IN THE UNITED STATES BANKRUPTCY COURT FOR THE EASTERN DISTRICT OF TENNESSEE

In re

Case No. 02-31000

COY LEE McCARTER
SUSAN RYMER McCARTER

Debtors

MEMORANDUM ON THE DEBTORS' OBJECTION TO CLAIM OF JOE F. JUSTICE, III

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RICHARD STAIR, JR.
UNITED STATES BANKRUPTCY JUDGE

This contested matter is before the court on the Debtors' Objection to the Claim of Joe F. Justice, III (Claim No. 42) (Objection) filed by the Debtors on June 5, 2003, seeking an order disallowing the claim filed by Joe F. Justice, III (Mr. Justice) on March 6, 2003, in the amount of $160,000.00.

An evidentiary hearing on the Objection commenced on October 20, 2003, and continued on October 24, 2003. The record before the court consists of twenty-seven exhibits introduced into evidence, several of which are duplicative, along with the testimony of Mr. Justice, William S. Denton, Jr., and the Debtor, Coy Lee McCarter. During closing arguments, the Debtors' attorney, for the first time, raised the defense of novation. The court, sua sponte, entered an Order on October 27, 2003, directing the parties to file supplemental briefs regarding the novation issue, and both parties filed their briefs on this issue on November 10, 2003.[1]

This is a core proceeding. 28 U.S.C.A. § 157(b)(2)(A), (B), (O) (West 1993).

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[1] In his supplemental brief, Mr. Justice raised the issue of the timeliness of the novation argument, asserting that because this issue was not expressly addressed by the Debtors in their Pretrial Brief it should not now be considered by the court. The court finds that Mr. Justice was not prejudiced by the raising of the argument by the Debtors, because the Debtors did argue in their Pretrial Brief that Mr. Justice's past-due obligation had been assumed by another entity, and accordingly, both parties introduced testimony and evidence specifically related to the issue of novation. Moreover, the court gave both parties the opportunity to thoroughly brief the issue before making its decision. *See Delmonico v. Allen (In re Allen)*, No. 3:99-CV-376, Mem. Op. at 8 (E.D. Tenn. Mar. 23, 2000) (affirming the bankruptcy court decision entered after the court allowed the parties to file supplemental briefs in support of an issue not expressly stated in the pleadings but supported by evidence presented at trial).

Additionally, the court notes that in their supplemental brief, the Debtors referred to Exhibit 4 that was not entered into evidence at trial. Similarly, Mr. Justice attached a page from the deposition of Mr. McCarter that was not included within the deposition excerpt comprising Exhibit 25 and was, thus, not introduced into evidence at trial. Notwithstanding that these documents were not introduced into evidence, to the extent that the parties deem this evidence relevant to the novation issue, both Exhibit 4 and the deposition excerpt, which will be included in Exhibit 25, will be made a part of the record and considered by the court.

I

The Debtors filed the Voluntary Petition commencing their bankruptcy case under Chapter 11 of the Bankruptcy Code on February 26, 2002. On that same day, the following two related Chapter 11 cases were also filed: (1) *In re Echota Development, LP* (Echota Development), Case No. 02-30998; and (2) *In re Great Smokies Management Corp*. (Great Smokies), Case No. 02-30999. Mr. Justice was listed on the Debtors' initial creditor matrix as "Joe Justus" with an incorrect address;[2] however, he was not listed as a creditor on either Schedule D (Secured Creditors), Schedule E (Unsecured Priority Creditors), or Schedule F (Unsecured Nonpriority Creditors). On March 1, 2002, a Notice of Commencement of Case was issued by the clerk and mailed to creditors, including "Joe Justus" at the incorrect address. This Notice, which fixed June 25, 2002, as the deadline for creditors to file proofs of claim, was not received by Mr. Justice. Mr. Justice was not scheduled as a creditor in the Echota Development or Great Smokies cases.

Mr. McCarter and Mr. Justice are former business associates and have known each other both professionally and socially for approximately six years. In 1999, Mr. McCarter and Mr. Justice began discussions to put together a timeshare project in Sevier County, Tennessee, and on November 23, 1999, they executed a Consulting Services Agreement (Consulting Agreement) with

[2] The listed address was "302 Henderson Avenue, Sevierville, Tennessee 37862." *See* TRIAL EX. 16. The record before the court shows that at all times pertinent to Mr. Justice's alleged claim, his address has been 222 Lexington Place, Sevierville, Tennessee 37862, and that he has never resided at the Henderson Avenue address.

a term of one-year.[3] *See* TRIAL EXS. 1 and 32. The purpose of the Consulting Agreement was the "engage[ment] in the business of developing, building and operating a first-class time share resort[.]" TRIAL EXS. 1 and 32. The Consulting Agreement also provided that the monthly compensation for the following consulting services to be provided by Mr. Justice would be $15,000.00:

> Consultant's services shall include (without limitation) the implementation of the design, financing, registration, development, resort operations, sales and marketing, timeshare operations, and of a timeshare Project located on property owned by [Mr. McCarter] and [his] affiliates in Sevier County, Tennessee[.]

TRIAL EXS. 1 and 32. Mr. Justice was given an office at the Echota Resort[4] administrative building, along with the use of all office equipment located at the Echota Resort.

In January 2000, both parties were aware that Mr. McCarter, Echota Development, and Great Smokies were having difficulties making the $15,000.00 payments under the Consulting Agreement. Nevertheless, Mr. Justice prepared the necessary documentation and created the necessary corporations to start the timeshare, assisted Mr. McCarter with obtaining financing, and hired a director of sales for the timeshare. Over the course of the next year, although Mr. McCarter did not make timely payments to Mr. Justice under the Consulting Agreement, he continued making every effort to pay Mr. Justice. The majority of these payments were made from the Operating Account for Great Smokies.

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[3] The Consulting Services Agreement was actually entered into by Mr. McCarter and MCSC, Inc., a corporation chartered by Mr. Justice. A detailed discussion of the relationship between Mr. Justice and MCSC, Inc., will follow in this Memorandum. *See also infra* note 8.

[4] Although the record is not totally clear, it appears that Mr. McCarter operated the timeshare project under which Echota Development, Great Smokies, and a third-related entity, Echota Resorts, LLC, played a part, collectively under the name of Echota Resort. Echota Resorts, LLC, is not a debtor in bankruptcy.

Sometime in late 2000, Mr. Justice left the Echota Resort and took other employment opportunities, including a position with Oakwood Homes in Greeneville, Tennessee, as a retail manager. Throughout this time, Mr. Justice maintained his office at Echota Resort, and he continued in his attempts to assist Mr. McCarter obtain financing for the timeshare project, even though he was no longer officially employed by or working with any of the Echota Resort entities.[5]

In early February 2002, Mr. McCarter informed Mr. Justice that he was filing for bankruptcy. Mr. Justice does not dispute that he had actual knowledge of the bankruptcy case, and in fact, he attended a hearing before the bankruptcy court on July 11, 2002, and later attended a meeting with the Debtors and others at the offices of the Debtors' attorney.

Shortly after the bankruptcy filing, Mr. McCarter told Mr. Justice that Mr. Timothy Seivers was interested in investing in a timeshare project. In March 2002, the Debtors, Mr. Justice and his wife, Janet O. Justice, Mr. Seivers, and others met at the Debtors' home to discuss various projects. Also, on March 29, 2002, Mr. Seivers paid Mr. Justice $50,000.00, which would allow Mr. Justice to come back and restart the timeshare project, and Echota Smoky Mountain Resort, LLC (ESMR), which was owned by Mr. Seivers (75%) and Mrs. Justice (25%), was formed. On May 3, 2002, Mr. Seivers and Mrs. Justice executed a document entitled "Unanimous Written Consent in Lieu of Organization Meeting of the Members of Echota Smoky Mountain Resort, LLC (A Tennessee Limited Liability Company)" (Unanimous Written Consent),

[5] *See supra* note 4.

in which Mr. Justice was named Project Manager of ESMR. *See* TRIAL EXS. 12 and 35. Pursuant thereto, Mr. Justice returned to his office at the Echota Resort and commenced the necessary steps to restart the timeshare project, and in August 2002, sales of the timeshare commenced. Mr. Justice was terminated from this employment on October 2, 2002, and one week later, Mrs. Justice was also terminated from ESMR. Both parties were barred from the Echota Resort premises and have continued to be barred since that time.

This bankruptcy case has resulted in many filings, hearings, and contested matters. The Debtors have filed four plans of reorganization and disclosure statements, but at this time, no plan of reorganization has been confirmed.[6] After Mr. Justice was terminated from his employment with ESMR on October 2, 2002, he met with an attorney to discuss the Debtors' bankruptcy and possible actions for breach of employment agreements. Mr. Justice later met with Patricia C. Foster, Attorney for the United States Trustee, in early March 2003, also to discuss any possible claims that he might have in the Debtors' bankruptcy case.

Thereafter, on March 6, 2003, Mr. Justice filed his proof of claim in the amount of $160,000.00 for "wages, salaries and compensation . . . for [u]npaid compensation for services performed from 11/99 to 12/01." TRIAL EXS. 15 and 31. On June 5, 2003, the Debtors filed their Objection, averring that the claim was untimely, unsupported by documentation, and false. The Debtors filed a Motion for Summary Judgment on August 7, 2003, which the court denied in an

[6] On October 28, 2003, the court entered an Order Approving Disclosure Statement, as Amended, Fixing Time for Filing Acceptances or Rejections of Plan, Fixing Time for Filing Objections to Confirmation, and Fixing Date for Hearing on Confirmation, Combined with Notice Thereof. This Order also scheduled the hearing on confirmation of the Debtors' Chapter 11 Plan for December 11, 2003, and set a deadline of December 4, 2003, for objections to confirmation and objections to discharge.

Order entered on September 9, 2003, and the trial on the Objection commenced on October 20, 2003.

II

A creditor may file a proof of claim. 11 U.S.C.A. § 501(a) (West 1993). Pursuant to Federal Rule of Bankruptcy Procedure 3003, the following applies to the filing of a proof of claim in a Chapter 11 bankruptcy case:

> (c) Filing proof of claim
>
> . . . .
>
> (2) Who must file
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> Any creditor . . . whose claim or interest is not scheduled . . . shall file a proof of claim or interest within the time prescribed by subdivision (c)(3) of this rule; any creditor who fails to do so shall not be treated as a creditor with respect to such claim for the purposes of voting and distribution.

FED. R. BANKR. P. 3003(c). If a proof of claim is based upon a writing, a copy of the writing must be attached to the filed claim or an explanation must be given as to why it is not attached. *See* FED. R. BANKR. P. 3001(c).

"A proof of claim executed and filed in accordance with [the Bankruptcy Rules] shall constitute prima facie evidence of the validity and amount of the claim," FED. R. BANKR. P. 3001(f), and "[a] claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest . . . objects." 11 U.S.C.A. § 502(a) (1993). Rule 3007 addresses objections to claims, providing that

> An objection to the allowance of a claim shall be in writing and filed. A copy of the objection with notice of the hearing thereon shall be mailed or otherwise delivered to the claimant, the debtor or debtor in possession and the trustee at least 30 days prior to the hearing. If an objection to a claim is joined with a demand for relief of the kind specified in Rule 7001, it becomes an adversary proceeding.

FED. R. BANKR. P. 3007. Once a debtor files an objection to a creditor's proof of claim,

> the Debtor bears the burden of going forward and presenting evidence to rebut or cast doubt upon, the creditor's proof of claim. The Debtor's burden is to produce evidence which, if believed, would refute at least one of the allegations that is essential to the claim's legal sufficiency. If the objector produces sufficient evidence to negate one or more of the sworn facts in the proof of claim, the burden reverts to the claimant to prove the validity of the claim . . . by a preponderance of the evidence.

In re Giordano, 234 B.R. 645, 650 (Bankr. E.D. Pa. 1999) (quoting *Galloway v. Long Beach Mortgage Co. (In re Galloway)*, 220 B.R. 236, 243-44 (Bankr. E.D. Pa. 1998)); *see also In re Walsh*, 264 B.R. 482, 484 (Bankr. N.D. Ohio 2001); *Namer v. Sentinel Trust Co. (In re AVN Corp.)*, 248 B.R. 540, 547 (Bankr. W.D. Tenn. 2000).

The Debtors filed their Objection to Mr. Justice's claim on June 5, 2003. As stated by the court upon the close of proof at trial, the issues to be addressed are (1) whether Mr. Justice, in his individual capacity, has a valid claim against the Debtors, and, if so, (2) whether Mr. Justice's failure to timely file his proof of claim was the result of excusable neglect.[7]

[7] The Debtors allege that Mr. Justice did not comply with the Federal Rules of Bankruptcy Procedure when he failed to either attach a copy of the Consulting Agreement to his proof of claim or to explain its absence therefrom. The court recognizes the importance of complying with the Rules; however, at trial, Mr. Justice sufficiently explained that a large majority of his $160,000.00 claim was not based upon the Consulting Agreement, but was instead based upon oral agreements that he had with Mr. McCarter.

III

The Debtors first argue that Mr. Justice is not rightfully a creditor in their bankruptcy case, and thus, his proof of claim must be disallowed. A creditor is defined in the Bankruptcy Code as "[an] entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." 11 U.S.C.A. § 101(10)(A) (West 1993). A claim is defined as "[a] right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured[.]" 11 U.S.C.A. § 101(5)(A) (West 1993).

The Debtors do not dispute that on November 23, 1999, Mr. McCarter and Mr. Justice executed the Consulting Agreement "by and among MCSC, Inc. and its Principal, Joe F. Justice III ('Consultant'), and C. Lee McCarter ('CLM')" for consulting and management services in connection with the Echota Resort timeshare project. TRIAL EXS. 1 and 32. The term of the Consulting Agreement was one year, with $180,000.00 in compensation to be paid for the term, consisting of monthly consulting fees of $15,000.00 each. The Consulting Agreement was executed by Mr. Justice for MCSC, Inc.[8]

The Debtors argue that based upon the Consulting Agreement, the only party with any potential claim against Mr. McCarter thereon is MCSC, Inc., and not Mr. Justice, individually, who executed the Consulting Agreement as MCSC, Inc.'s principal. Accordingly, because he is

[8] MCSC, Inc., also known as Mossy Creek Service Corporation, was incorporated under the laws of the State of Tennessee on August 4, 1999. It was administratively dissolved for failure to file an annual report on May 21, 2001. Nevertheless, at the time that the Consulting Agreement was executed, MCSC, Inc. was a valid corporation, and Mr. Justice was its President.

a distinct legal entity from MCSC, Inc., the Debtors argue that Mr. Justice cannot appropriate its potential claim. Additionally, the Debtors argue that MCSC, Inc. is no longer one of their creditors, because that obligation was assumed by ESMR.

In support of their argument that the claim actually belonged to MCSC, Inc., the Debtors introduced into evidence three documents. The first document was the Consulting Agreement itself, admittedly executed by both Mr. Justice and Mr. McCarter, which expressly states that the parties thereto are "MCSC, Inc. and its Principal, Joe F. Justice III ('Consultant'), and C. Lee McCarter ('CLM')." TRIAL EXS. 1 and 32. Additionally, on the endorsement page, the Consulting Agreement is executed MCSC, Inc., "By: Joe F. Justice, III." TRIAL EXS. 1 and 32.

The second document introduced into evidence to support the Debtors' assertion was a letter dated January 10, 2000, to Mr. McCarter from Mr. Justice. *See* TRIAL EXS. 20 and 34. The letter was printed on MCSC, Inc. letterhead, and states, in part, the following: "As you are aware, under the terms and conditions of the Consulting Agreement between MCSC, Inc. and you, I am required to deliver certain documents for your review and approval." TRIAL EXS. 20 and 34. The letter was signed by "Joe F. Justice III[,] President[,] MCSC, Inc." TRIAL EXS. 20 and 34.

Third, the Debtors introduced into evidence a copy of Mr. Justice's resume, which lists the following under his professional experience:

> 1999 - Present MCSC, Inc. Sevierville, Tennessee
> *President*
> • This company provides management and financial consulting services to timeshare, real estate development and hospitality industry clients such as . . . Echota Resorts, Sevierville, Tennessee . . . .

TRIAL EX. 38. Although Mr. Justice did not agree that the resume was his true and correct resume, he did, at trial, acknowledge that at the time that the Consulting Agreement was executed, he was the president of the Tennessee corporation known as MCSC, Inc.

Mr. Justice filed his proof of claim in the amount of $160,000.00, an amount he testified was due based upon services he performed in connection with the Consulting Agreement and based upon oral agreements between himself and Mr. McCarter after January 2000, when Mr. Justice claims the Consulting Agreement was breached and no longer controlling. As proof of the amount owed, Mr. Justice introduced into evidence a Memo on MCSC, Inc. letterhead, dated October 4, 2001, to Mr. McCarter from Mr. Justice, regarding consulting fees payable and attaching a spreadsheet, executed by Mr. Justice, evidencing fees due, payments made, and payments owed. *See* TRIAL EX. 8. The total balance due, as reflected on this document, is $159,600.00, including October 2001. TRIAL EX. 8. Mr. Justice testified that he prepared this document in response to Mr. McCarter's September 11, 2001 handwritten request "for an up-to-date accounting of our MCSC agreement through September 2001" so that Mr. McCarter could catch up the past due payments due to Mr. Justice. TRIAL EX. 3.

In response and in support of his assertions that he is a creditor of the Debtors, Mr. Justice introduced into evidence copies of checks payable to Joe Justice for consulting fees and deposit slips to Mr. Justice's personal account. *See* TRIAL EX. 6. All checks were payable to Mr. Justice, individually, and were paid from the Debtors' personal checking account as well as the Operations Account and the Rental Account of Great Smokies. *See* TRIAL EX. 6. Additionally, Mr. Justice testified that Mr. McCarter occasionally paid him cash. During his testimony, Mr. McCarter

acknowledged that he had made all payments pursuant to the Consulting Agreement to Mr. Justice personally, stating that he had been instructed by Mr. Justice to do so. Nevertheless, Mr. McCarter held steadfast in his assertions that the actual obligation was owed to MCSC, Inc. and not to Mr. Justice, individually.

Mr. Justice acknowledged that MCSC, Inc. was incorporated in August 1999, but he testified that he set up the company only as a framework for his personal engagements as a private consultant. Although he created MCSC, Inc. as a corporation, Mr. Justice testified that it was never active because it never applied for or received a tax identification number, never filed a tax return, never established a bank account, and never had any revenues and/or expenses. Additionally, MCSC, Inc. was administratively dissolved in 2001 by the Tennessee Secretary of State for failure to file annual reports. Finally, Mr. Justice testified that he was the only party owed the money under the Consulting Agreement, as evidenced by the fact that he, personally, was listed on the Debtors' original creditor matrix while MCSC, Inc. was not listed anywhere in any of the Debtors' filings in the bankruptcy case.

Under Tennessee law, "[a] corporation is presumptively treated as a distinct entity, separate from its shareholders, officers, and directors." *Oceanics Schs., Inc. v. Barbour*, 112 S.W.3d 135, 140 (Tenn. Ct. App. 2003). Because "[a] corporation is a person separate and apart from the persons who own the stock, . . . the burden of an obligation of the corporation is not a burden which may be regarded as falling upon the stockholders, although it indirectly affects them." *Schlater v. Haynie*, 833 S.W.2d 919, 924 (Tenn. Ct. App. 1991). In accord, the opposite is true, in that a stockholder or officer cannot personally collect an obligation owed to a corporation.

> Even a stockholder who is the sole shareholder of a corporation may not bring a suit to right a wrong done to the corporation. [Instead, s]tockholders may bring an action individually to recover for an injury done directly to them distinct from that incurred by the corporation and arising out of a special duty owed to the shareholders by the wrongdoer.

Hadden v. Gatlinburg, 746 S.W.2d 687, 689 (Tenn. 1988); *see also Parker v. Bethel Hotel Co.*, 34 S.W. 209, 215 (Tenn. 1895) ("The shareholders are neither responsible for the debts nor for the torts of the corporation. In the absence of special circumstances, the shareholders cannot be parties, either plaintiffs or defendants, in actions respecting corporate rights, nor have they any title or direct interest in the property of the corporation."). "[T]he fact that one owns all the stock of a corporation does not make him the owner of its property." *Hinton v. Carney*, 250 S.W.2d 364, 365 (Tenn. 1952).

As previously stated, there is a presumption that corporations are distinct legal entities, wholly separate from their officers, directors, and shareholders. *Schlater*, 833 S.W.2d at 925. However, "[i]n an appropriate case and in furtherance of the ends of justice, the separate identity of the corporation may be discarded and the individual or individuals owning all its stock and assets will be treated as identical to the corporation." *VP Bldgs., Inc. v. Polygon Group, Inc.*, No. M2001-00613-COA-R3-CV, 2002 Tenn. App. LEXIS 11, at *11 (Tenn. Ct. App. Jan. 8, 2002) (citing *Muroll Gesellschaft M.B.H. v. Tenn. Tape, Inc.*, 908 S.W.2d 211, 213 (Tenn. Ct. App. 1995)). The corporate veil will be pierced, and the corporate entity will be disregarded upon a showing that the corporation is a "sham" or "dummy" organization, or such action is necessary to accomplish justice. *Muroll Gesellschaft*, 908 S.W.2d at 213. This principle is to be applied with "great caution and not precipitately" in light of the assumption of corporate separateness, and

the party seeking to pierce the corporate veil bears the burden of proof in order to justify such action. *Schlater*, 833 S.W.2d at 925. "[U]sually a combination of factors is present in a particular case and is relied upon to resolve the issue." *Schlater*, 833 S.W.2d at 925. These factors include

> (1) whether there was a failure to collect [formerly] paid[-]in capital; (2) whether the corporation was grossly undercapitalized; (3) the non-issuance of stock certificates; (4) the sole ownership of stock by one individual; (5) the use of the same office or business location; (6) the employment of the same employees or attorneys; (7) the use of the corporation as an instrumentality or business conduit for an individual or another corporation; (8) the diversion of corporate assets by or to a stockholder or other entity to the detriment of creditors, or the manipulation of assets and liabilities in another; (9) the use of the corporation as a subterfuge in illegal transactions; (10) the formation and use of the corporation to transfer to it the existing liability of another person or entity; (11) the failure to maintain arms length relationships among entities.

Fed. Deposit Ins. Corp. v. Allen, 584 F. Supp. 386, 397 (E.D. Tenn. 1984) (citations omitted).

Here, it appears that several of the above factors are present with regards to MCSC, Inc. and Mr. Justice. First, Mr. Justice created the corporation, but he failed to obtain a tax identification number, did not file any tax returns on behalf of MCSC, Inc., and never issued any stock. Second, Mr. Justice's undisputed testimony is that he created MCSC, Inc. merely as an instrumentality or business conduit for his individual private consulting business. Third, MCSC, Inc. never received any revenues, never paid any expenses, and never acquired any assets. Fourth, there was no arm's length relationship between Mr. Justice and MCSC, Inc. Mr. Justice consistently represented himself as MCSC, Inc., and even though the Consulting Agreement was actually between MCSC, Inc. and Mr. McCarter, all payments pursuant thereto were made directly to Mr. Justice, who endorsed the checks, deposited them into his personal bank account, and used the funds for his personal benefit. Finally, Mr. Justice acknowledges that he failed to

follow corporate formalities, among them, his allowing MCSC, Inc. to be administratively dissolved for failure to file annual reports, his failure to obtain the requisite tax identification number, and his failure to file corporate tax returns. Also telling is the Debtors' initial inclusion on their creditor matrix of Mr. Justice, individually, and their exclusion of any references to MCSC, Inc. Despite his testimony to the contrary, the court is satisfied that Mr. McCarter always dealt with Mr. Justice as an individual and that he did not deal with Mr. Justice in any representative capacity as an agent or employee of MCSC, Inc. Based upon this evidence, this court finds that Mr. Justice and MCSC, Inc. are one and the same entity.

IV

The court must next address the Debtors' argument that even if Mr. Justice was at some point a creditor, Mr. McCarter is no longer liable for any outstanding obligations to Mr. Justice under the Consulting Agreement. The Debtors argue that a novation occurred,[9] whereby Mr. McCarter was released from liability of the obligation to Mr. Justice, which was then assumed by ESMR. "A novation is a contract which substitutes a new obligation for an old one which is thereby extinguished." *Jahn v. Harrison*, No. 03A01-9604-CH-00132, 1999 Tenn. App. LEXIS 520, at *9 (Tenn. Ct. App. Aug. 26, 1996) (citations omitted). "The four essentials of a novation are: (1) a previous valid obligation; (2) an agreement supported by evidence of intention; (3) the extinguishment of the previously valid obligation; and, (4) a new, valid obligation." *Stokely Hospitality Enters. v. J.S. Eledge Oil Co., Inc.*, No. 03A01-9402-CH-00042, 1994 Tenn. App.

[9] *See supra* note 1.

LEXIS 414, at *8-*9 (Tenn. Ct. App. July 29, 1994). The following scenarios evidence a novation:

> [A] novation may be effected in three ways: (1) by the substitution of a new obligation between the same parties, with intent to extinguish the old obligation; (2) by the substitution of a new obligor in place of the old one, with intent to release the latter; and (3) by the substitution of a new obligee in place of the old one, with intent to transfer the rights of the latter to the former.

Steinberg v. Johnson (In re Edward M. Johnson & Assocs., Inc.), 61 B.R. 801, 806 (Bankr. E.D. Tenn. 1986).

The Debtors, as the parties asserting the defense, bear the burden of proof, which "must be clearly established by evidence of the discharge of the original debt by express agreement or by the acts of the parties clearly showing the intention to work a novation." *Jahn*, 1999 Tenn. App. LEXIS 520, at *9-*10; *see also Bank of Crockett v. Cullipher*, 752 S.W.2d 84, 89 (Tenn. Ct. App. 1998). "Although a novation is never presumed, a novation need not be shown by express words, but may be implied from [a totality of] the facts and circumstances attending the transaction and from the conduct of the parties thereafter." *Edward M. Johnson & Assocs., Inc.*, 61 B.R. at 806; *see also Bland v. Bank of Bartlett*, No. 02A01-9310-CH-00222, 1994 Tenn. App. LEXIS 561, at *8 (Tenn. Ct. App. Oct. 10, 1994) ("In determining the intent of the parties, the court should consider the words, conduct and all of the circumstances.").

On the other hand, the mere assumption of a debt by a third party does not, without more, release the initial parties from their original contractual arrangement. *See, e.g., First Am. Nat'l Bank v. Hall*, 579 S.W.2d 864, 869 (Tenn. Ct. App. 1978).

> [A novation] differs from an assignment because it requires the assent of all the parties while an assignment requires neither the knowledge nor the assent of the obligor and because an assignment cannot change the obligor's performance. A novation extinguishes the existing contract. An assignment, on the other hand, does not extinguish the existing contract but rather transfers the assignor's rights against the obligor to the assignee. Thus, the assignee succeeds to the assignor's rights under the original agreement. The assignee's rights under the original contract are subject to all the defenses available against the assignor at the time of the assignment.
>
> . . . .
>
> A simple novation involving the substitution of an obligee results when an obligee promises its obligor to discharge the obligor's duty in consideration for the obligor's promise to a third person to render the performance due or some other performance. It requires the agreement of all the parties to the old contract and to the new contract.

Pac. E. Corp. v. Gulf Life Holding Co., 902 S.W.2d 946, 958 (Tenn. Ct. App. 1995) (internal citations omitted).

At trial, Mr. Justice expressly denied that he released Mr. McCarter from his obligation under the Consulting Agreement. In and of itself, this assertion weighs heavily against the finding that a novation occurred. However, intent must be determined by examination of a totality of the facts and circumstances presented.

The Debtors introduced into evidence the Unanimous Written Consent, executed on May 3, 2002, by Mr. Seivers and Mrs. Justice. *See* TRIAL EXS. 12 and 35. This document provides the initial basis for operations for ESMR, and states, in material part, the following:

> In Accordance with the Provisions of the Tennessee Limited Liability Company Act, the undersigned [Tim Seivers and Janet O. Justice], being all of the members of [ESMR], . . . do hereby consent to in writing the adoption of the following resolutions for the purpose of adopting the Operating Agreement and

other regulations deemed advisable for the operation of the business, and to complete the organization of the Company.

. . . .

RESOLVED that the Operating Agreement for the Company is approved and that it be signed by the members and entered into the book of minutes.

RESOLVED that Mr. Joe F. Justice III ("Justice") shall serve as Project Manager of the Company on the terms and conditions as described in the Employment Agreement which include but are not limited to the following:

A. Basic Duties.

Justice will act as Project Manager of [ESMR]'s timeshare and cabin rental business. Justice shall provide timeshare, finance and management services for Company using his broad management, timeshare and finance industry skill and knowledge. Justice shall perform such other administrative and managerial services and duties as shall be delegated or assigned to Justice by the Company's Board of Managers from time to time.

B. Other Duties / Exclusivity.

So long as employed by the Company, Justice agrees to devote full time and efforts exclusively on behalf of the Company and its affiliates and to competently, diligently, loyally and effectively discharge all duties of a Project Manager with the following exceptions: Justice has two outstanding agreements with Gulf-Co-Invest and Escapes! Inc. for Consulting Services. Justice agrees that he will not utilize Corporate time to fulfill these obligations. He further states that he does not anticipate that he will expend more than 185 hours on these projects over the course of the next year. Justice shall devote his entire productive time, ability and attention to the Company's business during the term of his employment. Company acknowledges that it will coordinate with Justice so that its services can be provided in a flexible manner. Justice shall not, however, engage in any other business duties or render services of a business, commercial or professional nature to any person or organization whether for compensation or otherwise, without the prior written consent of the Company's Board of Managers.

C. Justice Benefits.

Justice shall be entitled, in accordance with Echota's policies and procedures for senior executive personnel and Plan Documents, to participation in any pension, savings, 401(k) and profit-sharing plans, health insurance, leave, vacation and other employment benefits as are made available from time to time by the Board to or for the benefit of Company management.

D. Past Services.

The Company acknowledges the past work Justice has performed and expressly assumes the obligation to pay Justice $160,000 from profits earned in connection with the first phase of the Company's timeshare project. $50,000 of this obligation has already been paid to Justice. The remaining $110,000 will be paid out as the profitability of the Company allows as determined by the Board of Managers.

E. Reimbursement Of Expenses.

During the term of his employment, Company shall reimburse Justice for all reasonable out-[of]-pocket expenses, including, without limitation, travel (including airfares, hotels and restaurants), attendance fees for participation in seminars and conferences on Company's behalf, and long-distance telephone expenses, paid or incurred by Justice in the course of the provision of services hereunder, approved in advance by Company.

. . . .

RESOLVED that the Managers be, and they hereby are, authorized to take all such actions as may be necessary or desirable in order to carry out the provisions of the preceding resolutions, and that all such actions taken by the Co-Operations Managers for and on behalf of the Company prior to the date hereof be, and they hereby are, ratified in all respects.

. . . .

FURTHER RESOLVED that the Co-Operations Managers are directed to file this Consent of Members in Lieu of Organization Meeting, together with the documents attached hereto, among the records of the Company.

WHEREFORE, the undersigned [Tim Seivers and Janet O. Justice], being all of the members of the Company, by signing this Unanimous Written Consent in Lieu of Organizational Meeting of the Members of the Company do hereby

consent to and adopt the preceding resolutions and actions as of the date set forth below.

TRIAL EXS. 12 and 35. During the trial, Mr. Justice agreed that there is only one $160,000.00 debt that he is owed; i.e., the claimed $160,000.00 in past due compensation due from Mr. McCarter, and that this $160,000.00 is the same that is referred to in the Unanimous Written Consent, executed by his wife, Janet Justice. Additionally, Mr. Justice acknowledged receipt of the $50,000.00 payment referenced in the Unanimous Written Consent from Mr. Seivers pursuant thereto. *See* TRIAL EX. 9.

In addition, the Debtors introduced into evidence a copy of a financial statement entitled "Personal Financial Statement of: Joe F. Justice as of: 4/30/02" which was signed and dated at the bottom by Mr. Justice (Financial Statement). TRIAL EX. 37. This document consists of a one-page listing of assets, liabilities, and net worth, followed by four pages of "details" of the listed assets and liabilities. Under assets, the Financial Statement shows "Notes & contracts receivable" in the amount of $110,000.00. TRIAL EX. 37. There are no listings for outstanding wages, compensation, or any other category concerning money owed by Mr. McCarter on this Financial Statement, and in fact, Mr. McCarter is not listed anywhere within the five pages making up the Financial Statement. *See* TRIAL EX. 37. Moreover, the first page of "Details" shows, in table form, a breakdown under the "Assets" heading all "Notes and Contracts held." TRIAL EX. 37. The material columns on this table read as follows:

From Whom Owing	Balance Owing	Original Amount	Original Date	History / Purpose
Echota Smoky Mountain Resort, LLC	$110,000	$160,000	10/2/2001	Consulting Fees

TRIAL EX. 37. These listings, and the lack thereof of others, indicate the validity of the Debtors' averments that the debt owed to either Mr. Justice or his alter ego, MCSC, Inc., was assumed by ESMR, a company in which neither of the Debtors has an ownership interest, and which is solely owned by Mr. Seivers and Mrs. Justice.

In rebuttal, Mr. Justice testified that although it was signed and dated, the Financial Statement was merely "a worksheet" that the Debtors took from his private files still on location at Echota Resort. He maintains that the Financial Statement is not a true and correct copy because it contains what he termed are "obvious errors," including the listing of ownership interest in ESMR, which in actuality belongs to Mrs. Justice. Mr. Justice also testified that the Unanimous Written Consent was merely an assignment between ESMR and Mr. McCarter and that he never agreed to their "side agreement" for ESMR to assume the $160,000.00 debt owed to Mr. Justice. Accordingly, Mr. Justice argues that he is not bound by the terms of the Unanimous Written Consent. Additionally, he testified that Mr. Seivers paid him the $50,000.00 to entice Mr. Justice to return to the timeshare project in March 2002, and that he never agreed to or intended to agree to a release of the $160,000.00 owed by Mr. McCarter.

Taking all of the facts and circumstances in their totality, the court finds that while Mr. Justice may have had a claim against Mr. McCarter on February 26, 2002, when the Debtors commenced their Chapter 11 bankruptcy case, a novation occurred before Mr. Justice filed the claim whereby Mr. McCarter was released from his liability to pay Mr. Justice under the Consulting Agreement and as set forth by Mr. Justice in his Memo to Mr. McCarter on October 4, 2001. *See* TRIAL EX. 8. Although Mr. Justice testified that he did not intend to release Mr.

McCarter from any liability under the Consulting Agreement, his actions and documents introduced into evidence establish otherwise.

First, the Unanimous Written Consent, executed by Mrs. Justice, speaks for itself and expressly states that ESMR would be assuming the obligation owed to Mr. Justice for his past services. While Mr. Justice himself did not execute this document, his wife, who was a 25% owner of ESMR, did execute the document, which ratified all previous actions taken to form ESMR and addressed the employment of Mr. Justice as Project Manager, along with very specific terms of that employment.[10] Moreover, Mr. Justice received and accepted a $50,000.00 check from Mr. Seivers. *See* TRIAL EX. 9. This payment was expressly addressed in the Unanimous Written Consent. *See* TRIAL EXS. 12 and 35. At trial, Mr. Justice acknowledged that there was only one $160,000.00 debt. Clearly, and by Mr. Justice's own testimony, the $160,000.00 due under the Consulting Agreement is the same $160,000.00 referenced in the Unanimous Written Consent, of which Mr. Justice has already received $50,000.00.

Second, even though Mr. Justice testified that he was not an owner of ESMR, the evidence shows that he was nevertheless an essential player in the company's business. Mr. Justice was expressly denoted as "Project Manager" of ESMR in the Unanimous Written Consent, with

[10] The court takes judicial notice that although Mrs. Justice was present at trial, she was not called to testify, causing the court to make an adverse inference based upon the missing witness rule that "if a party has it peculiarly within his power to produce witnesses whose testimony would elucidate the transaction, the fact that he does not do it creates the presumption that the testimony, if produced, would be unfavorable." *Graves v. United States*, 14 S. Ct. 40, 41 (1893); *see also State v. Middlebrooks*, 840 S.W.2d 317, 334 (Tenn. 1992) ("[If a] party has it peculiarly within his power to produce a witness whose testimony would naturally be favorable to him, the failure to call that witness creates an adverse inference that the testimony would not favor his contentions."). In invoking the rule, the court notes that Mrs. Justice, the witness, was available to testify but was not called, she had knowledge of material facts, and a relationship existed "between the witness and the party that would naturally incline the witness to favor the party[.]" *Middlebrooks*, 840 S.W.2d at 334.

specific duties, responsibilities, and benefits. *See* TRIAL EXS. 12 and 35. Additionally, Mr. Justice attended at least one meeting of the Board of Managers of ESMR, conducted on May 20, 2002, in which Mr. Justice "was asked to represent member Janet Justice in the meeting and was given the authorization to vote her interests." TRIAL EX. 14. The minutes also state that Mr. Justice chaired the meeting and established an agenda for future meetings. TRIAL EX. 14. Of even greater significance is the following excerpt from the May 20, 2002 Minutes:

> 1. AGENDA
>
> The Board discussed the Operating Agreement and attachments which was executed by Timothy Seivers and Janet Justice. A motion to accept the Operating Agreement and attachments as the governing document was presented. On motion of Timothy Seivers, seconded by Lee McCarter, the Operating Agreement is approved with the following vote polled: McCarter, Seivers, Justice - Aye. The [sic] All contracts submitted to the Board are subject to routing for approval as to form and content.

TRIAL EX. 14. Not only does this evidence that Mr. Justice was intricately involved in the management and operations of ESMR, but it also establishes that Mr. Justice personally, on behalf of his wife, accepted the Operating Agreement, which was also referenced in the Unanimous Written Consent, and thus, ratified all agreements made therein, including the assumption of the $160,000.00 from Mr. McCarter by ESMR. It is unreasonable to believe that Mr. Justice was unaware of and/or not in agreement with the terms of the Unanimous Written Consent, including the new agreement for ESMR to be the sole party liable for the remaining $110,000.00 due under the Consulting Agreement.

This ratification is further buttressed by the inclusion on his Financial Statement of a contract receivable from ESMR of $110,000.00, along with his failure to list any obligation owed

to him by Mr. McCarter, and the "Details" table evidencing the original $160,000.00 obligation, $50,000.00 paid and accepted by Mr. Justice thereon, the $110,000.00 remaining balance, and most notably, the original date incurred of October 2, 2001, which is two days before the Memo to Mr. McCarter giving the updated balance. *See* TRIAL EX. 37; TRIAL EX. 8. The court acknowledges that Mr. Justice testified that this Financial Statement was merely a "worksheet." However, the court also recognizes that the Financial Statement was signed by Mr. Justice and dated April 30, 2002, approximately one month after he received the $50,000.00 payment from Mr. Seivers.

All of these documents taken together outweigh Mr. Justice's testimony at trial that he did not intend to release Mr. McCarter from his obligation to pay $160,000.00. The court finds that the Unanimous Written Consent, along with the Minutes from ESMR's May 20, 2002 Board of Managers Meeting, and Mr. Justice's signed and dated Financial Statement constituted a new contract, in which ESMR was substituted for Mr. McCarter as the party liable for the outstanding $110,000.00 owed to Mr. Justice under the Consulting Agreement, and a novation occurred. By virtue of this novation, Mr. McCarter's personal liability was extinguished and was fully accepted by all parties thereto, i.e., ESMR, Mr. McCarter, and Mr. Justice, as being owed by ESMR and ESMR alone. Accordingly, the court finds that even though Mr. Justice may have been a creditor of the Debtors on the date their petition was filed, he was not a creditor of the Debtors the date his Proof of Claim was filed, and the claim must therefore be disallowed. *See* FED. R. BANKR. P. 3001(e)(1) ("If a claim has been transferred other than for security before proof of the claim has been filed, the proof of claim may be filed only by the transferee or an indenture trustee.").

Having determined that Mr. Justice is not a creditor of the Debtors entitled to file a claim, the court need not address the issue of whether his failure to timely file a proof of claim was the result of excusable neglect.

An order consistent with this Memorandum will be entered.

FILED: November 25, 2003

BY THE COURT

/s/ Richard Stair, Jr.

RICHARD STAIR, JR.
UNITED STATES BANKRUPTCY JUDGE

IN THE UNITED STATES BANKRUPTCY COURT FOR THE EASTERN DISTRICT OF TENNESSEE

In re

Case No. 02-31000

COY LEE McCARTER
SUSAN RYMER McCARTER

Debtors

O R D E R

For the reasons stated in the Memorandum on the Debtors' Objection to Claim of Joe F. Justice, III filed this date, the court directs that the Debtors' Objection to the Claim of Joe F. Justice, III (Claim No. 42) filed on June 5, 2003, is SUSTAINED. The claim filed by Joe F. Justice, III, on March 6, 2003, in the amount of $160,000.00 is DISALLOWED.

SO ORDERED.

ENTER: November 25, 2003

BY THE COURT

/s/ Richard Stair, Jr.

RICHARD STAIR, JR.
UNITED STATES BANKRUPTCY JUDGE