Contracts Tea no. 8 (October 2011)

SOUTH CAROLINA

When contract disputes are decided through procedural rules, court misses the opportunity to state what the law is on who bears the risk with regard to availability of the property for specific use.

In *Atlantic Coast Builders and Contractors v. Lewis*, Opinion No. 27044 Heard January 7, 2011 – Filed September 26, 2011, the South Carolina Supreme Court, in a contract case, decided for the plaintiff relying on the "two issue" and "law of the case" rules. Pursuant to the "two issues" rule, if a court's decision is based on more than one ground, the appeal has to address all the grounds otherwise the ground that is not appealed becomes the "law of the case".

While one blogger has criticized the applicability of these rules in *Atlantic Coast*,[1] -- because we write about contracts and not about procedure -- we do not express any opinion on this. We want to write about something else. But let's consider the facts of the case first.

On March 28, 2003, Atlantic Coast Builders and Contractors ("Atlantic Coast") entered into a commercial lease whereby Atlantic Coast would lease from Laura Lewis ("Lewis") a property located in Beaufort County for twelve months at a monthly rate of $3,500. Article 2 (Use) provided that "Lessee shall use and occupy the premises for Building & Const. office. The premises shall be used for no other purpose. Lessor represents that the premises may lawfully be used for such purpose." Article 5 (Ordinances and Statutes) provided "Lessee shall comply with all statutes, ordinances and requirements of all municipal, state and federal authorities now in force, or which may hereafter be in force, pertaining to the premises, occasioned by or affecting the use thereof by Lessee".

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[1] Substantially the criticism is that the "two issue" rule should not apply here because the plaintiff had sued for breach of contract, negligent misrepresentation, and unjust enrichment and the judge – while finding for the plaintiff on all three theories - had awarded only legal damages and an not equitable relief. Even if the defendant appealed only the legal theories underlying the damages award (and not the equitable relief of unjust enrichment) - the equitable theory cannot become the rule of the case. See Nexsen Pruet blog at award.http://nexsenpruetonthedocket.blogspot.com/2011/09/error-preservation-in-south-carolina.html

Although Lewis represented in the lease that the property could lawfully be used for a building and construction office, the property was zoned "rural" hence meaning virtually all commercial uses were prohibited. When on May 28, 2003, a Beaufort County zoning official served Atlantic Coast with a notice and warning of two violations for Atlantic Coast' s failure (among others) to obtain a certificate of zoning compliance before occupying the premise, Atlantic Coast vacated the property, relocated its business, and ceased making rental payments. Atlantic Coast brought action against Lewis on grounds of negligent misrepresentation, unjust enrichment, breach of contract, and breach of covenant of quiet enjoyment. Lewis counterclaimed for breach of contract. The master in equity entered judgment in favor of Atlantic Coast. Lewis appealed and the Court of Appeals affirmed the decision on negligent misrepresentation and breach of contract and the denial of the relief on Lewis's counterclaim for breach of contract. The Supreme Court granted Lewis's request of certiorari but then found that "arguments are unreviewable" based as said on the "two issue" rule and "law of the case":

> The Court of Appeals affirmed the master pursuant to Rule 220(b), SCACR, finding the master properly granted judgment in favor of respondent. . . . Petitioner did not appeal all grounds on which the master's judgment was based. Namely, she did not challenge the determination that respondent was entitled to recover based on unjust enrichment. Thus, under the two-issue rule, the Court of Appeals should have declined to address the merits of petitioner's argument since petitioner failed to challenge all three grounds on which the master's judgment was based . . . . Because petitioner did not appeal the master's finding of unjust enrichment.[2]

The Chief Justice dissented. In her opinion, the "two issue rule" does not apply.[3] In addition, she thinks that the Supreme Court should decide the merits of the case if at all

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[2] The SC also decided the issue of a security deposit but we will not deal with this issue. Just for completeness: the master failed to address the return of a security deposit, which Atlantic Coast had sought to be returned from Lewis. Lewis argued that the Court of Appeals erred in holding the issue of the security deposit was not preserved. The Supreme Court disagreed.

[3] In her dissenting opinion, Justice Toal opines as follows:

> [I]t was unnecessary for Lewis to argue unjust enrichment on appeal because it had no bearing on the award of damages that Lewis prayed to have reversed. . . . In my opinion, the

possible. When it is unclear whether a procedural rule that would preclude deciding the merit applies, the Court should decide in favor of the preservation of one issue.[4]

On the merits, the Chief Justice would not have found for Atlantic Coast: "[T]he premises was not zoned for use as a commercial office, and therefore, the lease had no lawful purpose … this lease was an illegal contract and, therefore, void and unenforceable … As such, the parties were not entitled to relief under any legal theory, and the Court is constrained to leave the parties as we found them."

We agree with Justice Toal's first part of the reasoning. In case a procedural rule clearly precludes the merit, it would be obviously unfair to the party who relied on that to ignore the rule and decide the merits. When the application of the rule is uncertain at best – as it is here – we agree with the Chief Justice that the Court should take the opportunity to state the law.

We do not quite agree with her reasoning when it comes to the merit. In her dissent, the Chief Justice cites to *McConnell v. Kitchens*, 20 S.C. 430, 437–38 (1884): it "is a well-settled principle of contract law that "a contract to do an act which is prohibited by statute, or which is contrary to public policy, is void, and cannot be enforced in a court of justice."

The problem is that, as the Chief Justice recognizes, "Th[e] Court has never addressed the validity of a lease such as this one."[5] Absent a specific rule in point of contracts entered in violation of zoning, we should apply general contractual principles: a contract can be void because of inconsistency with the law only where this inconsistency is a violation of a public policy. The Restatement (Second) of Contracts §178 provides when a contractual term is void because of violation of public policy:

> A promise or other term of an agreement is unenforceable on grounds of public policy if [i] legislation provides that it is unenforceable or [ii] the

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existence of this preservation bar is questionable, and I elect to resolve that question in favor of preservation.

[4] In her dissenting opinion, Justice Toal opines as follows:

> In my opinion, an over-zealous application of appellate preservation rules denigrates the primary purpose of the judiciary, which is to serve the citizens and the business community of this state by settling disputes and promoting justice. . . . I believe that where the question of preservation is subject to multiple interpretations, any doubt should be resolved in favor of preservation. . . .

[5] The Chief Justice adds: "However, I believe where the only contemplated use of a lease is for a purpose prohibited by the applicable zoning regulations, the lease is illegal and wholly unenforceable."

interest in its enforcement is clearly outweighed in the circumstances by a public policy against the enforcement of such terms.

In other words, the Restatement provides for two situations of unenforceability: (i) either there is a statute that provides that a certain contractual term is unenforceable because of public policy (which is not the case here or (ii) the court must make a balance between the public policy and the interest for enforcement.

Since there is no statute providing for unenforceability, we should go through the balancing test to find that the contract is unenforceable. Until a court makes the balance, the contract between Atlantic Coast and Lewis is perfectly enforceable and its breach entitles the nonbreaching party to damages.

If the contract is enforceable, then an issue of contract interpretation arises. The rule is that you should construe the contract as a whole and give effect to every provision, trying to reconcile them, if at all possible. In this case, it would be possible to reconcile the two apparently inconsistent provisions. Article 2 plainly constitutes a warranty by the Lessor of the permissible use of the property. Article 5 states that the Lessee -- inside the permissible use – must comply with the applicable law. So under this principle of interpretation, the Lessor should bear the responsibility for noncompliance with zoning.

Another expansion of the reach of arbitration clauses: A US district court holds that a third-party beneficiary is bound, also for tort actions, by the arbitration provision contained in the contract.

On September 13, 2011, the US District Court for District South Carolina, in *THI of South Carolina at Columbia, LLC v Wiggins*,[6] using the doctrine of the third-party beneficiary, enforced an arbitration clause.

These are that facts: In June 2009, Deborah Wiggins ("Wiggins") -- acting as personal representative of her father's estate -- brought an action for damages associated with the death of her father, Earl Hall ("Hall")[7] against Magnolia Manor–Columbia, Inc., a legal entity which operated Magnolia Manor of Columbia ("Magnolia Manor"), a residential health

[6] See the article "ARBITRATION – VALID AGREEMENT – NURSING HOME – RESIDENT'S CONTRACT", South Carolina Lawyer, available at: "http://charlestonsclawyers.com/news-and-blogs/1128-arbitration--valid-agreement--nursing-home--residents-contractn.html

[7] Wiggins brought three tort actions: survival claim for negligence, a wrongful death claim, and a claim of negligence *per se*.

care center. Hall died while a resident of Magnolia Manor. Wiggins obtained a default judgment against Magnolia Manor-Columbia and then Wiggins indicated an intent to move in state court to add or substitute THI of South Carolina at Columbia, LLC. ("THI"), a Delaware limited liability company -- which later came to operate Magnolia Manor-- as a judgment debtor on the default judgment. THI moved to compel arbitration of the dispute based on an arbitration clause ("Arbitration Provision") included in the Admission Contract ("Contract") through which Hall was admitted to Magnolia Manor.

Hall became a resident of Magnolia Manor on May 4, 2005. The Contract was executed that same day. It stated that it was "executed ... by and among Magnolia Manor-Cola, a corporation located at 1007 N. King St. Columbia S.C. 29223 (the 'Health Care Center'), and Earl Hall ('Patient/Resident'), and/or Deborah Wiggins ('Fiduciary Party')".

The name "Earl Hall" is printed over the signature line for the Patient/Resident. Wiggins signed the Contract over the signature line for "Fiduciary Party" and marked the block indicating that she signed as an "Immediate Family Member."

Wiggins questioned whether the capacity in which she signed is binding on her father's estate.[8]

The Arbitration Provision stated:

> Pursuant to the Federal Arbitration Act, any action, dispute, claim or controversy of any kind (e.g., whether in contract or in tort, statutory or common law, legal or equitable or otherwise) now existing or hereafter arising between the parties in any way arising out of, pertaining to or in connection with the provision of health care services, any agreement between the parties, the provision of any other goods or services by [Magnolia Manor] or other transactions, contracts or agreements of any kind whatsoever, any past, present or future incidents, omissions, acts, errors, practices or occurrence causing injury to either party whereby the other party or its agents, employees or representatives may be liable, in whole or in part, or any other

[8] Wiggins challenged the enforcement of the arbitration provision *against Hall* (or his estate) – "[t]here is nothing in the record to indicate that [Wiggins] had authority to act as agent for [Hall], legally bind [Hall] or waive [Hall]'s right to a jury trial "-- and actually also contested THI's right to enforce the arbitration agreement against Wiggins. This latter argument was based on the fact that THI was not a party to the Contract (or Arbitration Provision) because the documents do not mention "THI of South Carolina at Columbia, LLC. In addition, she argued that the arbitral forum selected by the parties was unavailable at the time the parties executed the Contract.

> aspect of the past, present or future relationships between the parties shall be resolved by binding arbitration administered by the National Health Lawyers Association[.]

While the court dedicated a large part of the decision to the reasons why the Federal Arbitration Act applied in the case, to the citizenship of the parties, and to the issue whether THI was an alter ego of Magnolia Manor–Columbia, Inc., we concentrate our discussion on whether Hall (hence Wiggins for his estate) was bound by the arbitration or not.

Holding to apply South Carolina law,[9] the court found for the enforceability of the arbitration clause.

Because Wiggins acted as personal representative of Hall's estate, Wiggins was bound by the Arbitration Provisions if Halls was bound.[10]

Agreeing with THI's arguments that Wiggins was bound by arbitration as Hall was a third-party beneficiary of the Contract and because in addition he would be estopped because he received the Contract's benefits,[11] the court enforced the Arbitration Provision.

In particular, on the third-party beneficiary issue, the court held:

> Third–Party Beneficiary Status. Under South Carolina law, "[a] third-party beneficiary is a party that the contracting parties intend to directly benefit." *Helms Realty, Inc. v. Gibson–Wall Co.*, 363 S.C. 334, 611 S.E.2d 485, 488 (S.C.2005); see also *Touchberry v. Florence*, 295 S.C. 47, 367 S.E.2d 149, 150 (S.C.1988) ("[t]he presumption that [a] contract is not enforceable by an individual may be overcome by showing that he was intended to be the direct beneficiary of the contract."). Hall did not sign the Contract; however, he is named as the resident to be admitted to the facility. Id. The terms of the Contract refer to

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9 Since "[Wiggins's] arguments raise issues of contract formation which [must be decided] … under the governing state's law. . . . the court applies South Carolina law in addressing Wiggins' three challenges to the validity and enforceability of the Arbitration Provision."

10 See S.C.Code Ann. § 62–3–703),

11 Citing to *See Int'l Paper Co. v. Schwabedizzen Maschinen & Anlagen GMBH,* 206 F.3d 411, 417–18 (4th Cir.2000) (holding that to allow a party to claim the benefit of the contract and simultaneously avoid its burdens would both disregard equity and contravene the purposes underlying enactment of the [FAA], the court held that it would be inequitable to allow Hall's estate to disavow the Arbitration Provision contained in a contract signed by an immediate family member and under which Hall received many benefits.)

> benefits and responsibilities of the resident, the facility, and the fiduciary party. Id. Hall's care was the essential purpose of the Contract. Thus, Hall was an intended third-party beneficiary of the Contract which was signed by Wiggins in her capacity as an immediate family member. It follows that Hall was bound by the Arbitration Provision immediately prior to his death and, consequently, that it remains binding on his estate.

Because the court based its decision on the theory of third-party beneficiary and on equitable grounds, the court did not reach the issue whether Wiggins was bound by the Arbitration Provisions because of the capacity in which she signed (i.e. as an agent or not).[12]

While we do not express any opinion on the propriety of the equitable decision, we think that in finding Hall's estate bound by the Arbitration Provision on a third-party-beneficiary theory, the court misapplied the law.

The court cites to *Helms Realty, Inc. v. Gibson-Wall Co.* for the definition of "third-party-beneficiary". In that case, a broker argued that he was a third-party beneficiary of the sale contract between a seller and a buyer of a real estate. In refusing this argument, the SC Supreme Court specified that

> A third-party beneficiary is a party that the contracting parties intend to directly benefit. There is no evidence that Respondent and the Buyer intended to directly benefit Appellant. Appellant's expected benefit was merely incidental.

The court also cites to *Touchberry v. City of Florence,* S.E.2d 149 (1988). In that case the property owner of Florence, SC argued that he was *a* third party beneficiary of a

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[12] In footnotes 11 and 13 of its decision, the court explained that

> Wiggins . . . argues that [her signature] does not bind her as personal representative of her father's estate . . . Because the court resolves the issue on other grounds, it need not reach the issue of whether the capacity in which Wiggins signed binds the estate.

And also: THI raises several other arguments to support its contention that Wiggins had authority to bind Hall to the arbitration agreement including that Wiggins had statutory authority and apparent authority to do so. However, as the court finds that Hall was bound as third-party beneficiary and under the doctrine of equitable estoppel, the court need not reach these additional arguments.

service contract between City of Florence (City) and Florence County.[13] The SC Supreme Court found that Owner was a third-party beneficiary of the contract because "[t]he language of the agreement here clearly shows that the contracting parties intended for the agreement to be enforceable by residents of the MSA."

While the reference to those precedents is correct, we think the US District Court draws from the case law a wrong consequence.

It is undisputed in SC that a third-party beneficiary is a party that the contracting parties intend to directly benefit and that the language of the contract matters in this evaluation. It is also undisputed that a third-party beneficiary who decides to enforce the contract cannot pick and choose what he wants: if he takes the benefits of the contract, he also takes the burden associated with it, such as the forum selection clause/arbitration clause inserted in it.[14] The law in SC is not different from the Restatement (Second) of Contract § 304 (Creation of Duty to Beneficiary): "[a] promise in a contract creates a duty in the promisor to any intended beneficiary to perform the promise, and the intended beneficiary may *enforce* the duty."

The problem is another. Wiggins sued in tort, not in contract. Therefore Wiggins was not enforcing the Contract when she brought her action. If she had brought an action for breach of contract, and Hall was to be found a third-party beneficiary, then she could not have brought the action in a forum different from the arbitral one. This is not the case, however.

But a moment, you might say, parties can always agree to subject tort actions to arbitration and this is exactly what the parties did in the Arbitration Provision of the

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[13] The Owner lived in Florence County on a property, which was contiguous to the City. The City had an ordinance requiring annexation of contiguous property as a condition for receiving City services and utilities. Florence County Council (Council) created a municipal Service Area (MSA), which included Owner's property. In 1984, Council entered a franchise agreement with City, which granted the City the exclusive right to provide water and sewer services in the MSA "to any area within the [MSA] which requests such service". While Owner's property was in the MSA area, the City refused the service to Owner because his property was not annexed to the City.

[14] The US District Court makes this reasoning to find that Wiggins, as Hall's estate personal representative, is equitable estopped from disavowing the arbitration clause (see above our footnote 12) but the same reasoning can more simply rely on third-party beneficiary doctrine.

Contract.[15] This is true, of course. You are perfectly right. The parties can certainly agree on such a covenant (the parties can also agree on a covenant not to sue, for that matter). The *parties* can do that, and they are obviously bound by that agreement. But someone who *has not agreed* on the covenant itself is not bound by it. He can sue in tort wherever he wants.

A court cannot resort to the theory of third-party beneficiary to compel arbitration in tort, even if the court finds that the person who wants to bring a tort action is, by chance, a third-party beneficiary of the contract in which the covenant happens to be.

But this is not the end. Hall (and his estate) is likely bound by the Arbitration Provision also in relation to tort action. Not on a third-party beneficiary ground, however. Hall was probably bound on agency theory. That is exactly the part that the court chose not to decide.

Wiggins was Hall's daughter, i.e. an immediate family member. She signed the Contract to let her father to enter the health care facility and her father entered the facility the day she signed the Contract and received the benefits of it. It is evident – even if she contests it – that Wiggins signed the contract as an agent of her father. She was her father's agent, either because he gave authority to her, or because he let her appear as having authority[16] or because he ratified her conduct[17] by entering the health care facility and living there for a long time.

Since an agent signed the Contract on his behalf and the Contract contained the Arbitration provision that also covered tort actions, Hall – and his estate – are bound to bring any claim in front of the arbitrator.

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[15] We read in the Arbitration Provision: "Pursuant to the Federal Arbitration Act, any action, dispute, claim or controversy of any kind (e.g., whether in contract or *in tort,* statutory or common law, legal or equitable or otherwise)"

[16] From Knapp, Crystal, Prince, "Problems in Contract Law: Cases and Materials", 6th Edition, p. 107:

> Even in the absence of any actual authority, however, a principal may be legally bound by the actions of its agent if the principal has done or said something that leads the other party reasonably to believe that the agent does indeed have actual authority to do the act in question.

[17] *Id.*

> Finally, even where an agent has no authority at all—either actual or apparent—to enter into a particular contract on behalf of the principal, a principal that later learns of its agent's action and approves of it will be liable on that contract by virtue of such "ratification."

In conclusion, the US District Court, which refused to analyze the capacity in which Wiggins signed the Contract, unfortunately reached the right conclusion (enforcing arbitration) for the wrong reason.

INTERNATIONAL

With this issue we continue our efforts to expand treatment of international law by adding comments from our new editor for Central America, Ivanova María Ancheta Alvarado, Abogada y Notaria in Guatemala.

Guatemala opens up to investors with a mega bid.

Guatemala is opening a very interesting investment opportunity (Licitation PEG-1-2011) in the energy sector. The National Energy Commission is extending a public invitation to bid for the generation of up to 800MW for a term of 15 years, initiating on May 1, 2015. We expect that the licitation will generate very interesting contracts issues. The main idea behind the bid is to diversify the energy matrix of Guatemala to make it more efficient, trying to promote regional energy integration at a minimum environmental impact.

The licitation is directed to generators of *renewable resources* (lake hydraulics, biomass, wind, solar, renewable distributed generation (central of 5MW)), or non-renewable resources (coal, bunker, natural gas). Contracts are offered for a period of up to 15 years for new generation plants and up to 5 years for power plants in operation. Tendered object of the bid: if the type or contract is the option to purchase or to load curve difference, the bid offers a number of power and energy including price in US$/KW per month and US$MW/ per hours respectively; if the type of the contract is with generated energy, it is offered only the amount of energy and its corresponding price.

The contract will be awarded to those bids that minimize supply distributors.

The legal requirements to present bids are minimal. Among others: (i) designation of an authorized representative who must be fully empowered to receive notices and communications on behalf of the applicant and to make inquiries, comments or requests for clarification and modification of tender, on the applicant's behalf; (ii) some capitalization requirements.

For more information visit the website of the National Electric Energy Commission www.cnee.gob.gt.

Guatemala's new Forfeiture Law: foreign companies should pay attention when choosing joint venture partners.

Like Colombia in 2002 and Peru in 2008, Guatemala has passed a Forfeiture Law ("Act") with the purpose to fight crime, corruption, drug trafficking, in short all the manifestations of organized crime.[18] Companies making business in Guatemala should carefully consider this statute and its implications when selecting their commercial partners.

The purpose of the Act is to establish a specific and exclusive instrument to extinguish property rights on assets obtained or derived from illegal or criminal activities. Pursuant to the Act, the forfeiture can ensue (i) for assets that originate from illegal or criminal activities; (ii) for increase in equity (either direct or indirect) of a person under investigation; (iii) for assets or business that have been used as a means or instrument for the commission of crimes; (iv) to assets that were the proceeds from assets that originated from criminal activities. The Attorney General is responsible for directing and conducting investigations in these cases, and for promoting appropriate actions before the competent courts. The forfeiture procedure is conducted while respecting constitutional guarantees for every accused. The Regulations of the Act provide for the establishment of the National Asset Management Forfeiture and of a National Secretary of Administration Forfeiture Assets. These two entities have the authority to manage the seized properties when a final decision for the assets to become part of the heritage of the state exists.

For further information, send an email to info@nathancrystal.com.

[18] The Forfeiture Law, published in the Official Journal Guatemalteco on December 29, 2010, should have wholly entered into force on August 12, 2011; however, the statute has been the subject of challenges so it is still not generally applied.