

~~UNDER SEAL~~ - No objections filed

IN THE CHANCERY COURT FOR THE STATE OF TENNESSEE
TWENTIETH JUDICIAL DISTRICT, DAVIDSON COUNTY

KATHY HOLT WEEDMAN, JACK)
SANDERS HOLT, JANELLE HOLT,)
JUDY BAUMAN and DONNA)
ETHRIDGE,)

Plaintiffs,)

VS.)

SANDERS MANUFACTURING)
COMPANY, OWEN SANDERS,)
JAMES J. SANDERS III, ERIC O.)
SANDERS, and LOREN G.)
KIRKPATRICK,)

Defendants.)

NO. 16-464-BC

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FILED

MEMORANDUM AND ORDER: (1) GRANTING PLAINTIFFS' SUMMARY JUDGMENT MOTION THAT DEFENDANTS HAVE NOT COMPLIED WITH T.C.A. § 48-18-504(c) AND 506 AND ENJOINING ADVANCED FEES; AND (2) SETTING 6/23/17 DEADLINE TO SCHEDULE RULE 16 CONFERENCE TO SELECT TRIAL DATE

Ruling on Plaintiffs' Summary Judgment Motion

This case is before the Court on the Plaintiffs/Shareholders' motion for entry of summary judgment to determine as a matter of law that the Individual Defendant Directors of Defendant Sanders Manufacturing Company (the "Corporation") have unlawfully had their legal fees paid in this case by the Corporation and that a February 2016 corporate

Resolution constitutes an illegal conflicting interest transaction, quoting Plaintiffs' as follows.

Pursuant to Tennessee State Statutes, Shareholders request that this Court determine that:

- (1) As a matter of law, the Directors are not entitled to mandatory indemnification;
- (2) As a matter of law the Directors failed to follow the procedures for permissive indemnification, and/or failed to follow the corporate form and are personally liable to Sanders Manufacturing for the damages suffered by Sanders Manufacturing for their actions — the entirety of the funds advanced on the Directors' behalf;

As a matter of law, the Directors failed to comply with the statutorily imposed duty to disclose to all shareholders in that Sanders Manufacturing was expending corporate funds to indemnify the Directors under Tenn. Code Ann. § 48-26-202;

- a. As a matter of law the directors' failure to perform this duty amounts to fraudulent concealment;
 - b. The Directors, as a matter of law, are personally liable to Sanders Manufacturing for the damages suffered because of their failure to comply with Tenn. Code Ann. § 48-26-202 and/or their fraudulent concealment;
- (3) As a matter of law the Directors converted corporate assets and are personally liable to Sanders Manufacturing for the entirety of the funds they converted;
 - (4) As a matter of law, should the Directors be found to have not authorized the disbursement, that Eric Sanders breached the duty of his office as Sanders Manufacturing Treasurer and is personally liable to Sanders Manufacturing for the resulting damages;
 - (5) As a matter of law, even if the indemnification procedures were met (which did not occur), no board action was taken to authorize Sanders Manufacturing to disburse the funds used to indemnify the Directors.

- (6) As a matter of law, the vote to pass the Resolution was an improper directors' conflicting transaction, and;
- (7) As a matter of law, the Directors are precluded from any future indemnification in this action because:
 - a. They received an improper benefit, and/or;
 - b. They have not been wholly successful in defending the claims alleged against them and are personally liable to Sanders Manufacturing.

Reply to Response to Motion for Summary Judgment, May 3, 2017 at 1-2.

After considering the law, the arguments of Counsel and the summary judgment record, the Court grants the motion in part and denies it in part as follows, correlating the ruling with the numbering of the above-requested relief.

With respect to request for relief 1, for entry as a matter of law that the Defendants are not entitled to mandatory indemnification, and request for relief 7(b), that the Defendants have not been wholly successful in defending the claims alleged against them, this requested relief is denied on the grounds that it is premature. The explicit text of Tennessee Code Annotated section 48-18-503 is that mandatory indemnification is not triggered until the conclusion of the lawsuit. In pertinent part, the statute provides that indemnification by a corporation is mandatory for a director "who was wholly successful on the merits or otherwise, in the defense of any proceeding to which the director was a party because the director is or was a director of the corporation" No final order has been entered in this case. No party has prevailed. Thus, whether the Individual Defendant Directors shall be

wholly successful has not yet been determined in this case. Accordingly, summary judgment on requests 1 and 7(b) above is denied.

As to the requested relief that the Court determine as a matter of law that the Individual Defendant Directors failed to follow the procedures for permissive indemnification and/or failed to follow the corporate form, the first part of request for relief 2 above, the Court begins with the Plaintiffs' objection that the term "good faith" does not appear in the written affirmations as required by Tennessee Code Annotated section 48-18-504(a)(1) and (2). These subsections provide as follows:

§ 48-18-504. Reimbursement of expenses of party to proceeding

(a) A corporation may pay for or reimburse the reasonable expenses incurred by a director who is a party to a proceeding in advance of final disposition of the proceeding if:

- (1) The director furnishes the corporation a written affirmation of the director's good faith belief that the director has met the standard of conduct described in § 48-18-502;
- (2) The director furnishes the corporation a written undertaking, executed personally or on the director's behalf, to repay the advance if it is ultimately determined that the director is not entitled to indemnification;

The affirmations provided by the Individual Defendant Directors state the following:

Pursuant to T.C.A. §49-18-504, the undersigned being a director of Sanders Manufacturing Company (the "Company") hereby represents and warrants the following:

1. That all actions taken by me in my capacity as a director for the Company were taken with the reasonable belief that the actions were in the best interest of and at least not opposed to the best interest of the Company, were not illegal or unlawful and with respect to any issues involving the Retirement Plan were based on a reasonable belief that the actions taken were in the best interest of participants and beneficiaries of the Retirement Plan and that the actions were consistent with the contractual provisions of the Retirement Plan and the law.
2. That I hereby personally guarantee the prompt repayment to the Company of any such sums advanced on my behalf by the Company in the event that I should be adjudged by the Court to be liable to the Company for any sums advanced on my behalf related to the litigation styled *Weedman v. Sanders Manufacturing Company, et al.* Docket No. 16-46-BC [sic].

Statement of Uncontested Material Facts, March 28, 2017, Exhibit D.

Although the term "good faith" does not appear in the writing, that form is not fatal, nor violative of the statute. The Court concludes, as a matter of law, from construction of the text of the written affirmations, that their wording communicates in substance that the person providing the affirmation is attesting that the actions were taken in good faith. As to form, then, Plaintiffs' motion for summary judgment is denied.

With respect to requests for relief 2 and 5 above, challenging Defendants' compliance with Tennessee Code Annotated sections 48-18-504(c) and 48-18-506, Plaintiffs' motion for summary judgment is granted. The pertinent Code sections are quoted as follows.

§ 48-18-504. Reimbursement of expenses of party to proceeding

* * *

(c) Determinations and authorizations of payments under this section shall be made in the manner specified in § 48-18-506.

§ 48-18-506. Determination of indemnification; authorization and evaluation as to reasonableness

(a) A corporation may not indemnify a director under § 48-18-502 unless authorized in the specific case after a determination has been made that indemnification of the director is permissible in the circumstances because the director has met the standard of conduct set forth in § 48-18-502.

(b) The determination shall be made:

(1) By the board of directors by majority vote of a quorum consisting of directors not at the time parties to the proceeding;

(2) If a quorum cannot be obtained under subdivision (b)(1), by majority vote of a committee duly designated by the board of directors (in which designation directors who are parties may participate), consisting solely of two (2) or more directors not at the time parties to the proceeding;

(3) By independent special legal counsel:

(A) Selected by the board of directors or its committee in the manner prescribed in subdivision (b)(1) or (b)(2); or

(B) If a quorum of the board of directors cannot be obtained under subdivision (b)(1) and a committee cannot be designated under subdivision (b)(2), selected by majority vote of the full board of directors (in which selection directors who are parties may participate); or

(4) By the shareholders, but shares owned by or voted under the control of directors who are at the time parties to the proceeding may not be voted on the determination.

(c) Authorization of indemnification and evaluation as to reasonableness of expenses shall be made in the same manner as the determination that indemnification is permissible, except that if the determination is made by special legal counsel, authorization of indemnification and evaluation as to reasonableness of expenses shall be made by those entitled under subdivision (b)(3) to select counsel.

The statutory requirements are clear on their face and require that one of three methods must be used—Board vote, Appointed Committee vote, or Independent Legal Counsel—before payment of litigation defense costs and fees of directors may be advanced by the Corporation.

Applying these statutes, the Court finds that there is no dispute of fact that the statutes have not been complied with. This finding is derived from Defendants' Responses to Plaintiffs' Statement of Uncontroverted Material Facts, paragraphs 1, 3, 4, 6-19. These establish that in discovery of the Corporation's books, minutes, and documents no evidence has appeared which demonstrates or indicates that any of the three alternatives of section 48-18-506(b)(1), (2) or (3) have occurred. This is circumstantial evidence that none of the three alternatives of section been taken by the Corporation.

Further, Defendants have not refuted this circumstantial evidence with evidence of their own, such as an affidavit or a Rule 56 designation of additional uncontroverted material facts. As provided in *Rye v. Women's Care Ctr. of Memphis, M PLLC*, 477 S.W.3d 235, 265 (Tenn. 2015), *cert. denied*, 136 S. Ct. 2452, 195 L. Ed. 2d 265 (2016):

“[W]hen a motion for summary judgment is made [and] . . . supported as provided in [Tennessee Rule 56],” to survive summary judgment, the nonmoving party “may not rest upon the mere allegations or denials of [its] pleading,” but must respond, and by affidavits or one of the other means provided in Tennessee Rule 56, “set forth specific facts” *at the summary judgment stage* “showing that there is a genuine issue for trial.” Tenn. R. Civ. P. 56.06. The nonmoving party “must do more than simply show that there is some metaphysical doubt as to the material facts.” *Matsushita Elec. Indus. Co.*, 475 U.S. at 586, 106 S. Ct. 1348. The nonmoving party must demonstrate the existence of specific facts in the record which could lead a rational trier of fact to find in favor of the nonmoving party. . . . The focus is on the evidence the nonmoving party comes forward with at the summary judgment stage, not on hypothetical evidence that theoretically could be adduced, despite the passage of discovery deadlines, at a future trial [emphasis in original].

It is therefore ORDERED that the Plaintiffs’ motion for summary judgment is granted with respect to items 2 and 5 above to the extent that the Court concludes as a matter of law that the Defendants have not complied with Tennessee Code Annotated sections 48-18-504(c) and 48-18-506.

With respect to the remedy for failing to comply with the requirements of Tennessee Code Annotated section 48-18-504(c) and 48-18-506, it is ORDERED that the Defendant Corporation is enjoined and prohibited from advancing fees and expenses to pay the defense of the Individual Defendant Directors in this case until further order of the Court.

With respect to the remainder of 2 above, asserting personal liability of the Individual Defendant Directors for damages to the Corporation and seeking recovery of damages for fraudulent concealment, and with respect to the relief sought in requests 3, 4, and 7(a) above, for summary judgment on personal liability of the Individual Defendant Directors, fraudulent concealment, conversion, Eric Sanders breach of office and receipt of an improper benefit, all of these requests for relief concern conduct involving wrongful intent. Whether such intent exists in this case presents genuine issues of material fact precluding entry of summary judgment. Further precluding entry of summary judgment at this time is that because the degree of culpability can not be determined on summary judgment nor can the scope and kind of reimbursement remedy be determined. That is, the nature of the remedy depends on the degree of culpability. Additionally, the outcome of the other aspects of the case, not before the Court on summary judgment, affect whether damages are recoverable or a set-off. It is therefore ORDERED that Plaintiffs' motion for summary judgment on personal liability of the Individual Defendant Directors, fraudulent concealment, conversion, Eric Sanders breach of office and receipt of an improper benefit is denied.

Lastly, as to Plaintiffs' summary judgment motion on request for relief 6 above, that the February 2016 Resolution was an improper directors' conflicting transaction, the motion is denied on the grounds that competing inferences can be drawn. The analysis for this determination comes from the February 2, 2017 Memorandum and Order granting in part and

denying part Defendants' motion for summary judgment, at 7-8, 15-19 and 21-22, and is quoted below and incorporated herein by reference.

It is ORDERED that the Defendants' claim, that the Board of Directors had no choice but to adopt the February 2016 Resolution to take action to fund the Plan because Tennessee law requires that, is denied. As explained in detail in the analysis below, the record at this time does not establish that the adoption of the Resolution under Tennessee Code Annotated section 48-24-109 was required. Moreover, the record at this time establishes that adoption of the Resolution was premature. Under these circumstances of premature action, competing inferences can be drawn.

One inference is the one asserted by Defendants that adoption of the Resolution was a "proactive" plan, made upon advice of counsel and financial consultants, to make reasonable provision for a known claim of the Corporation as it determines to sell off assets. The competing inference is that because the Resolution was not required at the time by Tennessee Code Annotated section 48-24-109 and was premature, adoption of the Resolution was a way to prefer payment of the retirement benefits of the Individual Defendant Directors' and to assure those were paid even before the Corporation was dissolved and before the claims of other creditors were dealt with as provided in Tennessee Code Annotated sections 48-24-106, 107, and 109. The latter inference, that the retirement benefits of the Individual Defendants are being preferred, states a claim for a conflict of interest transaction that did not comply with Tennessee Code Annotated sections 48-24-703 and 704. Accordingly, the claims contained in paragraphs 1.40-1.77 of the Verified Complaint remain pending.

* * * *

(b) Summary Judgment Denied For All Parties On Conflict
Of Interest Transaction

Having concluded that this Court does have jurisdiction to determine the claims at paragraphs 1.40-1.77 of the *Verified Complaint* and section 1 of the *Prayer For Relief*, the Court further determines that with respect to these paragraphs Defendants' motion for summary judgment must be denied and Plaintiffs' request for judgment as a matter of law is denied.

Defendants' theory for dismissing this claim is that the Board "had no choice," that the vote passing the Resolution was necessary to fulfill their statutory duty under Tennessee Code Annotated section 48-24-109. Quoting *Morrow v. Iron & Steel Co.*, 87 Tenn. 262, 273, 10 S.W. 495, 499 (1888), that upon the winding up a corporation creditors must be first paid and that the ownership of the corporation by the stockholders of assets is subject to the higher and superior rights of creditors, the Defendants argue that the participants and beneficiaries under the Plan are general unsecured creditors of the Corporation, and, therefore, have a superior right to the Plaintiff Shareholders or any other shareholders of the Company. In support of this the Defendants cite to paragraph 8.5 of the Plan which provides that beneficiaries of the Plan are unsecured creditors of the Corporation:

8.5 Unfunded Arrangement: The Participants Beneficiaries under the Plan are general unsecured creditors of the Company for distribution of benefits under the Plan. The benefits are not subject in any manner to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment or garnishment by creditors (whether secured or unsecured)

Further, the Defendants forecast that the Resolution had to be adopted or litigation by the Top Hat plan beneficiaries would ensue.

The Plan is unfunded, and the Plan benefits have been paid from the Company's cash flow. The Company has a continuing obligation to pay benefits under the Plan. As the Company is wound up and revenue ceases, there will be insufficient funds to pay the Company's obligations to the beneficiaries of the unfunded Plan. If the Board of Directors had not acted to fund the Plan in the course of winding up Company business, then the Company would have been exposed to claims of the Plan beneficiaries. While funding the Plan leaves less money available to distribute to the Plaintiff stockholders, funding the Plan is actually in the Company's best interest because funding the Plan avoids exposing the Company to liability to litigation costs, which would further deplete Company assets.

Memorandum in Support of Motion Summary Judgment by Defendants, October 28, 2016 at pp. 5-6.

The following facts, particularly the timing of the Resolution, combined with the text of Tennessee Code Annotated section 48-24-109, however, present competing inferences to the Defendants' assertion that the Board had no choice and that adoption of the Resolution was necessary for the Board to fulfill its statutory duty under Tennessee Code Annotated section 48-24-109.

By its terms, section 48-24-109 is triggered when a Corporation is dissolved, and it is marshaling its assets and identifying the claims of creditors to be paid:

(a) Directors shall cause a dissolved corporation to discharge or make reasonable provision for the payment of claims and make distributions of assets to shareholders after payment or provision for claims.

(b) Directors of a dissolved corporation that has disposed of claims under § 48-24-106 or § 48-24-107 shall not be liable for breach of subsection (a) with respect to claims against the dissolved corporation that are barred or satisfied under § 48-24-106 or § 48-24-107.

In this case at the time the Resolution was adopted, the Corporation had not been dissolved, the condition stated in section 48-24-109(a) for it to be applicable. Even now, a year after the Resolution was adopted, the Corporation is still in the process of selling assets and it has not been dissolved. Further, at the time the Resolution was adopted and even now, claims of creditors have not been identified as provided in the precursive Tennessee Code Annotated sections 48-24-106 and 107 to prompt the condition for the Board's duty under section 48-24-109 to pay the claims of creditors prior to distributing funds to the shareholders. Thus, the summary judgment record does not establish that the conditions for the Board's duty under section 48-24-109 were present in 2016 when the Resolution was adopted, nor even now, because dissolution has not occurred and claims of creditors are not being identified to be paid prior to distribution to the shareholders.

Also premature in terms of the claims process of a dissolved corporation is that the summary judgment record does not show if there are other creditors of the Corporation. There is no proof in the record on the assets and liabilities of the Corporation and what those will be at time of dissolution.

Absent those facts, it is not known if there will be other secured and/or unsecured creditors who will have to be paid, how that will be handled in conjunction with funding the Top Hat plan, and if the Corporation may be insolvent. Under these circumstances, the Defendants have not established on summary judgment that the Defendants' had an affirmative duty to fund the Plan. This is especially the case because under ERISA a Top Hat Plan is not required to be funded. The participants are unsecured creditors who take the risk that if the Corporation is insolvent they will not be paid. Unlike other ERISA plans, the participants of a Top Hat plan are not preferred or guaranteed payments if the Corporation is insolvent. Illustrative of these points are cases showing how Top Hat plans are handled in the context of insolvency and bankruptcy.

In *In re IT Grp., Inc.*, the Third Circuit Court of Appeals explained that Top Hat plans, similar to the one in this lawsuit, are to remain unfunded in the face of insolvency because of the nature of the participants' rights which are that of a general, unsecured creditor

* * * *

Thus, the adoption of the Resolution to pay the Plan in February 2016, by the very terms of section 48-24-109, was not necessary and it was premature. From this unnecessary, premature adoption of the Resolution, a competing inference, contrary to the Defendants' summary judgment, can be drawn that Defendants' adoption of the Resolution was a conflict of interest transaction requiring the Board to have followed the requirements of Tennessee Code Annotated sections 48-24-703 and 704 Safe Harbor provisions. It is undisputed that those provisions were not followed.

Accordingly, because of the competing inferences that can be drawn, paragraphs 1.40-1.77 of the *Verified Complaint* and section 1 of the *Prayer For Relief* withstand the Defendants' *Motion For Summary Judgment*. Plaintiffs' claim that the Resolution was ineffective because it was not adopted in compliance with Tennessee Code Annotated sections 48-24-703 and 704 remains pending. The above facts and law, as well, present competing inferences with respect to the application of the business judgment rule, and it does not provide a basis for granting Defendants' motion for summary judgment with respect to Plaintiffs' claims at paragraphs 1.40-1.77 of the *Verified Complaint*.

On the other hand, denying Defendants' summary judgment does not require judgment for the Plaintiffs. In opposition to Plaintiffs' facts and inferences, the Defendants have not had the opportunity under Tennessee Civil Procedure Rule 56 to counter designate facts such as advice of counsel or financial advisors.

Accordingly, because of competing inferences, the claims at paragraphs 1.40-1.77 of the *Verified Complaint* and the relief requested in section 1 of the *Prayer For Relief* to injoin and declare the February 2016 Resolution a nullity remain pending.

Rule 16 Conference to Set for Trial

This case has been on file a year and, therefore, must be set for trial. It is ORDERED that by June 23, 2017, Counsel shall contact the Docket Clerk, Mrs. Smith (615-862-5719), on their availability, on the dates stated below, for a Rule 16 Conference to be conducted by telephone to (1) identify the issues for trial, (2) set a discovery cut-off date and (3) select a trial date:

- June 29, 2017 at noon
- July 6, 2017 at 10:30 a.m.
- July 11, 2017 at noon

Removal of Seal

Lastly, the seal on this Memorandum and Order shall be removed on June 30, 2017, unless before that date Counsel, collectively or separately, file an objection and state the redactions they seek and the reasons for those.



ELLEN HOBBS LYLE
CHANCELLOR
BUSINESS COURT DOCKET
PILOT PROJECT

cc by U.S. Mail, email, or efile as applicable to:

William B. Hawkins III
Eric G. Evans
Ronald H. Pursell
Edward Hadley
James Catalano



MAILED
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