United States Bankruptcy Court
District of New Mexico

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Comments: Memorandum Opinion on 1) Motion to Stay Proceedings and Compel Arbitration by Transamerica Small Business Capital, Inc. and 2) Motion to Dismiss by FAS Construction Management, Inc.

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UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEW MEXICO

In re:
EMS ENTERPRISES, L.L.C.,
Debtor. No. 11-99-15376 SA

EMS ENTERPRISES, L.L.C.,
Plaintiff,
v. No. 00-1033 S

TRANSAMERICA SMALL BUSINESS SERVICE, et al.,
Defendants.

MEMORANDUM OPINION ON
1) MOTION TO STAY PROCEEDINGS AND COMPEL ARBITRATION
BY TRANSAMERICA SMALL BUSINESS CAPITAL, INC. AND
2) MOTION TO DISMISS BY FAS CONSTRUCTION MANAGEMENT, INC.

This matter is before the Court on 1) defendant Transamerica Small Business Capital, Inc.'s ("TSBC"'s) Motion to Stay Proceedings and to Compel Arbitration and 2) a Motion to Dismiss filed by defendant FAS Construction Management, Inc., ("FAS"). FAS is represented by its attorney Nathan H. Mann. TSBC is represented by its attorney David G. Reynolds. E.M.S. Enterprises, L.L.C. ("EMS") opposes 1) dismissal of FAS and 2) arbitration, and filed responses through its attorney Steven Schmidt and P. Diane Webb. Defendant DBCS Corporation ("DBCS") also opposes arbitration and filed a response through its attorney Daniel J. Behles. Having considered the file and the arguments of counsel, and being sufficiently advised, the Court issues this Memorandum Opinion as its Findings of Fact and Conclusions of Law.

FACTS

TSBC's predecessor in interest, Emergent Business Capital, Inc. ("Emergent") entered into two agreements, one with FAS Construction Management, Inc. and one with FAS Disbursement, LLC, on June 26, 1998. These agreements are attached to the complaint as Exhibits F and G respectively. FAS was to provide construction management services and construction fund disbursement services to Emergent in connection with the construction of a Microtel Inn for Debtor. Exhibit F to the complaint is an "Agreement for FAS Construction Management Services" ("Construction Management Agreement") between Emergent as "Lender", and FAS Construction Management, Inc. as "Consultant". The Agreement was executed only by Emergent and FAS Construction Management. Article 4.2 states:

> Consultant's services are for the benefit of Lender and SBA [sic] only and are not for the benefit of any other third party, including but not limited to Borrowers, Borrower's contractors/ subcontractors/ suppliers/ consultants, or prospective or subsequent purchaser or user of the projects. Nothing contained herein shall be deemed to create any contractual relationship between Consultant and any third party other than SBA; nor shall anything contained herein be deemed to give any party any claim or right of action against Lender or Consultant which does not already exist without this Agreement.

Article 7.1 of the Agreement states:

> Subject to and following a good faith effort on the part of both parties to at first negotiate and resolve any dispute, all claims, disputes and other matters in question before the parties to the Agreement, arising

> out of or relating to this Agreement or the breach thereof, shall be decided by arbitration in accordance with the Construction Industry Rules of the American Arbitration Association.

Article 8.1 states “This Agreement shall be governed by and construed in accordance with the laws of the State of South Carolina.”

Article 8.2 is an integration clause:

> This Agreement represents the entire and integrated Agreement between the Lender and Consultant, and supersedes all prior negotiation, representations or agreement, either written or oral. There are no agreements between the parties regarding the subject matter hereof except as specifically set forth herein. This Agreement may be amended only by written instrument signed by both the Consultant and the Lender.

Exhibit G is an “Agreement for FAS Disbursement Services” (“Disbursement Services Agreement”) between Emergent as “Lender”, and FAS Disbursement, LLC as “Consultant”. The Agreement was executed only by Emergent and FAS Disbursement, LLC. Article 5.1 states:

> This agreement shall benefit and be binding on the parties and their respective successors.

Article 6.5 states:

> Consultant’s services are for the benefit of Lender and the SBA only and are not for the benefit of any third party, including but not limited to Borrowers, Borrowers’ contractors/ subcontractors/ suppliers/ consultants, or prospective or subsequent purchaser or user of the projects. Nothing contained herein shall be deemed to create any contractual relationship between Consultant and any third party; nor shall anything contained herein be deemed to give any third party any claim or right of action against Lender or Consultant which does not otherwise exist without regard to this Agreement.

Article 7.1 states “This Agreement shall be governed by and construed in accordance with the laws of the State of South Carolina.”

Article 8.1 provides for arbitration:

> Subject to and following a good faith effort on the part of both the parties to at first negotiate and resolve any dispute, all claims, disputes and other matters in question between the parties to the Agreement, arising out of or relating to this Agreement or the breach thereof, shall be decided by arbitration in accordance with Construction Industry Arbitration Rules of the American Arbitration Association then obtaining.

Article 9.1 contains an integration clause:

> This Agreement, together with any signed Addendum, represents the entire and integrated Agreement between the Lender and Consultant, and supersedes all prior negotiation, representations or agreement, either written or oral. There are no other agreements between the parties regarding the subject matter hereof except as specifically set forth herein. This Agreement may be amended only by written instrument signed by both the Consultant and Lender.

Article 10 incorporates two Exhibits, A and B. Exhibit A is a “Loan Consultant Services Work Authorization”, signed by Emergent and FAS Disbursements, LLC, which authorizes FAS Disbursement to perform the Loan Consultant services and fixes the fee at $9,900. Exhibit B is a letter issued at the loan closing for the Microtel Inn. It serves as Emergent’s authorization of FAS Disbursement LLC to act as an agent for Emergent in connection with administrative functions concerning the loan. It contains the following language:

> Important: Consultant is working solely for Lender as its administrative agent. No modifications or amendments to the loan documents can be made without the prior written agreement of Lender. Consultant's sole obligations with respect to this project is to Lender and Consultant has no contractual obligation to Borrower, or to Borrower's contractor (or to their subcontractors/ vendors/ design professionals/ consultants), or to any other third party.

This exhibit was signed by Emergent, by Debtor, and by DBCS Corp. as contractor. The phrase "acknowledged and agreed" appears before Debtor's and DBCS's signature.

Transamerica seeks to enforce the arbitration provision against EMS under the theory that EMS is a third-party beneficiary of the contracts.[1] EMS opposes arbitration, claiming 1) that the arbitration provision applies only to Transamerica and FAS, not to third parties, and 2) that arbitration is not required for core bankruptcy matters even if provided for by contract. The disposition that the Court makes of this matter does not require it to address the second issue at this time.

FAS seeks dismissal under Rule 7012(b)(6) on the grounds that 1) EMS is not a third party beneficiary under the contract, and 2) FAS owes no duty to EMS that would support a tort claim. EMS responds that conduct of the parties would demonstrate that

[1]In its complaint EMS has pleaded, among other theories, that it is a third-party beneficiary of the contracts between Transamerica and FAS.

it is, in fact, a third party beneficiary under the contract, and that FAS owed it a duty.

Conclusions of Law

Motion to Stay Proceedings and Compel Arbitration

The Federal Arbitration Act, 9 U.S.C. § 1 et seq., establishes a federal policy favoring arbitration, requiring that federal courts "rigorously enforce agreements to arbitrate." Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 226 (1987)(citations omitted.) This federal policy does not extend to situations in which the identity of the parties who have agreed to arbitrate is unclear. McCarthy v. Azure, 22 F.3d 351, 355 (1st Cir. 1994). "Though a person may, by contract, waive his or her right to adjudication, see 9 U.S.C. § 2, there can be no waiver in the absence of an agreement signifying an assent." Id. Therefore, whether a party has submitted himself to arbitration is a matter of the parties' intent as expressed in the contract. Id. See also Thomson-CSF, S.A. v. American Arbitration Association, 64 F.3d 773, 776 (2nd Cir. 1995)("Arbitration is contractual by nature –'a party cannot be required to submit to arbitration any dispute which he has not agreed to so submit.'" (quoting United Steelworkers of America v. Warrior & Gulf Navigation Co., 363 U.S. 574, 582 (1960).)

The Bankruptcy Court looks to state law to provide the rules for interpreting a contract. Haber Oil Co., Inc. v. Swinehart (Matter of Haber Oil Co., Inc.), 12 F.3d 426, 443 (5th Cir. 1994). Both agreements in this case recite that the governing law is that of South Carolina. EMS questions this choice of law, although it reserved the right to argue the issue at a later date. Application of South Carolina law results in a determination that EMS is not a third party beneficiary; application of New Mexico law provides a possibility that EMS may be a third party beneficiary.

A) South Carolina law

Under South Carolina law, a third party not in privity with the contracting parties generally has no right to enforce a contract. Goode v. St. Stephens United Methodist Church, 329 S.C. 433, 445, 494 S.E.2d 827, 833 (Ct. App. 1997); Bob Hammond Construction Company, Inc. v. Banks Construction Company, 312 S.C. 422, 424, 440 S.E.2d 890, 891 (Ct. App. 1994). There is a presumption that an individual who is not a party to the contract may not enforce it. Stokes v. Westinghouse Savannah River Company, 206 F.3d 420, 429 (4th Cir. 2000)(applying South Carolina law). However, a third party beneficiary can enforce a contract if the parties intended to create a direct, rather than an incidental or consequential benefit to the third person. Goode, 329 S.C. at 445, 494 S.E.2d at 833 (citation omitted).

The fact that a party might ultimately and indirectly benefit from a contract is not sufficient. Bob Hammond Construction Company, 312 S.C. at 425, 440 S.E.2d at 892. The parties' intention is derived from the language of the contract. Jacobs v. Service Merchandise Company, Inc., 297 S.C. 123, 128, 375 S.E.2d 1, 3 (Ct. App. 1988)(citing Superior Automobile Insurance Co. v. Maners, 261 S.C. 257, 199 S.E.2d 719 (1973)). If a contract's language is plain, unambiguous, and capable of only one reasonable interpretation, no construction is required and the contract's language determines the instrument's force and effect. Id. If the contract is in writing, there is a strong implication that the whole intention of the parties has been expressed and there is no agreement or intention contrary to that expressed. Lingefelt v. Forest Hills Homes, Inc., 305 S.C. 197, 200, 406 S.E.2d 394, 396 (Ct. App. 1991). When the written agreement is clear and complete, extrinsic evidence of agreements or understandings contemporaneous with or prior to the execution of the written instrument may not be used to contradict, explain or vary the terms of the written agreement. Id. This is especially true when the written instrument contains a merger or integration clause. Gilliland v. Elmwood Properties, 301 S.C. 295, 302, 391 S.E.2d 577, 581 (1990).

B) New Mexico law

Under New Mexico law, a contract generally cannot be enforced by a person who is not a party to it or in privity with it. Tarin's, Inc. v. Tinley, 2000-NMCA-048, 1999 WL 1893675, at 3 (Ct. App. 1999). New Mexico follows the distinction between intended beneficiaries and incidental beneficiaries; only intended beneficiaries can seek enforcement of a contract. Id.

> The paramount indicator of third party beneficiary status is a showing that the parties to the contract intended to benefit the third party, either individually or as a member of a class of beneficiaries. Such intent must appear either from the contract itself or from some evidence that the person claiming to be a third party beneficiary is an intended beneficiary.

Valdez v. Cillessen & Son, Inc., 105 N.M. 575, 581, 734 P.2d 1258, 1264 (1987)(citations omitted). When a contract's terms are clear and unambiguous, courts ascertain the intent of the parties from the ordinary meaning of the language in the agreement. Continental Potash, Inc. v. Freeport-McMoran, Inc., 115 N.M. 690, 704, 858 P.2d 66, 80 (1993). "If the court decides a writing was intended as the contract, the court is bound by the parol evidence rule from hearing collateral evidence for the purpose of construing the contract in a manner that varies or contradicts the clear and unambiguous language of the contract." C.R. Anthony Company v. Loretto Mall Partners, 112 N.M. 504, 507, 817 P.2d 238, 241 (1991). If a document is intended as a complete integration of the parties' agreement, the parol

evidence rule further requires exclusion of evidence that contradicts or changes the terms of the document. Taylor v. Allegretto, 112 N.M. 410, 413, 816 P.2d 479, 482 (1991). A court may, however, be called upon to decide if the written contract is ambiguous or has mistakenly stated a term contrary to the parties intent. C.R. Anthony Company, 112 N.M. at 507, 817 P.2d at 241. Under New Mexico law a court may consider extrinsic evidence to make a preliminary finding either on the question of ambiguity, Mark V, Inc. v. Mellekas, 114 N.M. 778, 781, 845 P.2d 1232, 1235 (1993), or on the question of whether the agreement mistakenly states a term contrary to the parties intent, C.R. Anthony Company, 112 N.M. at 507, 817 P.2d at 241.

In Tarin's Inc., the New Mexico Court of Appeals discussed contractual relationships peculiar to the construction industry. It noted that "in the absence of an express agreement otherwise, a subcontractor is not in privity with the owner and must look to the general contractor, while the owner is liable only to the general contractor." 1999 WL 1893675 at 3. Similarly, absent privity, a subcontractor owes no duty to a property owner. Id. The Court did acknowledge, however, that even absent privity a property owner may still have enforceable rights as a third-party beneficiary. Id. Ordinarily a property owner would not be a third-party beneficiary of a contract between the general

contractor and subcontractor. Id. at 4. This "presumption" is subject to challenge, however, by appropriate proof. Id.

Finally, under New Mexico law contracts that disclaim the existence of third party beneficiaries are enforced as written:

> It is fundamental that "if two contracting parties expressly provide that some third party who will be benefitted by performance shall have no legally enforceable right, the courts should effectuate the expressed intent by denying the third party any direct remedy. . . ." This is consistent with our duty to enforce the will of the parties as it is written. (Internal citation omitted.)

Cobos v. Dona Ana County Housing Authority, 121 N.M. 20, 25, 908 P.2d 250, 255 (Ct. App. 1995) aff'd. on other grounds 126 N.M. 418, 421, 970 P.2d 1143, 1145 (1998).[2]

The Court finds the contracts are not ambiguous. Both contain absolutely clear language that the shared intent of the parties is that there be no third party with any interest whatsoever in the contracts. There is no express intent that EMS be a beneficiary; indeed, the contracts expressly provide that no benefit is intended for "Borrowers ... or prospective or subsequent purchaser or user of the projects". The contracts

[2]In reaching its decision, the Court of Appeals found that a provision disclaiming the existence of third party beneficiaries was not against public policy as an attempted exculpation of negligence. 121 N.M. at 25, 908 P.2d at 255. The Court distinguished between a party attempting to insulate itself from a negligence claim and the creation of rights in a third party. Id.

also contain integration clauses, providing that the contracts are the entire agreement of the parties.

Under South Carolina law, extrinsic evidence contradicting the clear or unambiguous terms of the integrated contract – that there be no third party beneficiary – cannot be considered. The inquiry ends there under South Carolina law; EMS is not a third party beneficiary.

If New Mexico law were to apply, the Court still finds that, on their face, the language of the contracts is not susceptible to different readings with regard to third party beneficiary status. However, New Mexico law also provides a party the opportunity to submit extrinsic evidence that a seemingly unambiguous agreement really is ambiguous or that it does not reflect the true intent of the parties. Mark V, Inc., 114 N.M. at 781, 845 P.2d at 1235; Tarin's Inc., 1999 WL 1893675 at 4. Thus the Court should consider extrinsic evidence to determine if the contracts were in fact ambiguous or did not reflect the true

intent of the parties,[3] subject to the conditions set out at the end of this memorandum opinion.

If EMS were to establish that it is a third party beneficiary, it would thereby ordinarily be required to arbitrate. Nonsignatory parties to a contract can be bound to an arbitration provision under "ordinary principles of contract and agency." Thomson-CSF, S.A., 64 F.3d at 776. Bases for such treatment include: 1) incorporation by reference, 2) assumption, 3) agency, 4) veil-piercing/alter ego, and 5) estoppel. Id. A third-party beneficiary of a contract with an arbitration clause would also be bound to arbitration. Lee v. Grandcor Medical Systems, Inc., 702 F.Supp. 252, 255 (D. Co. 1988); Interpool Limited v. Through Transport Mutual Insurance Association Limited, 635 F.Supp. 1503, 1504 (S.D. Fl. 1985).

However, EMS further argues that the bankruptcy context of this litigation permits the Court to override the arbitration

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[3] Generally the burden is on the party claiming third party beneficiary status to demonstrate that the parties to the contract intended to benefit the third party. Tarin's Inc. 1999 WL 1893675 at 3. Should EMS attempt such a showing, it may argue that it did benefit or would have benefitted from performance of the contracts. It is obvious EMS could benefit from performance of the contracts, but mere receipt of benefits is not inconsistent with being an incidental beneficiary with no rights in the contracts. See id. This evidence would therefore not overcome, or even contradict, the clear wording of the contracts that EMS is not a third party beneficiary with any rights. Were that the only evidence offered by EMS, the Court would find that EMS is not a third party beneficiary.

provisions of the agreements. And EMS cites the language of the agreements which require all disputes "between the parties" to be arbitrated, as evidence that EMS can be a third party beneficiary of the contracts but not be bound by the arbitration requirement.[4] The Court does not need to rule on these arguments yet, given the interim disposition that the Court makes of TSBC's motion.

Thus, at this time the Court cannot rule on whether the parties must arbitrate, but will do so depending on EMS's election and tender of evidence.

The Motion to Dismiss

Only Counts 2 and 4 of EMS's complaint are directed at FAS. Count 2 is a complaint for turnover of estate funds from TSBC and/or FAS. It alleges that TSBC or FAS is holding funds of the estate and has refused to pay them to EMS. To the extent that Count 2 claims that FAS is holding funds from TSBC that are in reality the funds of EMS, as an example, the Court finds that Count 2 states a claim for relief, and denies FAS's motion with respect to Count 2.

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[4] Since EMS's argument is that the parties' conduct (as opposed to the language of the agreement) is what has made it a third party beneficiary, its argument does not contradict the language of the agreements that unequivocally recite that the only parties to the agreements are TSBC and FAS. However, interpreting the agreements to exclude any third party beneficiaries, including EMS, is the most common sense reading of the agreements and the specific language cited by EMS.

Count 4 is against FAS for negligence and breach of contract. It alleges that FAS allowed DBCS to be paid improperly, that FAS improperly monitored disbursements of funds to DBCS, that FAS had a duty to ensure DBCS was only paid in accordance with the contracts, that FAS did not properly monitor progress of the project, as a result that the cost of the project increased, and that EMS has been damaged. As discussed above, although it appears that EMS is not a third party beneficiary to the contracts between TSBC and FAS, it is entitled to the opportunity to prove that it is. Therefore, to the extent these are contract claims, they cannot be dismissed, but rather should be disposed of consistent with, and by the same procedure set out for, the ruling on TSBC's motion.

To the extent the EMS claims sound in tort, the Court finds that FAS had no duty to EMS under the terms of the contracts. The Court also finds no other relationship between EMS and FAS that would support a finding of duty.

Furthermore, the injuries alleged are purely economic injuries between corporations in a commercial setting, and the Court has doubts that tort is the proper avenue for relief, as opposed to contract. See Laurens Electric Cooperative, Inc. v. Altec Industries, Inc., 889 F.2d 1323, 1325-26 (4th Cir. 1989))(applying South Carolina law)(holding that claim for economic loss between commercial entities with apparent equality

in ability to provide self-protection could not be supported under tort theories; conventional contract law defines the rights of the parties and provides the appropriate remedies); Utah International, Inc. v. Caterpillar Tractor Company, 108 N.M. 539, 540, 543, 775 P.2d 741, 742, 745 (Ct. App.) cert. denied 108 N.M. 354, 772 P.2d 884 (1989)(holding that economic loss claim in commercial setting when there is no large disparity in bargaining power cannot be recovered in action for strict products liability or negligence).[5] Accord AFM Corporation v. Southern Bell Telephone and Telegraph Company, 515 So.2d 180, 181-82 (Fl. 1987)(In an action concerning the purchase of services, "[W]e conclude that without some conduct resulting in personal injury or property damage, there can be no independent tort flowing from a contractual breach which would justify a tort claim solely for

[5] "We so hold in order to allow commercial parties to freely contract and allocate the risk of defective products as they wish. The buyer may bargain for additional warranties from the seller and pay a higher price, or may forego warranty protection entirely in order to obtain a lower purchase price. Insurance against economic loss is readily available to the party who wishes to acquire it, and in a commercial setting we believe insurance provides adequate protection to the party who suffers a loss from injury of a product to itself." Utah International, Inc. v. Caterpillar Tractor Company, 108 N.M. at 542, 775 P.2d at 744. Consistent with this analysis, the Court of Appeals cited to East River S.S. Corp. v. Transamerica Delaval, Inc., 476 U.S. 858, 870 (1986), in which the Supreme Court held that a purely economic commercial loss (defined as no damage to another person or property) "is essentially the failure of the purchaser to receive the benefit of its bargain – traditionally the core concern of contract law."

economic losses."); Francis v. Lee Enterprises, Inc., 89 Hawai'i 234, 244, 971 P.2d 707, 717 (1999)("We. . .hold that Hawai'i law will not allow a recovery in tort, including a recovery of punitive damages, in the absence of conduct that (1) violates a duty that is independently recognized by principles of tort law and (2) transcends the breach of the contract.")[6]; Skouras v. Brut Productions, Inc., 45 A.D.2d 646, 647, 360 N.Y.S.2d 811, 813 (1974)("As a general rule, a breach of contract does not give rise to a tort action.").

Therefore, the negligence portion of Count 4 should be dismissed.

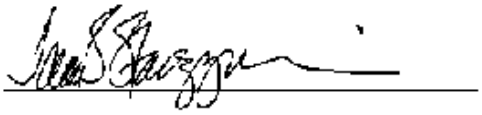
Conclusion

Based on South Carolina law, EMS cannot be considered a third-party beneficiary of either the Construction Management Agreement or Disbursement Services Agreement, and therefore the TSBC motion would have to be denied on that basis. But based on New Mexico law, the Court cannot rule out the possibility that EMS is a third-party beneficiary of either or both of the two agreements. Therefore the Court will enter an order requiring EMS to elect whether it will continue to pursue third-party

[6] "Even [sic] Justice Holmes recognized, over 100 years ago, that breaching a contract constitutes a morally neutral act, stating that '[t]he duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it – and nothing else.'" (Citation omitted.) Francis v. Lee Enterprises, Inc., 89 Hawai'i at 243, 971 P.2d at 716.

beneficiary status.[7] If it does, EMS will also be required to make a tender of evidence setting out the basis for the claim, including identifying documents and witnesses, summaries of what EMS anticipates each witness would say, and affidavits from available witnesses. Following the tender of evidence, EMS must then request a hearing on dealing with the tender.[8]

With respect to the motion to dismiss, the Court will enter an order granting the motion to dismiss the negligence claim of Count 4, reserving a ruling on the contract claim of Count 4, and denying the motion as to Count 2.



Honorable James S. Starzynski
United States Bankruptcy Judge

I hereby certify that, on the date stamped above, a true and correct copy of the foregoing was either electronically transmitted, faxed, delivered or mailed to the listed counsel and parties:

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[7] At the hearing conducted on April 5, 2000, EMS suggested that it might withdraw its claim to third party beneficiary status in order to resolve the arbitration controversy. The Court is now giving EMS the opportunity to do that if it wishes.

[8] In light of the facts that under South Carolina law (the choice of law recited by the agreements) EMS is not a third party beneficiary, and that even under New Mexico law EMS faces the difficult task of overcoming the explicit contrary language of the agreements, it does not seem unfair to require EMS to make an initial factual showing of its entitlement to make such a claim.

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