

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

LESLIE NEWMAN, Commissioner of the)
Tennessee Department of Commerce and)
Insurance, (Marie Murphy, Special Deputy)
Commissioner of Commerce and Insurance)
for the State of Tennessee))
))
Petitioner,)
))
VS.))
))
SMART DATA SOLUTIONS, LLC, a)
Tennessee limited liability company, et al.,)
))
Respondents.)

NO. 10-507-III
Damages Petitioner Against
Evans/Petree PC and
William L. Hendricks, Jr.

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CLARENCE H. HARRIS
DAVIDSON CO. CHANCERY CT.
N.C. & M.

MEMORANDUM AND ORDER

This lawsuit was filed by the State of Tennessee in March of 2010 to liquidate companies conducting insurance business. The petition for liquidation was granted by this Court in May of 2010. The status of the case is that the Liquidator is presently marshaling assets of the companies. Part of that process is the assertion by the Liquidator of claims on behalf of the liquidated entities pursuant to Tennessee Code Annotated section 56-9-313(b)(1).

One such claim is a Petition to recover damages on behalf of one of the liquidated entities, Smart Data Solutions, LLC (“SDS”), from Evans/Petree PC, a Memphis law firm, and William L. Hendricks, an attorney of the firm, (collectively referred to herein as the “Attorneys”), for alleged acts of legal malpractice the Attorneys are claimed to have

committed in their representation of SDS beginning in February of 2008. The Attorneys have filed a Tennessee Rule of Civil Procedure 12.02(6) motion that the Petition should be dismissed for failure to state a claim. The motion was argued before the Court on August 25, 2011, and taken under advisement.

After reviewing the Petition, considering the arguments of counsel, and after reading and researching the law, the Court concludes that the Attorneys are correct that the Petition is defective in its failure to state facts establishing the essential elements of a legal malpractice claim. Instead of dismissing the Petition, however, the Court shall provide the State thirty days to amend to cure the deficiencies. The opportunity to amend is without prejudice to the Attorneys to reassert the motion to dismiss should they determine that the amended petition is nevertheless insufficient. Identified below are the deficiencies of the Petition which must be cured to state a claim, and the law and reasoning on which the Court bases its decision.

Applicable Law

Counsel agree on the governing law. Their dispute is whether the Petition is sufficient when the governing law is applied to the allegations of the Petition.

The first aspect of the applicable law is the Rule 12.06(2) motion to dismiss standard, recently set out by the Tennessee Supreme Court in *Webb v. Nashville Area Habitat for Humanity, Inc.* In that case the Tennessee Supreme Court clarified the appropriate standard

for courts to apply when ruling on a Rule 12.02(6) motion to dismiss in light of the United States Supreme Court's recent decisions in *Bell Atlantic Corp. v. Twombly* and *Ashcroft v.*

Iqbal:

A Rule 12.02(6) motion challenges only the legal sufficiency of the complaint, not the strength of the plaintiff's proof or evidence. *Highwoods Props., Inc. v. City of Memphis*, 297 S.W.3d 695, 700 (Tenn. 2009); *Willis v. Tenn. Dep't of Corr.*, 113 S.W.3d 706, 710 (Tenn. 2003); *Bell ex rel. Snyder v. Icard, Merrill, Cullis, Timm, Furen & Ginsburg, P.A.*, 986 S.W.2d 550, 554 (Tenn. 1999); *Sanders v. Vinson*, 558 S.W.2d 838, 840 (Tenn. 1977). The resolution of a 12.02(6) motion to dismiss is determined by an examination of the pleadings alone. *Leggett v. Duke Energy Corp.*, 308 S.W.3d 843, 851 (Tenn. 2010); *Trau-Med of Am., Inc. v. Allstate Ins. Co.*, 71 S.W.3d 691, 696 (Tenn. 2002); *Cook ex rel. Uithoven v. Spinnaker's of Rivergate, Inc.*, 878 S.W.2d 934, 938 (Tenn. 1994); *Cornpropst v. Sloan*, 528 S.W.2d 188, 190 (Tenn. 1975) (*overruled on other grounds by McClung v. Delta Square Ltd. P'ship*, 937 S.W.2d 891, 899–900 (Tenn. 1996)). A defendant who files a motion to dismiss “admits the truth of all of the relevant and material allegations contained in the complaint, but . . . asserts that the allegations fail to establish a cause of action.” *Brown v. Tenn. Title Loans, Inc.*, 328 S.W.3d 850, 854 (Tenn. 2010) (quoting *Freeman Indus., LLC v. Eastman Chem. Co.*, 172 S.W.3d 512, 516 (Tenn. 2005)); *see Edwards v. Allen*, 216 S.W.3d 278, 284 (Tenn. 2007); *White v. Revco Disc. Drug Ctrs., Inc.*, 33 S.W.3d 713, 718 (Tenn. 2000); *Holloway v. Putnam Cnty.*, 534 S.W.2d 292, 296 (Tenn. 1976).

In considering a motion to dismiss, courts “must construe the complaint liberally, presuming all factual allegations to be true and giving the plaintiff the benefit of all reasonable inferences.” *Tigg v. Pirelli Tire Corp.*, 232 S.W.3d 28, 31–32 (Tenn. 2007) (quoting *Trau-Med*, 71 S.W.3d at 696); *see Leach v. Taylor*, 124 S.W.3d 87, 92–93 (Tenn. 2004); *Stein v. Davidson Hotel Co.*, 945 S.W.2d 714, 716 (Tenn. 1997); *Bellar v. Baptist Hosp., Inc.*, 559 S.W.2d 788, 790 (Tenn. 1978); *see also City of Brentwood v. Metro. Bd. of Zoning Appeals*, 149 S.W.3d 49, 54 (Tenn. Ct. App. 2004) (holding that courts “must construe the complaint liberally in favor of the plaintiff by . . . giving the plaintiff the benefit of all the inferences that can be reasonably drawn from the pleaded facts”). A trial court should grant a motion to dismiss “only when it appears that the plaintiff can prove no set of facts in support of the claim that would entitle the plaintiff to relief.” *Crews v. Buckman Labs. Int'l, Inc.*, 78

S.W.3d 852, 857 (Tenn. 2002); *see Lanier v. Rains*, 229 S.W.3d 656, 660 (Tenn. 2007); *Doe v. Sundquist*, 2 S.W.3d 919, 922 (Tenn. 1999); *Pemberton v. Am. Distilled Spirits Co.*, 664 S.W.2d 690, 691 (Tenn. 1984); *Fuerst v. Methodist Hosp. S.*, 566 S.W.2d 847, 848 (Tenn. 1978); *Ladd v. Roane Hosiery, Inc.*, 556 S.W.2d 758, 759–60 (Tenn. 1977). We review the trial court’s legal conclusions regarding the adequacy of the complaint de novo. *Brown*, 328 S.W.3d at 855; *Stein*, 945 S.W.2d at 716.

Under Tennessee Rule of Civil Procedure 8, Tennessee follows a liberal notice pleading standard, *see Leach*, 124 S.W.3d at 92–93, which recognizes that the primary purpose of pleadings is to provide notice of the issues presented to the opposing party and court. *Abshure v. Methodist Healthcare–Memphis Hosps.*, 325 S.W.3d 98, 103 (Tenn. 2010); *see also* Robert Banks, Jr. & June F. Entman, *Tennessee Civil Procedure* § 5–4(a) (3d ed. 2009) (“The essential function of the pleadings is simply to give notice of a claim or defense. History, as Professors Wright and Miller point out, has shown that the pleadings cannot successfully do more.”) (footnotes omitted). Our state’s notice pleading regime is firmly established and longstanding; this Court recognized well before the Tennessee Rules of Civil Procedure were adopted that “[t]he object and purpose of any pleading is to give notice of the nature of the wrongs and injuries complained of with reasonable certainty, and notice of the defenses that will be interposed, and to acquaint the court with the real issues to be tried.” *Hammett v. Vogue, Inc.*, 179 Tenn. 284, 165 S.W.2d 577, 579 (Tenn. 1942).

To be sufficient and survive a motion to dismiss, a complaint must not be entirely devoid of factual allegations. Tennessee courts have long interpreted Tennessee Rule of Civil Procedure 8.01 to require a plaintiff to state “the facts upon which a claim for relief is founded.” *Smith v. Lincoln Brass Works, Inc.*, 712 S.W.2d 470, 471 (Tenn. 1986) (quoting *W & O Constr. Co. v. City of Smithville*, 557 S.W.2d 920, 922 (Tenn. 1977)). A complaint “need not contain detailed allegations of all the facts giving rise to the claim,” but it “must contain sufficient factual allegations to articulate a claim for relief.” *Abshure*, 325 S.W.3d at 103–04. “The facts pleaded, and the inferences reasonably drawn from these facts, must raise the pleader’s right to relief beyond the speculative level.” *Id.* at 104. Thus, as we observed in *Leach*,

“While a complaint in a tort action need not contain in minute detail the facts that give rise to the claim, *it must contain direct allegations on every material point* necessary to sustain a

recovery on any legal theory, even though it may not be the theory suggested . . . by the pleader, *or contain allegations from which an inference may fairly be drawn that evidence on these material points will be introduced at trial.*”

124 S.W.3d at 92 (quoting *Donaldson v. Donaldson*, 557 S.W.2d 60, 61 (Tenn. 1977)) (alteration in original); *accord Givens v. Mullikin ex rel. Estate of McElwaney*, 75 S.W.3d 383, 399 (Tenn. 2002). Moreover, courts are not required to accept as true assertions that are merely legal arguments or “legal conclusions” couched as facts. *Riggs v. Burson*, 941 S.W.2d 44, 47–48 (Tenn. 1997).

Webb v. Nashville Area Habitat for Humanity, Inc., M2009-01552-SC-R11CV, 2011 WL 2905584, at *2-4 (Tenn. July 21, 2011).

The second aspect of the applicable law is the essential elements of a legal malpractice claim. These elements are provided in *Lazy Seven Coal Sales v. Stone & Hinds, P.C.*, 813 S.W.2d 400, 403 (Tenn. 1991), a case cited by counsel for each side. To survive dismissal, a legal malpractice complaint must allege, under *Webb*, some facts that the following, identified in *Lazy Seven*, are present: (1) the lawyers owed the client a duty, (2) that they breached the duty, and (3) that the breach of duty proximately caused damages to the client.

The essential element of the legal malpractice claim in this case that the Attorneys assert is missing from the Petition is the first element: allegations of a duty. In that regard, counsel for the Attorneys have cited to the Court a Connecticut case, *Soma v. Gracey*, 544 A.2d 668, 672 (Conn. App. 1988). *Soma* instructs this Court that an essential component of an allegation of duty is the source of that duty. *Soma* states the elementary point that “It is axiomatic that the duty of the attorney to act does not extend to the business of the client in

general. *Erickson v. Civic Plaza Nat. Bank*, 422 S.W.2d 373 (1967). The obligation of the attorney is to provide the service for which he was hired. 7 AM. JUR. 2D, *Attorneys at Law* § 129.” Moreover, *Soma* explains that an attorney cannot be negligent for omitting to perform a task if the obligation the attorney undertook for the client did not include the omitted task.

The Court’s review of *Erickson*, a Kansas case cited in *Soma*, provides additional insight into the essential allegations for establishing the existence of a duty. The *Erickson* court began its analysis of the duty element of an alleged legal malpractice claim by specifying the services in that case the attorney was retained to perform, i.e. the *Erickson* court identified the scope of the attorney’s duty. That court’s review of the record began with a determination that the lawyer in the case “was hired by defendant Barket to perform legal services necessary to obtain a national bank charter His duties included correspondent between the organizers and Comptroller of the Currency; as liaison between the two, he was required to maintain the documents supporting the application for the new bank.” After defining the scope of the attorney’s duty, the *Erickson* court reasoned that the alleged negligence of the attorney of entering into a contract for a stock subscription on behalf of the client did not derive from the attorney-client relationship because that act was outside the scope of the attorney’s tasks he was retained to perform.

Soma and *Erickson* are instructive to this Court in demonstrating that a critical aspect of the essential element of duty in a legal malpractice claim is identification of the scope of

that duty. Without that identification, it is impossible to determine whether the duty has been breached and whether the attorney is liable.

Examination of Petition

Turning to the allegations of the Petition, the Court finds at page 4 of the Liquidator's Memorandum in Response to Motion to Dismiss of Evans/Petree PC, and William C. Hendricks, Jr. (August 22, 2011), an excellent synopsis, of great assistance to the Court, of the paragraphs of the Petition which the Liquidator asserts sufficiently allege the essential elements of a legal malpractice claim. There the Liquidator identifies the following paragraphs of the Petition as the Liquidator's allegations of duty: 56, 62, 80-82, 89, 96 and 100. The duties specified in these paragraphs can be divided into three categories:

- (1) Conflict of Interest—The Attorneys had a duty to SDS not to facilitate or represent Bart Posey, an owner of SDS, in his transfer of funds from SDS' account for his personal or other use. The source of this duty is the prohibition against attorneys representing multiple parties where the parties have a conflict of interest. (Paragraphs 56, 62).
- (2) Due Diligence on Sham Insurance—The Attorneys had a duty to SDS to ascertain (“conduct reasonable due diligence”) whether purported insurers Beema, Andone, and PT Prudential Life, were legitimate providers of insurance coverage. (Paragraphs 80-82, 89, 96).
- (3) Compliance Advice—The Attorneys had a duty to advise SDS to comply with state insurance regulations, take appropriate actions required to exempt the receivership entities from state insurance regulations, or terminate business activities. (Paragraph 100).

Analysis

Beginning with the allegations of malpractice in the Petition concerning a conflict of interest referred to in paragraphs 56 and 62 of the Petition, the Court concludes that Tennessee Code Annotated section 48-249-102(7), permits the transfer of money for the benefit of an owner-member unless the transfer would render the LLC insolvent. TENN. CODE ANN. §§ 48-249-306 and 307. Accordingly, the mere act of transfer of money from SDS to Bart Posey does not state a claim of a conflict of interest among clients for the Attorneys in this case. Only if there are circumstances of an illegal or wrongful transfer would a conflict arise.

In this regard, the Petition does allege in paragraphs 30, 47, 54, 56-57, 60-63 and 101 that the transfers were “fraudulent” and constituted “conversion” and “embezzlement.” As identified by counsel for the Attorneys, however, the Petition contains no factual allegations on which to base the conclusory labels of fraud, conversion and embezzlement. The Court’s independent review of the Petition located no allegations of facts such as insolvency or that SDS held the funds in trust or escrow to inform the conclusory legal terms conversion, fraud and embezzlement. As quoted above in *Webb*, the test in Tennessee for pleadings is that they must state some facts to support the legal theories. Applying this test to the Petition’s claim of legal malpractice on alleged conflict of interest transfers of funds by Bart Posey from SDS, the Court determines that the Petition, to withstand dismissal, requires allegations of

some facts to support the conclusory labels that the transfers in issue constituted conversion, fraud or embezzlement.

Considering next the second and third categories of the Liquidator's claims of legal malpractice in connection with: (2) SDS purchasing sham insurance and (3) SDS' compliance with state regulations, the Court finds that in this respect, as well, the Petition is deficient. Relating back to the discussions above of *Soma* and *Erickson*, the Court finds that the Petition does not link its allegation that the Attorneys had a duty of due diligence with respect to insurance products SDS purchased and a duty of advising SDS about regulatory compliance, to an allegation of the tasks the attorneys were retained by SDS to perform that would implicate such duties. The Court's independent review of the Petition reveals only that at paragraph 66 is there the vague allegation that the Attorneys were retained to represent SDS in "a matter in which the North Carolina Department of Insurance ("N.C.DOI") was investigating SDS and Posey for activities relating to the marketing/solicitation, placement and administration of insurance products." The Liquidator does not state facts such as the existence of a retainer agreement, correspondence between the Attorneys and SDS in which the latter requested due diligence or regulatory advice, the inherent nature of defending SDS in the North Carolina proceedings, and/or voluntary assumption on the part of the Attorneys of inquiring into the legitimacy of the purported insurance or regulatory compliance to support the allegations in the complaint that the Attorneys' scope of duty included such due diligence or regulatory compliance advice. In the absence of a statement of facts of the

source of the Attorneys' duty to perform due diligence and provide regulatory compliance advice, there is an insufficient basis in the Petition to allege such duties existed.

Lastly, the Attorneys' final basis for dismissal is estoppel. The Attorneys assert that the Liquidator has taken positions in obtaining judgments for SDS in two previous lawsuits on causation that SDS paid out monies for sham insurance based on the deception of the insurers and their agents. This position, the Attorneys assert, is inconsistent with the claim in this case that causation of SDS purchasing sham insurance was the alleged malpractice of the Attorneys. The doctrines under Tennessee law of superseding or intervening cause, and the comparative role of negligence to intentional conduct such as fraud require the development of additional facts and law such that the Petition is not susceptible to dismissal at this stage of the proceedings on the ground of estoppel.

It is therefore ORDERED that the Court sustains the Attorneys' assertion that the Petition fails to state sufficient facts to state a legal malpractice claim. It is further ORDERED that the State is provided through September 30, 2011, to amend the Petition to provide factual allegations specified above, without prejudice to the Attorneys to renew the

motion to dismiss if they contend the amended petition remains insufficient as a matter of law.



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