual should be held liable for corporate obligations is largely a factual one. An individual can hide behind the walls of a corporation, but that does not mean that the individual is not responsible when things go sour, and the corporation is not able to pay.

If It Looks Like a Debt, Paid Like a Debt, and Recorded Like a Debt, Guess What? *Matthews v. Matthews*, No. M2003-01159-COA-R3-CV, 2005 Tenn. App. LEXIS 204, 2005 WL 819728 (Tenn. Ct. App. Apr. 7, 2005).

By Scott Griswold

Where a corporate entity acts as if it has assumed a debt, even though no written agreement exists, Tennessee courts may find a valid assumption through an implied contract. The Court of Appeals recently addressed this issue in *Matthews v. Matthews*. The Court of Appeals held that a note, paid regularly from the limited liability company's (LLC's) proceeds and carried on financial statements as a debt, can become a valid debt of the LLC, even in the absence of a written agreement.

In *Matthews*, two brothers, as equal partners, purchased a local convenience store from their parents. The parents accepted a promissory note, secured by the property, from the sons. Subsequently, the brothers terminated the partnership and reorganized as a LLC. Both the LLC and the partnership paid the promissory note's monthly installment payment from the proceeds of the business and carried the debt on its financial records; however, no writings confirmed whether the debt, which was a personal obligation of the brothers, was assigned to the LLC.

After four years, a rift arose between the brothers, and they terminated their business relationship. This decision led to the Chancery Court ordering a closed auction to be held so the two brothers could bid against each other for the business. The auction created the current dispute about the LLC's liabilities. Appellant contended that the note was a personal debt shared between the brothers and not assumed by the LLC.

A court may find a valid implied contract exists, if the circumstances and conduct of the parties indicate there was mutual assent or intent. In *Matthews*, the LLC, a separate legal entity, carried the debt on its financial records as a liability and paid the monthly payments from the business's proceeds. The Chancery Court held that the LLC assented to assuming the note.

When two individuals with a preexisting personal relationship decide to go into business together, a legal and a business plan is desirable. A simple business plan would have delineated what assets and liabilities were to transfer to the business and which were to remain personal. By deciding key business decisions at the outset, the brothers could have avoided the expense and delay of litigation. *Matthews* illustrates the euphuism: "an ounce of prevention is worth a pound of cure." While hindsight may be 20/20, practicing attorneys should counsel clients who are entering into business transactions that well-thought-out written agreements are worth the time, money, and effort.

CONTRACTS

When Deletion Creates Confusion: Ambiguity Warrants the Use of Parol Evidence. *Citadel Investments, Inc. v. White Fox Inc., f/k/a The Jones Group,* No. M2003-00741-COA-R3-CV, 2005 Tenn. App. LEXIS 292, 2005 WL 1183084 (Tenn. Ct. App. May 17, 2005).

By Caitlin Shockey

The parol evidence rule requires courts to ascertain the meaning and intention of the parties by looking to the signed contract. This rule prevents a party from introducing extrinsic evidence of prior or contemporaneous negotiations or agreements that occurred between the parties that were not included in the final, integrated writing representing their agreement. However, when a contractual provision is susceptible to more than one reasonable interpretation and the terms of the contract are ambiguous, then extrinsic evidence may be used.

In *Citadel Investments, Inc. v. White Fox, Inc.,* appellants Fox and White purchased a controlling interest in the Jones Group. The dispute is whether Fox and White, when agreeing to purchase the corporation, also agreed to be personally liable for a promissory note to Citadel Investments entered into by the Jones Group.

The trial court found that there was no ambiguity in the agreement and barred parol evidence. On appeal, Fox and White insisted the agreement was ambiguous. Fox testified that a provision that would have made him and White personally liable was deleted from the Jones Group purchase agreement. He explained that the deletion was the result of negotiations he and White had with Jones, the principle shareholder, wherein they unequivocally informed Jones that neither Fox nor White would assume personal liability for Jones' personal guarantees. White also testified that Fox and White repeatedly stated to Jones that they would not undertake any personal liability.

The Court of Appeals reviewed two issues: (1) whether the trial court erred in ruling that the agreement was ambiguous and (2) whether Fox and White were deprived of a substantial right to introduce evidence, the exclusion of which more probably than not affected the outcome of the trial or resulted in prejudice to them.

As to the first issue, when an agreement has been reduced to a final, integrated writing, its true interpretation and purpose must be determined from the terms of the instrument itself. When a party contends an agreement is ambiguous, the court's initial task is to determine whether the language of the contract is ambiguous. Here, the appellate court found the provision in question unclear since the paragraph did not expressly identify who would repay the note. The phrase merely provided that the note would be repaid. The appellate court also found the agreement silent as to the identity of any party, other than the corporation, that is obligated to pay the principal balance.

Another phrase in controversy was the paragraph providing, "Buyers will restructure the debt of [the corporation] . . . ." The appellate court stated that although it could imply that Fox and White would personally repay the note, the provision could also be interpreted to require the Buyers, as officers and directors, to cause the corporation to repay it. Therefore, the agreement was susceptible to more than one reasonable interpretation. As such, the parol evidence could be used to determine the intention of the parties.

Citadel Investments illustrates that an ambiguous contract may warrant the use of parol evidence in an attempt to determine the intent of the parties. To avoid the use of parol evidence, transactional attorneys should ensure that all contract terms are unambiguous and that the final writing completely defines the transaction. If provisions to a contract are deleted, as was the case in *Citadel Investments,* it may be prudent for the transactional attorney to note this modification in the final agreement, perhaps in the recitals at the beginning of the agreement.

Unacceptable: The Recipient of Nonconforming Goods May Reject Them without Incurring a Payment Obligation or Allowing a Draw on a Letter of Credit. *Wings Manufacturing Corp. v. Lawson*, No. M2004-00265-COA-R3-CV, 2005 Tenn. App. LEXIS 485, 2005 WL 1950115 (Tenn. Ct. App. Aug. 12, 2005).

By Lauren Medley

When a buyer justifiably rejects goods, the goods have not been "accepted," and the buyer has no obligation to pay for them. Under the Uniform Commecial Code ("UCC") and the Tennessee Code Annotated ("TCA"), this protection extends to instances where a letter of credit to a seller insures against the buyer's nonpayment.

In *Wings Mfg. Corp. v. Lawson*, the seller made an agreement with the buyer for an order of pre-sold apparel. The goods did not meet the specifications in the contract, and the buyer notified the seller about the non-conformity and requested authorization to return the merchandise. Because the seller only authorized the return of one shipment, Lawson sold the remaining merchandise on the secondary market for a fraction of the price originally expected.

The buyer secured its obligation for payment with a domestic letter of credit, and the seller drew down the entire amount for the shipped merchandise, and then filed suit for the remaining balance. The buyer filed a counter-complaint for breach of contract claiming that the seller wrongfully drew down the letter of credit. The Tennessee Court of Appeals upheld the trial court's decision that the seller breached the contract entitling the buyer to damages for lost profits.

Under the UCC, the remedies available to a buyer depend in part on whether the buyer accepted or rejected the goods. Further, the mere receipt of goods does not qualify as an acceptance. Additionally, TCA Section 47-2-606 specifies that the acceptance of goods occurs when, after the buyer has a reasonable opportunity to inspect the goods, he signifies to the seller that they are conforming or that he will retain them in spite of non-conformity; he fails to make an effective rejection; or he does not act inconsistently with the seller's ownership. A seller is not generally entitled to recover the price of goods that are not accepted or that are rightfully rejected.

The Court of Appeals upheld the trial court's decision, holding that the buyer did not accept the goods in question. The goods were effectively rejected. Therefore, the buyer was not obligated to pay for them. To determine damages, the court looked at TCA Section 47-2-711 which states that a buyer who rightfully rejects goods may cancel the contract and recover damages, including incidental and consequential damages. In calculating damages, the court held that the parties must first determine lost profits by establishing the amount the buyer would have received if both parties fully performed according to the terms of the agreement. Second, the lost profits must be reduced by the amount the buyer received from selling the merchandise on the secondary markets. Third, parties must add any incidental and consequential damages. Lastly, the amount of the letter of credit that the seller wrongfully withdrew provides the final number for the calculation of damages owed to the buyer.

The letter of credit only serves as insurance to the seller in the case of non-payment by a buyer, but the buyer's obligation to pay is dependant on the seller's compliance with the contract. In this case, the seller's shipped goods did not comply.

As *Wings* illustrates, the acceptance or rejection of non-conforming goods determines whether a buyer is obligated to pay for those goods. When the seller breaches the contract, and the buyer is forced to sell the goods to mitigate losses, the seller is only entitled to a credit in the calculation of damages for proceeds from the sale. Transactional attorneys should advise seller clients that a draw on the letter of credit is barred, even to cover costs incurred, when the goods have been justifiably rejected. Buyer clients should be instructed to inspect goods and to notify the seller of any non-conformity and to reject the goods to prevent an "acceptance" and the following obligation to pay for the goods.

INSURANCE

Tennessee Tenants are Co-Insureds of their Landlords' Insurance Policy in the Absence of a Contrary Agreement. *Allstate Ins. Co. v. Watson*, No. M2003-01574-COA-R3, 2005 Tenn. App. LEXIS 126, 2005 WL 457846 (Tenn. Ct. App. Feb. 25, 2005) *appeal granted* No. M2003-01574-SC-R11-CV, 2005 Tenn. Lexis 669 (Tenn. Aug. 22, 2005).

By Josh Ganz

When a lease between a landlord and a tenant is silent as to who is responsible for securing fire insurance on the rental property, a question arises as to whether the tenant is a co-insured under the landlord's insurance policy. This question was recently decided by the Tennessee Court of Appeals in *Allstate Insurance Co. v. Watson*. The Court held that unless the lease explicitly states otherwise, a tenant is impliedly co-insured by the landlord's fire insurance policy. Thus, the landlord's insurer is barred from initiating a suit in subrogation against a negligent tenant.

In *Allstate Insurance*, pursuant to the landlord's fire insurance policy, the insurer, Allstate Insurance Company ("Allstate"), paid the landlord of rental property for losses sustained during a fire. At the time of the fire, Robert Watson ("Watson") was a tenant of the property. Watson's lease provided, "Residents are responsible for all damages to the apartment, intentional or non intentional." However, the lease was silent as to whether the landlord or the tenant was responsible for procuring property insurance. Relying on the provision in the lease, Allstate brought a subrogation action against Watson. The trial court found that Watson was not negligent in causing the fire, but he was liable to Allstate under supposed subrogation provisions in the lease.

Generally, there is a split of authority among jurisdictions on this issue. The minority view is that the tenant may be held liable in the event of a fire, and the landlord's insurer may pursue the claim against the tenant. The majority view holds that, in the absence of an agreement to the contrary, a tenant is a presumptive insured of his or her landlord's insurance policy — even when the tenant is not specifically named. The Tennessee Court of Appeals reversed the trial court's decision, relying on the majority viewpoint, otherwise known as the "reasonable expectations rationale." Implicit in this rationale is that the tenant's reasonable expectations are for the landlord to insure the property and pass the cost of insurance payments on to the tenant in the form of higher rent. Thus, the reasonable expectations doctrine presumes that the tenant is a co-insured. As such, the tenant is shielded from liability to the insurer because an insurer cannot seek subrogation from its own insured.

Subject to pending review by the Tennessee Supreme Court, the reasonable expectations rationale/co-insured doctrine will eliminate uncertainty and provide uniformity in the landlord-tenant relationship. If an insurer of a Tennessee landlord does not intend to cover the tenant of the rental property in its fire insurance policy, the landlord must include a provision in the lease which makes the tenant responsible for procuring fire insurance. Alternatively, and certainly easier administratively, insurance companies can raise landlords' fire insurance premiums to also cover tenants of the rental property. Regardless of which approach insurance companies take, Tennessee tenants will be affected—they will either pay for the insurance in the form of their own insurance policies or in the form of higher rent.

Insurance Exclusions Strictly Construed as to Childcare Arrangements. *Mid-Century Ins. Co. v. Williams*, 174 S.W.3d 230 (Tenn. Ct. App. 2005) *appeal denied* 2005 Tenn. LEXIS 791 (Tenn. Sept. 6, 2005).

By Leigh Griggs

Where a childcare arrangement constitutes a "business pursuit" and "home care service" within the exclusions in a homeowner's insurance policy, coverage of the wrongful death of a minor child in the insured's home and under the insured's care is barred. Such was the situation presented to the Tennessee Court of Appeals in *Mid-Century Ins. Co. v. Williams*.

In *Mid-Century Ins. Co. v. Williams*, the Defendant served as caregiver for her four grandchildren while her daughter, their mother, was at work. The Defendant received payment for these services from Southwest Resources, a Department of Human Services Facility. In addition to her four grandchildren, the Defendant agreed to watch the two children of Ms. Futrell, a family friend. Ms. Futrell's two children, Quisha and Petey, were ages four and one respectively. One morning the Defendant left Petey alone while the two older children were bathing, and Petey accidentally fell into the bathtub and drowned. Ms. Futrell filed a wrongful death lawsuit against the Defendant. The Defendant had a Special Form Homeowner's Package Policy issued to them by the Plaintiffs, but when the accident was reported, the Plaintiffs denied coverage based on the following exclusion: "We do not cover bodily injury . . . which arises from or during the course of business pursuits of an insured . . . or (4) results from the legal liability of any insured because of home care services provided to any person on a regular basis . . . Regular basis means more than 20 hours per week."

At trial, the Defendant testified as to her childcare services. The trial court found that the arrangement was informal and that the Defendant was not motivated by profit. Therefore, the exclusion of the homeowner's policy was not applicable.

The appellate court disagreed with the trial court's fact-finding, and held that both the business pursuit exclusion and the home care service exclusion barred coverage by the homeowner's insurance policy. Analyzing the record, the court believed that the AFDC payments of $300 a month that the Defendant received for caring for her grandchildren, together with her expectation of compensation by Ms. Futrell for keeping Petey and Quisha, revealed that the Defendant's motive was for profit.

After concluding that the childcare arrangement between the Defendant and Ms. Futrell was motivated by profit and that it was a continued or regular activity, the court interpreted the contract to determine whether it applied to the facts of this case. The court concluded that the language of the contract was not ambiguous and so it had to determine whether the arrangement constituted a business pursuit or home care service as provided in the exclusions relied upon by the Plaintiffs. Guided by the majority rule that "a pursuit is a business only if (1) there is a motive for profit AND (2) it is continued or regular activity" the court held that the childcare arrangement at issue in this case was a business pursuit and the arrangement constituted a home service within the meaning of the homeowner's policy; therefore, the trial court erred in concluding that the business pursuit exclusion in the homeowners policy did not bar coverage in this case.

As the *Williams* case illustrates, where an insurance policy unambiguously states exclusions concerning business pursuits and home care services, a childcare arrangement motivated by profit and conducted on a regular basis will fall within these exclusions. Insureds are well advised to take the language of the exclusions literally; insurers are, in turn, advised to provide unambiguous descriptions of the exclusions from coverage.

Debtors Must Be Provided with Written Notice of Insurance Denials. *Rice v. Andrew Johnson Bank*, No. E2004-01469-COA-R3-CV, 2005 Tenn. App. LEXIS 177, 2005 WL 711973 (Tenn. Ct. App. Mar. 29, 2005).

By Meredith Adams Mallard

Tennessee Code Annotated Section 56-7-909(a) (2000) ("Section 56-7-909") requires an insurance company to provide written notice of insurance denials. Thus, in Tennessee, if a debtor has applied and paid a premium to a bank for a credit life insurance policy and the insurance company denies the application, the debtor must be provided with written notice of the denial before a valid claim against the insurer arises. Insurers should be active participants in this notification process and should not rely on banks to inform debtors of such denials.

The debtor submitted an application with the bank for credit life insurance to insure the principal amount of his loan. The application stated that it was "'subject to approval'" but that insurance would be provided if a valid claim arose before the insurer took action on the application. The debtor paid the insurance premium, which was to be returned to the debtor if the insurance was denied. The bank then submitted the application, along with a portion of the premium, to the insurer.

The insurer denied the debtor's application by sending the bank a letter and returning its portion of the premium. The bank then credited the refunded premium to the debtor's loan. In the insurer's letter to the bank, the insurer requested that the bank notify the debtor of the denial and forward a copy of the letter to him. However, neither the bank nor the insurer sent written notice to the debtor informing him of the denial.

The debtor died without being notified that his insurance application had been denied. A representative of his estate requested that the insurer pay the bank the proceeds of the policy and that the bank declare the loan satisfied. The insurer and bank both refused to comply, asserting that the debtor was never covered under the insurance. The debtor's representative then sued, claiming that the insurance contract was valid because the debtor was never informed of the denial.

The Court of Appeals of Tennessee held that summary judgment by the trial court was inappropriate because a material issue of fact existed as to whether the debtor was provided with written notice of the coverage denial before his claim arose. Under Section 56-7-909, a debtor who has paid a bank a premium for credit life insurance must immediately be provided with written notice if the insurer denies the application. Additionally, the insurance company's policy contained language to the same effect.

During discovery, the insurer never affirmatively stated that they provided the debtor with the requisite written notice. Therefore, they had not demonstrated that they had taken action and provided the debtor with notice of the insurance denial before his claim arose. Because the insurer had not affirmatively negated an essential element of the claim, the court should have denied summary judgment for the defendants.

The decision emphasizes that insurance companies cannot take shortcuts and depend on banks to notify debtors that their insurance applications have been denied. If they do so, they run the risk that the bank will not provide the debtor with written notice and that the debtor will have a valid insurance claim that the insurer must satisfy. Instead, insurers should play it safe and themselves provide debtors with written notice of insurance application denials.

Insurance Companies Must Honor the Plain Meaning of Their Policies and Cover Contractors for Faulty Workmanship under the Subcontractor Exception. *Travelers Indemnity Co. of America, v. Moore & Assoc.,* No. M2004-01233-COA-R3-CV, 2005 Tenn. App. LEXIS 596, 2005 WL 2293009 (Tenn. Ct. App. Sept. 20, 2005).

By John Eskew

The Tennessee Court of Appeals held that while the standard commercial general liability insurance policy does not provide coverage to an insured contractor for the breach of contract grounded upon its own faulty workmanship, the exception for the damaged work or damage arising from the work performed by a subcontractor is indeed covered by the commercial general liability insurance and the insurance company must honor its deal with the insured.

The plaintiffs, Travelers Indemnity Company of America ("Travelers") issued Commercial General Liability ("CGL") insurance policies to the defendant, Moore & Associates ("Moore"). Moore entered into a construction contract with Hilcom Partners ("Hilcom") to design and build a Hilton Garden Inn hotel in Texas.

As most general contractors do, Moore used several subcontractors in the construction. The construction ended in 2002. In 2003, Hilcom filed a Demand for Arbitration alleging Moore negligently designed and installed the windows, allowing water and moisture to enter causing early deterioration and damage to the structure, walls, and fixtures.

Moore sought to use the GCL insurance policy, which reserved in Travelers a duty to defend Moore in the event of a demand for damages based upon property damaged by an "occurrence," to pay for the defense of the arbitration. Travelers brought this action asserting that it had no duty to defend Moore. Travelers argued the damage did not amount to "property damage caused by an occurrence other than to 'your work' according to the terms of the CGL." The chancery court granted Moore summary judgment, and Travelers appealed.

The Tennessee Appellate Court held that an insurer has a duty to defend when its policy arguably covers the claims raised against the insured. The policy does not provide coverage to an insured contractor for faulty work or materials where the damages claimed are the cost of correcting the work itself. However, the insurance industry itself included a subcontractors exception in its policies after 1986. This exception provides that if a subcontractor performs work leading to damage, the "your work" exclusion does not apply, and the CGL does cover it. The Court stated that such specific language drafted by the insurance company itself cannot be ignored when interpreting the case law. Therefore, whether the subcontractors and contractors work constitutes "property damage" or an "occurrence" triggering the exclusion exception must be determined. Damages to Hilcom were not limited to the defective work itself, but also the damage that resulted from the water and moisture seeping in and damaging the walls, structure and furnishings; therefore, "property damage" did occur. Since the damage resulted from the subcontractor's poor workmanship, the exception to the exclusion applies, and Travelers had a duty to defend Moore.

The Court seemingly predictably upheld the insurance policy by relying on a plain interpretation of the contract. Following the reasoning of other jurisdictions, the Court of Appeals held that the language implemented by the insurance company itself cannot be ignored. Transactional attorneys should be mindful of the court's willingness to follow a strict interpretation of the contract and draft carefully.

LABOR AND EMPLOYMENT

Most Covenants Not to Compete against Physicians are No Longer Enforceable in Tennessee. *Murfreesboro Med. Clinic v. Udom*, 166 S.W.3d 674 (Tenn. 2005).

By Aaron Belville

According to *Murfreesboro Med. Clinic*, a physician's covenant not to compete is unenforceable unless specifically authorized by statute. In reaching this decision, the Tennessee Supreme Court determined that the nature of the medical profession creates special policy considerations that should prevent enforcement of physician non-compete provisions.

Murfreesboro Medical Clinic ("MMC") is a private medical clinic located in Murfreesboro, Tennessee. In the early part of 2000, Dr. David Udom entered into an employment contract with MMC which provided that Udom would practice medicine at MMC for two years. The contract also contained a provision that, once his employment was terminated, Udom would not practice medicine within 25 miles of Murfreesboro for a period of 18 months. A little over a month after his contract expired with MMC, Dr. Udom informed MMC that he intended to open a solo practice in Smyrna, Tennessee, located approximately 15 miles from Murfreesboro. MMC then attempted to enforce the non-compete provision against Dr. Udom.

The Court began its analysis by stating that Tennessee law views covenants not to compete as restraints on trade that are generally disfavored. However, when legitimate business interests are implicated, Tennessee courts will still enforce reasonable covenants not to compete. To determine whether a non-compete clause is reasonable, courts consider time and territorial limitations, economic effects on both the employer and the employee, and the impact on the public interest. Covenants that involve important public policy concerns, such as those involving physicians, are typically construed more strictly.

The Supreme Court, citing the American Medical Association ("AMA") Code of Medical Ethics, which strongly discourages physicians' covenants not to compete, iterated several concerns associated with physician non-compete clauses that are not present in the usual employment context. These concerns include encouraging greater access to affordable, quality health care and promoting a patient's right to choose a physician and to maintain an ongoing relationship with that physician. Despite the dissent's preference to strike down the specific non-compete provision in *Murfreesboro Med. Clinic* as overbroad, the majority viewed physician non-compete agreements as negatively impacting the public's access to health care - something that should not be tolerated. While the Court noted that many states continue to view physician non-compete agreements no differently than other covenants not to compete, it did recognize a growing trend to treat them differently. In reaching its decision, the Court drew multiple comparisons between physician non-compete agreements and attorney non-compete agreements, which have been prohibited in Tennessee since the early 1990s.

In deciding that physician non-compete agreements are generally unenforceable, the Supreme Court noted certain situations where the Tennessee legislature has recognized an acceptable circumstance for a physician non-compete clause to be enforced. Tennessee Code Annotated Section 63-6-204 (2005) provides that, when the employer attempting to impose the non-compete agreement is a hospital, an affiliate of a hospital, or a faculty practice plan associated with a medical school, non-compete clauses may be enforceable.

Murfreesboro Med. Clinic is a good example of the growing trend across the nation to treat physician non-compete clauses differently than other employment contracts. This decision highlights some of the policy considerations that a court may use in determining whether to enforce a covenant not to compete.

Geographic Coverage of Employee Non-Compete Agreement Must Be Reasonable to Be Enforceable. *Outfitters Satellite, Inc. v. CIMA,* No. M2003-02074-COA-R3-CV, 2005 Tenn. App. LEXIS 86, 2005 WL 309370 (Tenn. Ct. App. Feb. 8, 2005).

By Jennifer G. Rowlett

Where geographic terms of a non-compete agreement are overly broad, the geographic area may be narrowed. *Outfitters Satellite, Inc. v. CIMA* illustrates a court's ability to revise contractual terms within the context of enforcing a non-compete agreement. Smith, a former employee of Outfitters Satellite ("Outfitters"), entered into a non-compete agreement with Outfitters after he had been employed by the company for several months and proven himself to be a successful salesperson. At that time, Smith had established relationships with Outfitters' customers. Thus, Outfitters structured an agreement that would prevent competition in the event Smith left the company. The non-compete agreement provided that, following his departure from Outfitters, Smith would not engage with any of its business competitors or interfere with the company's business relationships for a period of three years. The non-compete agreement contained no geographical limitations because of the worldwide potential for sales via the internet.

Smith did in fact leave the company. Additionally, he allegedly interfered with Outfitters' client relationships and entered negotiations for a contract with Outfitters' software developer. Outfitters filed suit seeking to enforce the non-compete agreement against Smith. The trial court found that Smith was in breach of the agreement because of his relationships with Outfitters' clients and dealers. Accordingly, the court enjoined Smith from competing with Outfitters for one year in North America.

On appeal, Smith averred that the non-compete was unenforceable, or, alternatively, that the geographical limitations of the non-compete were over-inclusive. The Tennessee Supreme Court recognizes the enforceability of non-compete agreements if they satisfy the standard of "reasonable under the particular circumstances." The court determined that at the time the non-compete agreement was made Outfitters had an interest in protecting itself from potential competition from Smith because he was a successful salesperson who had established relationships with the company's clients. Smith's employment and remuneration by Outfitters constituted consideration for the agreement. Further, the court noted Outfitters' vulnerability because of the losses it suffered following Smith's departure from the company, as well as the public policy argument of protecting businesses from unfair competition. Hence, the court determined that the non-compete agreement was enforceable.

The second issue before the court was whether the geographical limitation of the non-compete agreement was too broad. When determining if a non-compete agreement is reasonable, it is necessary to consider the elements of time and geography. The limitations on geography must not go beyond what is needed to protect the employer's legitimate interests. Testimony by Outfitters' president indicated that the company sought enforcement of the non-compete only within the United States, since that is its primary business location. Therefore, the appellate court limited the injunction to just the United States, rather than North America. The adjustment by the court produced reasonable limits on the scope of the non-compete agreement.

As *Outfitters Satellite, Inc.* illustrates, under Tennessee law, the terms of a non-compete agreement in an employment contract must be reasonable to be enforceable. If a court determines that the geographical terms are overly broad, the court may modify the terms to satisfy the reasonableness standard. Drafters of non-compete agreements should limit geographical restrictions to only those places vital to the employer's interests.

PROPERTY

Tennessee Court of Appeals Enforces Installment Land Contracts. *Kafozi v. Windward Cove, LLC*, No. E2004-01791-COA-R3-CV, 2005 Tenn. App. LEXIS 541, 2005 WL 2051292 (Tenn. Ct. App. Aug. 26, 2005).

By John Inman

The issue in this case is whether an installment sales contract (the "Contract") provided a due date for payment by the Plaintiffs of the balance of the purchase price of a subdivision lot, and whether the Plaintiffs breached the contract by not paying the balance. The Court of Appeals held that the Contract did provide a set due date and that the Plaintiffs breached the Contract by not paying the full amount by that date.

Plaintiffs Rabia and Audrey Kafozi signed an installment sales contract to purchase real property from Defendant Windward Cove, LLC for $100,000. The Contract provided that the Plaintiffs would pay $25,000 at signing and $2,000 each month for 12 months "until February 10, 2001, when the balance of the purchase price shall become due and payable. . . ." The Contract gave Plaintiffs the option to extend the due date for six months. The Contract also provided that "[F]or every month beyond the eighteen (18) months above-stated, [Plaintiffs] will pay a penalty of five percent (5%) figured on an annual basis of the unpaid balance till paid."

After twelve months, Plaintiffs took the six month extension option, and at the end of this six month period, Defendant gave Plaintiffs another six month extension. At the end of the second six month period, on February 10, 2002, Defendant sent Plaintiffs a notice of default and a demand for payment of the balance of the purchase price ($46,455.85). This letter restated language from the Contract giving Defendant ten days to cure from the date of default. Plaintiffs received the letter, but did not pay the balance within ten days. On February 27, 2002, Defendant sold the lot to a third party. The trial court held that the Contract did not provide a due date for payment by the Plaintiffs of the balance of the purchase price and awarded the Plaintiffs $54,500 plus 10% interest per annum from February 27, 2002, the date Defendant sold the property to a third party.

The Court of Appeals looked to the language of the Contract and found, after considering the two extensions, it clearly and unambiguously set a due date of February 10, 2002. The Court also discussed the penalty clause and found that it did not create ambiguity in the due date, but simply provided the Defendant with an additional remedy if Plaintiffs did not pay by the extended due date. The Court went on to suggest that if Plaintiffs could have shown that they were approved for a loan during the ten day cure period, the Court would have considered this as evidence favorable to Plaintiffs, however, Plaintiffs never raised this argument.

This decision results in a harsh outcome for the Plaintiffs, who paid roughly half of the purchase price for this lot and came away with nothing to show for it. The result shows that an installment land contract is a risky and ill-advised way to finance a real estate purchase. Practitioners should be mindful of this and realize that installment land contracts will be upheld.

Action for Professional Negligence of Auctioneer Enforceable Despite Signed Contract. *Land v. Dixon*, No. E2004-03019-COA-R3-CV, 2005 Tenn. App. LEXIS 401, 2005 WL 1618743 (Tenn. Ct. App. July 12, 2005).

By Kristine West

The Tennessee Court of Appeals discussed two issues in *Land v. Dixon*. First, the court held that a cause of action for misrepresentation does not exist when parties have prior knowledge of the misrepresentation and voluntarily proceed with the contract. Second, the court held that a cause of action for professional negligence of an auctioneer or real estate broker exists when the applicable standard of care is violated by the circumstances. This professional negligence action is not barred by the doctrine of merger. In addition, the plaintiff's choice to execute the contract resulting from the auction does not bar the claim.

The defendants conducted an auction of property. Prior to the auction, the defendants represented the auction as a sale by order of trustee in a published brochure. The defendants did not disclose their interest in the property and made other misrepresentations.

Before the auction began, the defendants announced that the auction would be conducted according to the "two-minute rule." The "two-minute rule" provides that once the auctioneer determines that too much time has passed between bids, the auctioneer will announce the start of a two minute period. Once the two minute period is called, if no new bid is submitted within two minutes, then the last person submitting a bid prior to the start of the two minute period becomes the purchaser of the property. Despite circumstances that should end the auction according to the "two-minute rule," the defendants continued with the auction. As a result, the plaintiffs paid a greater amount for the property than they would have paid if the two-minute rule had been enforced.

Plaintiffs filed a complaint concerning the misrepresentations made by the defendants and the professional negligence that occurred during the auction. However within an hour of this filing, the plaintiffs voluntarily closed on the contract with full knowledge of all the alleged misrepresentations made by defendants. The trial court dismissed both complaints for failure to state a claim upon which relief may be granted.

The court held that a claim based on misrepresentation is not actionable if the plaintiffs voluntarily close on the contract with full knowledge of alleged misrepresentations. Consequently, the plaintiffs are precluded from recovering damages based on these misrepresentations. A person who possesses all of the facts and who chooses to proceed with the purchase cannot recover on the basis of fraud or misrepresentation.

However, the plaintiff's choice to proceed with the contract does not preclude the plaintiff from bringing an action for professional misconduct. "A real estate broker who breaches the duty to act honestly and in good faith, and with reasonable skill and care, is potentially liable to a party injured by such a breach." The doctrine of merger does not preclude this action. The plaintiff should be allowed the opportunity to prove that the defendant's negligence or intentional tortious conduct damaged the plaintiff.

This decision highlights two basic principles that should guide attorneys. First, voluntarily entering into a contract with full knowledge of prior misrepresentations precludes one from later bringing actions for fraud or misrepresentation. Second, voluntarily entering a contract resulting from an auction does not preclude actions for professional negligence against the auctioneer or real estate broker.

TAX

Post-merger Continuation of a Consolidated Group after Its Common Parent Merged Downstream into a Subsidiary. *Falconwood Corp. v. U.S.*, 422 F.3d 1339 (Fed. Cir. 2005).

By Brian O'Shaughnessy

As a general rule, a consolidated group's continued existence is tied to its common parent.[1] If the common parent remains in existence, the group continues for a taxable year as long as at least one subsidiary is affiliated with the common parent just before and after the start of that year. 26 C.F.R. § 1.1502-75(d)(1). Thus, the consolidated group continues for the entire year even if the common parent disposes of all of its subsidiaries during the year. In that case, the group's return for the year includes the common parent's tax items for the full year and any subsidiary's items for the portion of the year during which it was a member. 26 C.F.R. § 1.1502-76(b)(1)(i).

If, however, the common parent merges downstream into an acquiring subsidiary, the consolidated group continues notwithstanding the fact the common parent no longer exists. The group continues, for example, if the acquiring subsidiary in form becomes the common parent of the group, and "there remains" at least one subsidiary in the group that had been in the group affiliated with the common parent of that group before the merger. *See* 26 C.F.R. § 1.1502-75(d)(2)(ii).

In *Falconwood Corp. v. U.S.*, the Federal Circuit Court of Appeals considered whether a consolidated group continued when the common parent merged into a subsidiary and, within three hours, the subsidiary sold all remaining subsidiaries to its shareholders.

Even though the merger and sales were part of a single plan, the court determined that the consolidated group continued with the acquiring corporation as its common parent. Consequently, the acquiring corporation could carry back its post-merger losses to offset group income from earlier years, resulting in a significant tax benefit.

At issue is whether the affiliated group survived when Parent merged with the taxpayer, thus fulfilling requirement that following a transfer of assets to a

[1] A consolidated group is an affiliated group of corporations that elects to file a consolidated return. *See* I.R.C. § 1501. The key advantage of filing a consolidated return is that one group member's financial loss may be used to offset another group member's gain.

subsidiary "*there remains* one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation and which was a member of the group prior to the date such former parent cease to exist." 26 C.F.R. § 1.1502-75(d)(2)(ii). Consistent with the substance over form doctrine, the Court of Federal Claims concluded that no subsidiaries remained affiliated with the acquiring subsidiary, largely because the disposition of the remaining subsidiaries was a part of the overall merger transaction.

The Court of Appeals for the Federal Circuit disagreed, concluding that the short-term ownership of the subsidiary stock satisfied the "affiliation" requirement. It found case law or regulations to define what period of time a subsidiary had to remain affiliated with the acquiring subsidiary for the group to survive. The court held that a plain meaning interpretation must be applied. If, however, a plain meaning interpretation applied to all cases, the step transaction doctrine never would.[2] The court stated that in this case the plain meaning interpretation, and not the step transaction doctrine, should apply because the taxpayer had an independent business purpose for the downstream merger. Thus, the court held there is no "principled difference between the three-hour time period in this case and the passage of days or weeks or months in some other case...." The statute is interpreted as simply requiring that there remains, if even for just a moment, a chain of includible corporations as existed immediately before the merger of the common parent into the taxpayer.

This case raises questions as to how the substance over form doctrine is applied to Treasury Regulations addressing consolidated groups. As a result of the holding, inexperienced taxpayers may reach the otherwise logical conclusion that form trumps substance and performing one merger a few hours before or after another will impact tax treatment prescribed in the Code and corresponding regulations. Although this case supports such a conclusion, it is an exception and not the rule.

[2] "The step transaction doctrine is a judicial manifestation of the more general tax law ideal that effect should be given to the substance, rather than the form, of a transaction, 'by ignoring for tax purposes, steps of an integrated transaction that separately are without substance.'" *Falconwood*, 422 F.3d at 1349 (quoting *Dietzsch v. U.S.*, 498 F.2d 1344, 1346 (1974)).

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