Piercing the Corporate Veil and Notifying Insurance Carriers

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EDITOR'S NOTE: THE FOLLOWING ARE SUMMARIES OF TEXAS AND FEDERAL APPELLATE COURT OPINIONS RELEASED OVER THE PAST FOUR MONTHS THAT ARE RELEVANT TO EXECUTIVES AND THEIR BUSINESSES.

Commercial Law, Fiduciary Duty

Lifshutz, et al. v. Lifshutz

THE BOTTOM LINE: Obligations owed to a partnership by its partners and to a corporation by its officers include a fiduciary duty not to usurp business opportunities for personal benefit.

James and Kymberly Lifshutz were married in 1990 and separated in 1997. During the marriage, James managed the business of Liberty Financial Corp., Liberty Properties Partnership, Texas Home Improvements Inc. and Berlee Lumber Co. Inc. (the businesses), all of which James and his brothers own directly or indirectly. The businesses were involved in real estate, including purchasing and collecting notes and rental real estate. The businesses paid various personal expenses for James and Kymberly. During the marriage, James purchased notes and rental real estate for the benefit of him and his wife. This discussion will focus on the businesses' claims. During the divorce proceedings, Kymberly sought to pierce the corporate veil of the businesses, which could make James' interest in the businesses part of the marital estate and thus subject to division. The businesses filed a breach of fiduciary duty claim against James; they sought damages for the personal expenses they paid on his behalf and a constructive trust or damages for the business opportunities James allegedly usurped for his and his wife's personal benefit. The trial court found James had breached his fiduciary duty but denied the businesses' claim for damages or a constructive trust, based on its finding that James and the businesses were alter egos. In the first appeal, the 4th Court found that the trial court improperly pierced the veil of the corporate entities, because the evidence was legally insufficient to support a finding of alter ego in a divorce case. Thus, the 4th Court reversed and remanded for a new trial on the issues of breach of fiduciary duty and the division of community property. On remand, the trial court denied the breach of fiduciary duty claim, finding that James was the alter ego of the businesses. The trial court also found that the businesses ratified any diversion of corporate opportunities, or else James had authority to divert the opportunities. On the second appeal, the businesses argued that James breached his fiduciary duty to them, and they sought to pre-empt his defenses to their breach of fiduciary duty claim by arguing that James and the businesses were not alter egos and, even if they were, a finding of alter ego is not a defense to a claim for breach of fiduciary duty; and the businesses didn't ratify James' conduct, and he lacked authority for his actions. First, in analyzing whether James breached his fiduciary duty to the businesses, the 4th Court noted that corporate officers — including partners — owe a fiduciary duty to their corporations. This duty includes an obligation not to usurp opportunities for their own benefit. The court found undisputed evidence that James took opportunities for himself without first offering them to the businesses. Second, the court stated that it already decided in the first appeal that James and the businesses were not alter egos, hence the alter-ego theory could not block the businesses' attempt to obtain damages for James' breach of fiduciary duty. The court added that, in a divorce, a trial judge can't find the spouse and business to be alter egos — such that the court can pierce the corporate veil and consider the business' assets part of the marital estate subject to division — unless 1. unity between the separate property corporation and the spouse exists, such that the separateness of the corporation has ceased to exist; and 2. the spouse's improper use of the corporation damaged the community estate beyond that which might be remedied by a claim for reimbursement. Third, the court found that the businesses did not ratify James' usurpation of corporate opportunities, because there was no disclosure of material facts of those opportunities to other shareholders. However, the court found that other shareholders did ratify the businesses' payment of James and Kymberly's personal expenses, because the shareholders were on notice of the practice and the businesses had been paying James' father's personal expenses for years. The appellate court rejected the trial court's finding that James had actual or apparent authority to usurp the businesses' opportunities.

San Antonio Court of Appeals, No. 04-05-00117-CV, April 26, 2006

Contracts, Assignment

Seagull Energy E&P Inc. v. Eland Energy Inc.

THE BOTTOM LINE: A party to a contract can't avoid its obligations simply by assigning its rights

to a third party, unless the contract specifically allows for such a release.

Seagull Energy E&P Inc. leased and operated two offshore oil and gas leases in the Gulf of Mexico. Eland Energy Inc. bought an interest in both leases, expressly assuming rights and responsibilities under two similar offshore operating agreements. Under the operating agreements, Eland and the other lessees shared the cost of operations, while Seagull, the operator, exploited the minerals and collected operating costs from the other lessees. Several years later, Eland sold its interest in these leases to Nor-Tex Gas Corp., also assigning to Nor-Tex its rights and obligations under the operating agreements. Nor-Tex didn't reimburse Seagull for its share of operating costs, and Seagull sought these costs from Eland. Eland refused to pay, because it no longer owned an interest in the leases. Seagull sued Eland and Nor-Tex for breach of the operating agreement. The trial court granted partial summary judgment in favor of Eland, finding that Nor-Tex breached the operating agreement and that Eland remained on the hook for expenses under the operating agreement. The court of appeals reversed the trial court's judgment to the extent it awarded damages against Eland, concluding that Eland did not have continuing liability under the operating agreements after the assignment of its working interest, because the agreements did not provide expressly for such a continuing obligation. The Supreme Court reversed the court of appeals' decision and rendered judgment in favor of Seagull. The court examined clauses in the operating agreement, finding that the parties did not expressly agree that assigning the working interest would end the assignor's obligations under the operating agreement. The court noted that a party to a contract generally can't escape its contractual obligations simply by assigning its rights to a third party. Because the operating agreement did not expressly provide that Eland's obligations under the operating agreement should terminate upon assignment, and because Seagull did not expressly release Eland following the assignment of its working interest, the court found that Eland remains bound under the operating agreement it previously signed.
Texas Supreme Court, No. 04-0662, June 16, 2006

■ Insurance, Settlements

Coastal Refining Marketing Inc., et al. v. U.S. Fidelity and Guaranty Co.

THE BOTTOM LINE: Providing an insurance company with late notice of a suit doesn't necessarily void coverage.

Weaver Industrial Services entered into a service contract with Coastal Refining & Marketing Inc. The contract required Weaver to provide labor, supervision and equipment for repairs and maintenance to Coastal's refinery and to name Coastal as an additional insured on some of Weaver's insurance policies. Weaver added Coastal to its U.S. Fidelity and Guaranty Co. policy. An explosion at Coastal injured one of Weaver's employees, Rolando Lopez. He and his common-law wife sued Coastal and its parent company for negligence and gross negligence. Coastal didn't tell USF&G about the suit but hired its own lawyers. After a mediation one year later, Coastal tendered $2 million to its excess insurer, Lexington Insurance Co., which assumed defense of the suit. The following month, Coastal's defense lawyers contacted the agents/producers of the USF&G policy and made a demand for insurance coverage. The demand letter noted another mediation that was scheduled for a few days from the date of the letter. Within about a week, a USF&G claims specialist contacted Coastal's lawyers and learned that trial was scheduled for the following month. The claims specialist sent a letter to Coastal's lawyers reserving USF&G's right to disclaim coverage due to late notice. Coastal's defense lawyers settled the suit, and USF&G filed a declaratory judgment action against Coastal, seeking a declaration that USF&G had no duty to indemnify Coastal for the settlement. USF&G moved for summary judgment on the grounds that Coastal breached explicit policy conditions by 1. failing to give USF&G notice of the Lopez suit for more than a year after it was filed, 2. settling the suit without USF&G's knowledge or consent, and 3. breaching its duty to cooperate with USF&G. The trial court granted USF&G's summary judgment motion without stating the grounds for its decision. Coastal appealed, admitting that it failed to provide USF&G prompt notice of the suit, as the policy required, but arguing that USF&G was not prejudiced by the delay. The 14th Court of Appeals reversed the trial court's grant of summary judgment in USF&G's favor and remanded the case to the trial court, finding that USF&G provided no proof of prejudice from the late notice and made no showing that Coastal failed to cooperate. The 14th Court noted that the policy's terms indicate that late notice does not void coverage in the absence of prejudice. The court rejected USF&G's claim that it was prejudiced because it "lost anticipated contractual benefits such as the rights to investigate and defend the suit, participate in negotiations, and control settlement." The court stated that USF&G didn't lose the right to investigate, it simply "chose to investigate at a pace that lagged behind the settlement negotiations." The court rejected USF&G's argument that Coastal's failure to obtain USF&G's consent to the settlement rendered the payments voluntary, which would have violated the policy. The court also rejected USF&G's claim that the settlement prejudiced USF&G, noting Coastal's expert's testimony that the settlement was reasonable, and stating that USF&G offered no evidence that it suffered monetary prejudice or any other kind of prejudice. Finally, the court rejected USF&G's claim that Coastal breached its duty to

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cooperate, finding that uncontroverted evidence showed that Coastal "requested coverage prior to settlement, and that USF&G was informed of the mediation, settlement negotiations, and the ultimate settlement agreement." The court noted that USF&G bore the burden of proving not only that Coastal failed to cooperate but that such failure prejudiced USF&G, which USF&G failed to do.
Houston's 14th Court of Appeals, No. 14-04-00651-CV, May 30, 2006

Torts, Negligence
The Kroger Co. v. Elwood
<u>THE BOTTOM LINE:</u> Employers are not insurers of their employees' safety.

Billy Elwood, a Kroger clerk, was hurt when a customer closed his hand in the door of her car when he was loading groceries into her vehicle. He'd placed his hand on the car's doorjamb and his foot on the cart to keep the cart from rolling down a slope in the parking lot. The trial court found Kroger negligent and awarded damages to Elwood, reducing those after finding him 40 percent at fault. The court of appeals affirmed but awarded Elwood 100 percent of his damages, because nonsubscribers to workers' compensation insurance such as Kroger are not entitled to a jury instruction on contributory negligence. The Texas Supreme Court reversed and rendered a decision that Elwood take nothing. The court noted that, while employers have a duty to warn employees of the hazards of employment and provide needed safety equipment or assistance, they are not insurers of their employees' safety. For Elwood to recover damages from Kroger, a nonsubscriber, he must prove that Kroger's negligence caused his injuries. The components of negligence include duty, breach, cause and damages. Employers have no duty to warn employees of hazards that are commonly known or about which the employee is already aware. Employees have no duty to provide equipment or assistance that is unnecessary to the job's safe performance. When an employee's injury results from performing the same character of work that employees in that position have always done, an employer is not liable if there is no evidence that the work is unusually precarious. Because Elwood's task was not unusually precarious, there was no evidence that the sloping parking lot had hurt other employees, and Elwood knew that putting his hand in a vehicle's doorjamb was dangerous, Kroger was not negligent, and Elwood was not entitled to damages.
Texas Supreme Court, No. 04-1133, May 12, 2006

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