TADC Commercial Litigation Newsletter

Spring 2011 Edition

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This newsletter is intended to summarize significant cases and issues impacting the commercial litigation practice area in the past six months. It is not a comprehensive digest of every case involving commercial litigation issues during that time period or a recitation of every holding in the cases discussed. This newsletter was not compiled for the purpose of offering legal advice.

Disclaimer language does not negate claim for fraudulent inducement—

Italian Cowboy v. Prudential Insurance Co.

Opinion delivered April 15, 2011
54 Tex. Sup. J. 822 (Tex. 2011)

In this case, the Texas Supreme Court has concluded that contract language does not disclaim reliance or bar a claim based on fraudulent inducement. The Supreme Court reversed a take-nothing judgment of the Eleventh District Court of Appeals (Eastland).

<u>Summary:</u>

This dispute arose when Jane and Francesco Secchi, the owners and operators of a restaurant, Italian Cowboy, terminated their restaurant's lease because of a persistent sewer gas odor. In their suit against their landlord, its management company, and its agent (collectively here, the "Landlord"), the Secchis sought to rescind their lease and recover damages for fraud and breach of implied warranty of suitability. The Landlord maintained that rescission was not warranted and sought recovery for breach of contract.

The trial court awarded the tenants damages, but, upon appeal, the Eastland Court of Appeals reversed and rendered a take-nothing judgment for the tenants and found for the Landlord on its claim for breach of contract.

The Texas Supreme Court reversed the appellate court's decision and rendered judgment for the tenant on its claim for rescission, premised on the Landlord's breach of the implied warranty of suitability.

The Texas Supreme Court, in rendering its decision, pointed out that it had recognized decades ago that agreeing to a merger clause did not waive one's right to sue for fraud should the party later discover that the representations it relied upon before signing the contract were fraudulent.

In *this* case, the Supreme Court addressed the issue of whether disclaimer-of-representation language within a lease contract amounts to a standard merger clause (and so disclaims reliance on representations) and negates an element of a party's claim for fraudulent inducement. The Court concluded that contract language does *not* necessarily disclaim reliance or bar a claim based on fraudulent inducement.

<u>Facts:</u>

During lease negotiations, the Secchis claimed that their property manager, Fran Powell, had told them that their building was practically new and had experienced no problems. In particular, Powell had allegedly stated "the building was in perfect condition, never a problem whatsoever."

The lease with Italian Cowboy contained the following relevant provisions:

14.18 Representations. Tenant acknowledges that neither Landlord nor Landlord's agents, employees

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> or contractors have made any representations or promises with respect to the Site, the Shopping Center, or this Lease except as expressly set forth herein.

14.21 Entire Agreement. This lease constitutes the entire agreement between the parties hereto with respect to the subject matter hereof, and no subsequent amendment or agreement shall be binding upon either party unless it is signed by each party . . .

The Secchis remodeled the property and began hearing rumors that a severe odor had plagued the previous tenant. When the Secchis asked the property manager about this, Powell assured them she had never heard of the problem.

Later, after renovations were complete, a foul odor materialized and the Secchis' restaurant failed to draw customers. At one point, the City of Dallas shut down the restaurant following a complaint to the health department. The Secchis learned the previous tenant had indeed had a problem, about which the landlord had known. At that point, the Secchis ceased paying rent, closed their restaurant, and sued the landlord, manager, and agent for fraud in the inducement, among other causes.

At trial, the court awarded $600,070 to the Secchis in actual damages, plus prejudgment interest and attorney's fees, plus $50,000 in exemplary damages. The trial court awarded nothing to the Landlord for its counterclaim of breach of contract.

On appeal, the Eastland court reversed this decision, determining that the lease contract had effectively disclaimed reliance on representations made by the Landlord, thus negating an element of Italian Cowboy's fraud claim.

The Texas Supreme Court, however, concluded that the disclaimer did *not* negate reliance. It found that a plain reading of the contract language indicated that the parties' intent was to include a standard merger clause only—not to disclaim reliance. Even if the parties had intended to disclaim reliance, said the Court, the contract provisions did not do so by "clear and unequivocal language."

The Texas Supreme Court's holdings:

The question of whether an adequate disclaimer of reliance exists is a matter of law, pointed out the Court. Therefore, to construe the contract, the Court has to ascertain the true intentions of the parties as expressed in the writing itself.

While the Landlord argued that Section 14.8 of the lease contract barred Italian Cowboy's fraud claim by its agreement that the Landlord did not make any representations outside the agreement, the Texas Supreme Court held that standard merger clauses often contain such language. It determined that the parties had no intent other than to include a standard merger clause, *not* a disclaimer of reliance on representations. For this reason, the Court decided it did not need to consider any extraneous evidence of the parties' intent to ascertain the true meaning of the instrument.

To hold otherwise, the Court concluded, would be to find that parties no longer have to disclose known defects if they include a general merger clause in a lease agreement.

Dispensing with the issue of disclaimer, the Supreme Court then went on to address the Landlord's claims that Italian Cowboy's fraud and breach-of-warranty claims failed as a matter of law and the Court concluded they did not.

Powell's representations were actionable, said the Court, and legally-sufficient evidence existed to demonstrate the representations were known to be false when made. Moreover, the reconstruction work needed to fix the odor problem was more than just simple repairs. The work required a complete rerouting of the sewer exhaust line.

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(Editor's Note: A strong dissent was filed by Justice Nathan Hecht, in which two other justices joined. The minority asserted that the majority had mischaracterized the case. Instead of the case being one involving the issue of whether a merger clause should excuse a party from having to disclose known defects, said the Dissent, the issue should have been one involving nondisclosure— i.e. *whether the Landlord had a duty to speak and deliberately remained silent.)*

Signatories to an arbitration agreement may grant their right to arbitrate to third parties—

In re Joseph Rubiola

Opinion delivered March 11, 2011
54 Tex. Sup. J. 654 (Tex. 2011)

In this case, the Texas Supreme Court concluded that a non-signatory to an arbitration agreement can compel a signatory to arbitrate if the non-signatory has been broadly included within the definition of a "party" to the agreement.

Summary:

In this mandamus proceeding, the sellers of a home sought to compel arbitration in a suit filed by the buyers of the home—*under an arbitration agreement the sellers did not sign.*

The buyers of the home (who had signed an arbitration agreement with a mortgage company affiliated with the sellers and the sellers' listing broker) objected to the arbitration.

The Texas Supreme Court held that the parties who actually *did* agree to arbitrate *(i.e.* the mortgage company and broker) could grant to the sellers the right to enforce the mortgage company's and broker's arbitration agreement. As such, the Texas Supreme Court found that the trial court erred when it denied the sellers' motion to compel arbitration under Section 4 of the Federal Arbitration Act. 9 U.S.C.S. § 4.

Facts:

This case concerns the sale and financing of a home. Brian and Christina Salmon agreed to purchase a home from Greg and Catherine Rubiola. The Salmons and Rubiolas signed a standard form Texas real estate sales contract, which did not contain an arbitration clause.

The transaction was handled by J.C. Rubiola, Greg's brother, who served as the listing broker for the property. J.C. and Greg Rubiola operated several real estate-related businesses and bought and sold real estate through Rubiola Management LLC, the general partner of Rubiola Realty Ltd., and Rubiola Properties, Ltd. J.C. and Greg Rubiola were also vice president and president, respectively, of Rubiola Mortgage Company, a corporation the brothers used to obtain financing for real estate buyers such as the Salmons.

After agreeing to purchase the Rubiolas' home, the Salmons applied for mortgage financing through Rubiola Mortgage Company using J.C. Rubiola as their mortgage broker and loan officer. As part of the loan process, the Salmons executed an arbitration agreement with the mortgage company that provided that "arbitrable disputes" included "any and all controversies or claims between the parties of whatever type or manner, including without limitation, all past, present and/or future credit facilities and/or agreements involving the parties."

The agreement defined "parties" to include:

> ". . . Rubiola Mortgage Company, and each and all persons and entities signing this agreement or any other agreements between or among any of the parties as part of this transaction. 'The parties' shall also include individual partners, affiliates, officers, directors, employees, agents, and/or representatives of any party to such documents, and shall include any other owner and holder of this agreement."

J.C. Rubiola signed the agreement on behalf of Rubiola Mortgage Company and the Salmons signed a form acknowledging J.C.'s dual role as a real estate agent and mortgage broker. The sale closed and the Salmons moved into their new home.

Several months later, the Salmons sued the Rubiolas and other entities and individuals involved in repairing the home (collectively "the Rubiolas").

The Salmons alleged that J.C. Rubiola, acting as both the listing agent and a principal involved in the home's construction and repair, made a series of misrepresentations and committed various violations of the Texas Deceptive Trade Practices Act.

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The Rubiolas answered and moved to compel arbitration, relying on the arbitration agreement signed by the Salmons and Rubiola Mortgage Company during financing. The trial court denied the motion, causing the Rubiolas to seek mandamus relief.

The Court of Appeals also refused to compel arbitration and the case went up to the Texas Supreme Court.

The Texas Supreme Court's holdings:
Applying the Federal Arbitration Act, the Texas Supreme Court noted that the Rubiolas had to establish that (1) there was a valid arbitration clause; and (2) the claims in the dispute fell within the agreement's scope.

While the Rubiolas contended that the agreement was broad enough to cover all of the Salmons' claims against them, the Salmons argued that the agreement extended only to disputes under the financing agreement (as opposed to the real estate sales agreement) and that it could not be used by non-signatories to compel arbitration.

The Supreme Court disagreed. First, the Court found that the agreement expressly provided that certain non-signatories were to be parties to the agreement (thus, such parties could compel arbitration under the agreement).

Next, it found that the claims asserted by the buyers against the sellers fell within the scope of the arbitration agreement.

Citing the agreement's broad definition of "arbitrable disputes"—which identified "all controversies between the parties . . . including without limitation, all past, present and/or future credit facilities and/or agreements involving the parties"—the Texas Supreme Court determined that the arbitration agreement was *not* limited to strictly the financing part of the transaction, but rather also extended to the real estate sales contract and the Salmons' complaints against the sellers and repair people regarding the sale.

Concluding that the signatories to an arbitration agreement may identify other parties in their agreement who may enforce arbitration as though they signed the agreement themselves, and finding the underlying arbitration agreement extended to the issues at hand, the Supreme Court determined that the trial court's order denying arbitration was an abuse of discretion.

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Legislative update—

Is a Texas version of the federal 12(b)(6) motion on the horizon?

Currently several bills are pending before the House Judiciary and Civil Jurisprudence Committee that would impact defense attorneys statewide.

One of these—HB 274—would require the adoption of rules providing for early dismissal of claims (similar to a 12(b)(6) motion under the Federal Rules of Civil Procedure).

The bill would also allow for an expedited trial process of claims valued at $10,000 - $100,000.

HB 274 would also allow a party—by its own motion (if the trial court certifies) or by a trial court on its own initiative—to permit an interlocutory appeal from an order involving a controlling question of law. It would also add reasonable deposition costs to the litigation costs that can be recovered under a Chapter 42 offer of settlement.

# # #

Won the judgment, but not sure how to collect it . . .?

Consider using a Turnover Order and Receivership

Courts have an affirmative duty to enforce their judgments. *In re Sheshtawy*, 154 S.W.3d 114, 118 (Tex. 2004)(quoting *In re Crow-Billingsley Air Park, Ltd.*, 98 S.W.3d 178, 179 (Tex. 2003). One of the best enforcement tools is a receivership and turnover order.

Receivers have the power of the court, not the restrictions of a party—

A receiver is an agent of the court—"the medium through which the Court acts"—and so shares the Court's immunity. *Veronica L. Davis v. James West, Henry Radoff and Prosperity Bank*, 317 S.W.3d 301 (Tex. App.—Houston [1st Dist.] 2009, pet. denied). As such, a receivership can be an especially effective tool for collecting on judgments.

A turnover receiver is appointed pursuant to Chapter 31 of the Texas Civil Practice and Remedies Code (*not* Chapter 64, which does not apply). *See* TEX. CIV. P. REM. CODE §31. 002(b)(1).

Turnover orders shift the burden of requiring *plaintiffs* to prosecute judgment enforcement to requiring *defendants* to turnover assets and information. They also end the "fox and hound" games plaintiffs frequently are subjected to when collecting their judgments.

Receivers may seize assets or subpoena information and documents without notice – then backtrack the paper trails to assets, bank accounts, additional information, and witnesses.

As a judge's agent, receivers may set reasonable time limits for discovery responses—and while a debtor who hides or sells assets during a regular post-judgment process is free to do so and the sales remain valid, the same tactics under a receivership are sanctionable as contempt if taken after an application for turnover is set for hearing. More importantly, the sales are VOID (not voidable).

It's easier and cheaper than you may think . . .

A receiver's bond may be nominal—or even waived. *Childre v. Great Sw. Life ins. Co.*, 700 S.W.2d 284, 288 (Tex. App.—Dallas 1985, no writ). Additionally, the typical fee charged by a receiver is 25% of what is collected – frequently with nothing being owed if nothing is collected.

. . . and the advantages are many.

Because they are not parties, receivers are typically not limited by the rules of civil procedure for discovery (*i.e.* they need not give 30 days for discovery) and turnover orders generally require turnover within 5 to 10 days, not 30 days, as under in normal post-judgment production. While the Texas Rules may generally require a defendant to make records available at a defendant's attorneys' offices – which may be 200 miles away – a turnover requires delivery *to the receiver's office.* Additionally, post-judgment discovery is not limited (*e.g.* 25 interrogatories) as in pre-judgment cases. TEX. R. CIV. P. § 190.6.

Additionally, receivers can do much that plaintiffs cannot, including:

- *Freeze bank and financial institution accounts;*
- *Obtain records from vendors and other creditors;*
- *Obtain and review credit bureau records;*
- *Redirect and open mail;*
- *Check addresses with postmasters;*
- *Backtrack county tax assessor records to determine which bank accounts were used to pay past taxes;*
- *Determine how cable television and cell phone bills are paid (check/credit card) and obtain service and billing addresses;*
- *Examine debtors and witnesses; and*
- *Service writs of turnover.*

So the next time you win a judgment—but do not know how to collect on it – consider the alternative of a receivership. It may just be the answer.

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Editor's Note: This article was contributed by Riecke Baumann of The Baumann Law Firm, and S. Christopher Gillett of Ashby, L.L.P. For more information regarding receiverships as a collection tool, please contact Mr. Baumann at Riecke@texascollect.com or 713-529-1600 or Mr. Gillett at chris.gillett@ashby-llp.com or 713-739-1100.

A third-party beneficiary can be entitled to damages for breach of commitment, even though not a party to a contract between lender and investor—

Basic Capital Mgmt. vs. Dynex Commercial

Opinion delivered April 1, 2011
54 Tex. Sup. J. 781 (Tex. 2011)

In this case, the Texas Supreme Court found that two owners of an investment scheme were entitled to recover for breach of a lender's commitment to an investor where the lender knew that the purpose of its commitment was to secure future financing for the two owners.

Although the owners—who were real estate investment trusts that the investor managed and held an ownership interest in—were not parties to the contract, the evidence established that the lender knew its breach would increase the investor's costs and so the lender could not profess blindness to the foreseeability that its breach would cost the owners.

Summary:
This case involved an action for breach of a commitment to provide financing for future real estate investments. The borrowers were to be entities that would be formed to hold each investment separately as opportunities arose.

The Texas Supreme Court held that the corporate owners of the entities were third-party beneficiaries of the agreement and that consequential damages for any breach of the commitment were foreseeable. As such, the Court reversed the judgment of the Dallas Court of Appeals, which had affirmed the trial court's judgment notwithstanding the verdict and which had rendered a take-nothing judgment for the lender.

Facts:
Basic Capital Management, Inc. (hereinafter "Basic") managed publicly-traded real estate investment trusts in which it also owned stock. These included American Realty Trust, Inc. (ART) and Transcontinental Realty Investors (TCI).

Respondent Dynex Commercial Inc. provided financing for multi-family and commercial real estate investors.

ART and TCI held investment property through wholly-owned "single-asset, bankruptcy-remotes entities" (or SABREs, for short).[1]

After several months of negotiations, Dynex agreed to loan three TCI-owned SABREs $37 million to acquire and rehabilitate three commercial buildings in New Orleans, if Basic would propose other acceptable SABREs to borrow $160 million over a two-year period.

TCI accepted the agreement as "borrower," although it was not a SABRE itself. The $160 million commitment (hereinafter "The Commitment") was between Dynex and Basic. It stated that each borrower would be a SABRE and that the SABREs would be owned by ART and TCI.

Dynex loaned the money to acquire the New Orleans buildings and funded a $6 million loan presented by Basic under the Commitment.

Thereafter, market interest rates rose, making the terms of the Commitment unfavorable to Dynex. As a result, Dynex refused to provide further funding for improvements or to make any other loans under the Commitment.

When Dynex refused to fund the loans, Basic Capital, ART, and TCI sued Dynex for breach of

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[1]A SABRE is an entity that owns a single asset and whose solvency is not dependent on affiliates. Lenders like Dynex commonly require a SABRE so that, in the event of default, collateral can be recovered more easily than from a debtor with multiple assets and multiple creditors. SABREs are usually formed concurrently with, or immediately prior to, the closing of a financing transaction, the purpose of which is to isolate the financial assets from the potential bankruptcy estate of the original entity, the borrower, or originator. A SABRE reduces the risk that a borrower will file bankruptcy or, if bankruptcy *is* filed, ensures the creditor procedural advantages in the bankruptcy proceeding.

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the Commitment, alleging that, as a result of Dynex's actions, transactions that would have qualified for funding were financed elsewhere at higher rates or not at all. They claimed damages for interest paid in excess of what would have been charged under the Commitment and for lost profits from investments for which financing could not be found. TCI also sued Dynex for breach of the New Orleans Agreement. Dynex counterclaimed for fraud.

TCI and ART alleged they were "intended beneficiaries" of the $160 million Commitment because their wholly-owned subsidiaries would own the properties and borrow the funds advanced by Dynex. Dynex controverted this claim, pleading that ART and TCI lacked standing to assert claims under the loan commitment. Dynex and the Petitioners filed cross-motions for partial summary judgment and the trial court granted the Petitioners' motion. Based on this ruling, the trial court issued an order in limine forbidding reference to the standing arguments before the jury.

After trial, the jury returned a verdict for the Petitioners, finding Dynex breached the Commitment, resulting in $256,233 in lost profits for Basic, $25 million in lost profits for ART and TCI, and $2 million in increased costs to obtain alternate financing for ART and TCI. The jury also found TCI lost $252 thousand as a result of Dynex's breach of the New Orleans Agreement and awarded $1.95 million in attorney's fees.

Dynex moved for judgment notwithstanding the verdict, urging that ART and TCI could not recover damages for breach because neither was a party to, nor a third-party beneficiary of, the agreement. Dynex also argued that Basic could not recover lost profits for breach because such consequential damages were not reasonably foreseeable.

The trial court granted the motion and rendered a take-nothing judgment for Dynex and the Petitioners appealed.

The appellate court agreed with Dynex, finding that ART and TCI were not third-party beneficiaries of the Commitment and that TCI was not a third-party beneficiary of the New Orleans Agreement. Both agreements, reasoned the Dallas Court of Appeals, were made for the benefit of the *borrowers* – the SABREs that ART and TCI were to create – not for the benefit of ART and TCI. The benefits to ART and TCI were, at most, indirect and unrecoverable, said the appellate court.

When the Petitioners countered that Dynex was contending that ART and TCI were not entitled to recover in the capacity in which they sued – a matter Dynex had not raised by a verified pleading as required by Rule 93(2) of the Texas Rules of Civil Procedure—the Court of Appeals disagreed and rejected the argument.

The Court of Appeals also rejected Petitioners' argument that Basic could recover lost profits as consequential damages for Dynex's breach of the Commitment. There was no evidence that Dynex knew – when it made its Commitment – what specific investments would be proposed or that other financing would not be obtainable, said the appellate court. As such, the Court of Appeals affirmed the trial court's judgment.

<u>The Texas Supreme Court's holdings:</u>

First, the Court agreed with the appellate court that Dynex's failure to file a verified denial under Rule 93(2) did not preclude it from contesting ART's and TCI's right to recover as non-parties.

The law on this issue was confusing, said the Court, and the issue was further complicated by the fact that Dynex had pled its challenge as a "lack of standing," which need not be raised by verified denial. (Moreover, the Court pointed out that the issue was raised by Petitioners themselves in their motion for summary judgment and, as such, no longer required a verified pleading.)

Next, the Texas Supreme Court ruled that Dynex knew the purpose of the Commitment was to secure future financing for ART and TCI, the real

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estate investment trusts that Basic Capital managed and in which it held an ownership interest. Basic Capital was never to be the borrower.

Indeed, as a practical matter, the parties knew that it would likely not be a SABRE that would enforce the Commitment. By its very nature as a single-asset entity, a SABRE would not be created until an investment opportunity actually presented itself and, without financing, there would be no investment. "It would be unreasonable," held the Court, "to require ART and TCI to have created SABREs for no business purpose, merely in order that those otherwise inert entities could sue Dynex."

The Texas Supreme Court agreed that as a general proposition, a corporate parent is *not* a third-party beneficiary of its subsidiary's contract merely by virtue of their relationship. However, here, said the Court, the benefit to each SABRE was not only inured to its parent, it was structured to also benefit Dynex. If Dynex and Basic had not intended the Commitment to benefit ART and TCI directly, said the Court, then the Commitment would have no purpose whatever.

With regard to Dynex's assertion that ART's and TCI's failure to request a jury finding on whether they were third-party beneficiaries was fatal to their recovery, the Court rejected Dynex's theory. The proper construction of an unambiguous contract, pointed out the Court, is a matter of law. As such, the Commitment itself—and the undisputed evidence regarding its negotiation and purpose—established that ART and TCI were third-party beneficiaries.

Turning to the third issue, the Texas Supreme Court then addressed whether Basic was precluded from recovering lost profits as consequential damages for breach of the Commitment because Dynex could not reasonably foresee them. Citing the RESTATEMENT (SECOND) OF CONTRACTS and *Hadley v. Baxendale*, the Court pointed out that foreseeability is a fundamental prerequisite to the recovery of consequential damages for breach of contract. Indeed, consequential damages are not recoverable unless the parties contemplated at the contemplated at the time they made the contract that such damages would be a probable result of the breach.

Here, Dynex contended that when it issued the Commitment, it could not have foreseen that its breach would cause Basic to suffer lost profits because it had no idea what specific investments Basic would propose or that alternative financing for the investments would be unavailable.

The Texas Supreme Court disagreed—stating that there was no question that Dynex knew that Basic Capital's purpose in arranging the $160 million commitment was to ensure financing for ART's and TCI's real estate investments. Dynex's executive vice president had even testified to this fact, pointed out the Court. Moreover, it would "be surprising if Dynex had agreed to lend Basic $160 million without such knowledge."

Dynex certainly knew that if market conditions changed and interest rates rose, its refusal to honor the Commitment would leave Basic having to arrange less favorable financing, said the Court. Certain that its breach would increase Basic's costs, Dynex could not now profess "blindness to the foreseeability that its breach would also cost Basic business."

With regard to the last issue on appeal—namely, whether Dynex in fact suffered lost profits—the Texas Supreme Court would not address this issue, instead leaving it for the court of appeals to decide on remand.

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