TRIAL TALK

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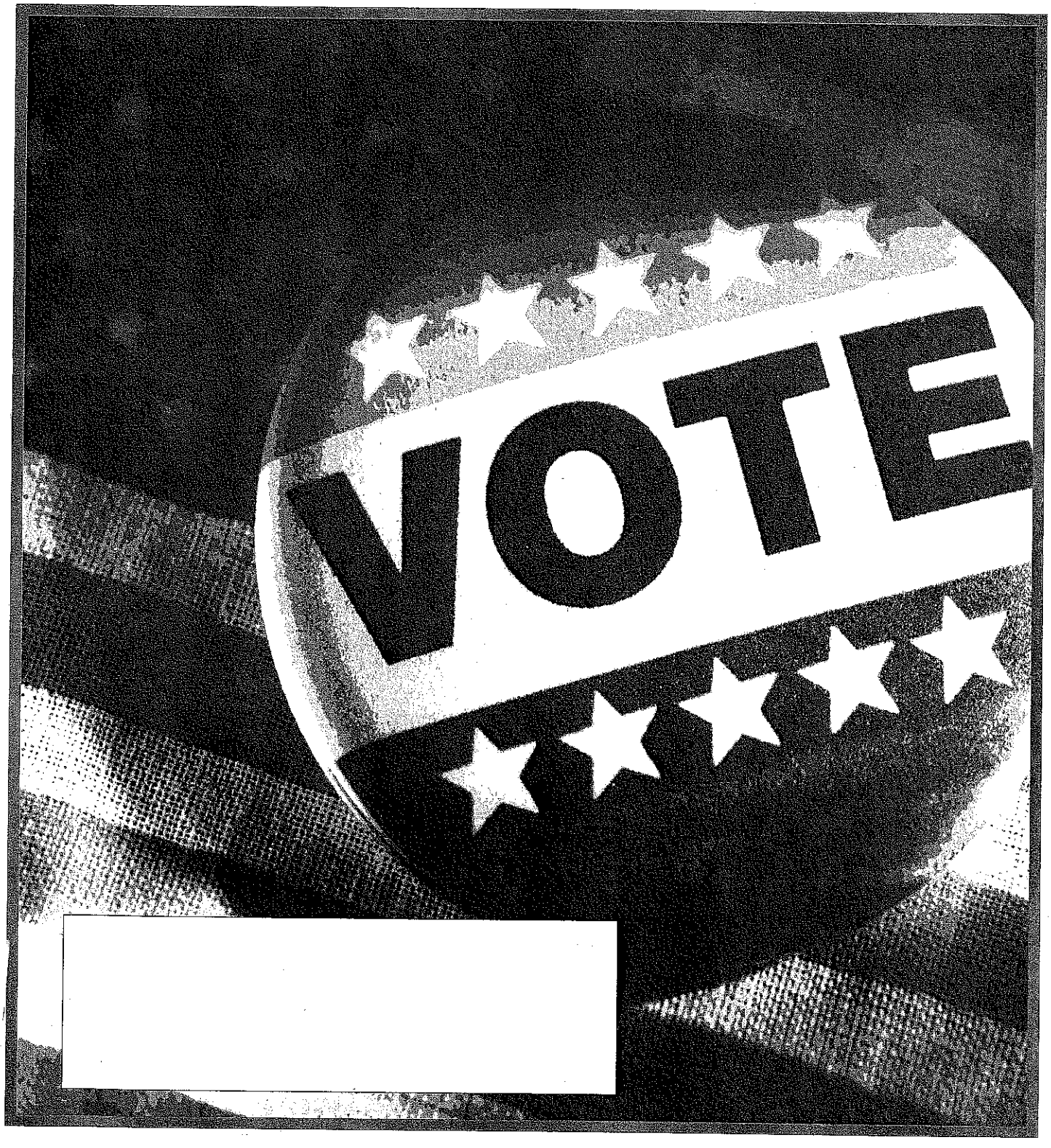

Unenforceability of Exculpatory Clauses and of the Economic Loss Doctrine in Cases Involving Intentional Tort

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Commercial litigators and tort litigators alike should be aware of the June 2008 decision in *Rhino Fund, LLLP v. Michael Hutchins*,[1] in which the Colorado Court of Appeals shed light on two important issues that can arise in cases involving claims of intentional torts. First, the court refused under the facts of that case to enforce a contractual limitation of liability that purported to exempt the defendant from liability for intentional misconduct. Second, the court made clear that the often-litigated and often-confused economic loss doctrine is not a defense to intentional tort claims. The decision is also noteworthy because it confirms the availability of claims for civil theft - and consequent treble damages - arising from commercial transactions.

A Loan Gone Bad

The defendant Michael Hutchins ran All Terrain Property Funds, LP, a startup investment fund designed to acquire nonperforming loans at a discount and to sell or collect them for a profit. All Terrain sought an investment from The Rhino Fund, LLLP ("Rhino"), a private investment management company. Rhino agreed to lend All Terrain $1.25 million for twelve months, with repayment of the loan secured by the proceeds All Terrain would collect during that time from six specific items of collateral. All Terrain assigned its rights to the proceeds from the collateral to Rhino and agreed to open an escrow account in which it would deposit the collateral proceeds as they were realized. The parties agreed that, at the end of the twelve months, Rhino would have the option of having its loan repaid or converting that loan into an equity investment in the All Terrain fund.

Rhino and All Terrain executed three related and overlapping documents describing the transaction: a Promissory Note for $1.25 million payable in twelve months, a Collateral Assignment of Net Proceeds Agreement establishing the collateral and the escrow account, and an Investor Agreement setting forth the terms of Rhino's option to convert its loan into a purchase of equity in the All Terrain fund.

All Terrain liquidated some of the six collateral assets in the year that followed, but did not deposit any of those proceeds into the escrow account. Indeed, All Terrain never even opened the escrow account. Instead, as All Terrain fell into financial distress due to its failure to attract equity investors, Hutchins directed that the collateral proceeds be spent instead of being placed into escrow. Some of the collateral proceeds, but not all, were spent in ways that directly benefited Hutchins, such as paying the salary he took as an employee of the All Terrain fund.

Rhino brought claims against the All Terrain fund and its related entities for breach of the Promissory Note and breach of the Collateral Assignment of Net Proceeds. The trial court granted summary judgment to Rhino on those contract claims. Rhino also sued Hutchins individually, inter alia, for conversion and for civil theft of the collateral proceeds that were supposed to be placed into escrow to secure repayment of Rhino's loan. After a trial to the court, Rhino obtained judgment against Hutchins for conversion and civil theft of the collateral proceeds. Pursuant to Colorado's civil theft statute[2], the civil theft award was trebled.

A Broad Exculpatory Clause Did Not Bar Rhino's Claims for Intentional Misconduct

On appeal, Hutchins' primary argument was that broad release language in Section 15 of the Investor Agreement barred Rhino's claims for conversion and civil theft. Section 15 stated:

> No present or future advisor, trustee, director, officer, partner, attorney, employee, shareholder or agent of [Rhino or All Terrain], or any partner in any of them shall have any personal liability, directly or indirectly, under or in connection with this Agreement or any agreement made or entered into in connection with this Agreement and [Rhino and All Terrain] and their successors and assigns hereby waive any and all such personal liability.

Hutchins argued that Section 15 barred Rhino from asserting claims for "any personal liability" against him "in connection with" the transaction, and that Rhino's claims for conversion and civil theft plainly arose "in connection with" the loan transaction. Hutchins

argued that Section 15 barred all claims against him, whether those claims sounded in mere negligence or instead sounded in intentional misconduct.

The court of appeals disagreed, finding that Section 15 violated public policy and was unenforceable to the extent it purported to bar Rhino from asserting claims for conversion and civil theft.[3] The tort of conversion is defined as any distinct, unauthorized act of dominion or ownership exercised by one person over personal property belonging to another. The statutory claim for civil theft is similar to conversion, but additionally requires proof of the wrongdoer's specific intent to permanently deprive the owner of its property.[4] Both claims fall into the category of intentional misconduct, rather than negligent misconduct.

The court explained that although Colorado as a general rule will uphold exculpatory clauses in a contract between sophisticated parties, no Colorado case has enforced an exculpatory clause that would permit a party to be completely absolved of its intentional, fraudulent or reckless acts. The court cited Restatement (Second) of Contracts §195, which succinctly states that "[a] term exempting a party from liability for harm caused intentionally or recklessly is unenforceable on grounds of public policy."[5] Although no Colorado decision had expressly adopted Restatement § 195, prior Colorado cases had reached the same conclusion as the Restatement by suggesting that Colorado would not enforce a purported release of liability for future intentional harm.[6]

Notably, the court did not make a blanket pronouncement that a contractual release of liability for intentional misconduct could **never** be enforced. On the contrary, it concluded that "on the particular facts presented,"[7] Section 15 of the Investor Agreement was unenforceable to the extent it purported to exempt Hutchins from liability for conversion and civil theft. Nevertheless, the particular facts presented may be the type that would likewise arise in other cases presenting intentional torts in a commercial context.

Intentional Tort Claims Are Not Barred by the Economic Loss Rule

The economic loss rule provides that tort claims may not be based on duties that are imposed solely by contract. The economic loss rule does not apply where the defendant owes the plaintiff a duty of care that is independent of any contractual duty. The definition and application of the economic loss rule have been defined largely, but not entirely, by claims for negligence arising in the construction industry.[8]

Defendants in contract and commercial cases often assert the economic loss rule as a defense to any tort claim arising out of a relationship that was initially created by contract. Hutchins did exactly that, asserting that Rhino's tort claims arose out of the three-contract relationship under which Rhino made its loan to All Terrain and thus were barred by the economic loss rule.

The court rejected Hutchins' argument on several grounds. First, Hutchins had a separate and independent duty in tort not to convert Rhino's funds and a separate legislatively-imposed duty to avoid civil theft. Thus the economic loss rule does not bar claims for the intentional torts of conversion and civil theft.

Second, the economic loss rule is designed to prevent tort claims where the parties' contract provides remedies for the allegedly improper conduct. The agreements between Rhino and All Terrain, however, did not address Rhino's remedies in the event the collateral was diverted. As a result, the economic loss rule did not bar tort claims that would provide remedies for that diversion.

Finally, the contracts at issue were between Rhino and All Terrain. Rhino had no contractual remedy **against Hutchins** for his conversion and civil theft of the collateral proceeds because Hutchins was not a party to the contracts. Again, therefore, the economic loss rule was inapplicable.

The Moral of the Story

One could argue that in recent years the economic loss rule has been routinely asserted as a defense in many cases where it does not apply. It is equally true, however, that tort claims are routinely asserted in garden variety contract disputes where they do not belong. The *Rhino Fund* case presented some extreme facts: an escrow commitment that was evaded, the diversion of collateral specifically designated to secure repayment of a loan, use of the collateral proceeds in part to enrich the defendant, and in general the conscious circumvention of a well-defined security agreement to the plaintiff's direct injury. In such stark fact situations, responsible parties cannot hide behind contractual relationships, or behind contractual limitations of liability, to avoid tort liability, including the treble liability imposed by Colorado's civil theft statute.

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1 *Rhino Fund, LLLP v. Hutchins*, P.3d, 2008 WL 2522308, Colo. App., June 26, 2008 (NO. 06CA1172).

2 C.R.S. § 18-4-401.

3 *Rhino* at *3.

4 *Itin v. Ungar*, 17 P.3d 129, 135 n.10 (Colo. 2000); 17 P.3d 129 (Colo. 2000); *Glenn Arms Assoc. v. Century Mortgage & Inv. Corp.*, 680 P.2d 1315 (Colo. App. 1984).

5 *Rhino* at *2.

6 *B&B Livery, Inc. v. Riehl*, 960 P.2d 134, 135 (Colo. 1998); *Heil Valley Ranch, Inc. v. Simkin*, 784 P.2d 781, 783 (Colo. 1989).

7 *Rhino* at *5.

8 *See, e.g., BRW, Inc. v. Dufficy & Sons, Inc.*, 99 P.3d 66, 74 (Colo. 2004); *Town of Alma v. AZCO Const. Inc.*, 10 P.3d 1256 (Colo. 2000); *Town of Alma v. AZCO Const. Inc.*, 10 P.3d 1256 (Colo. 2000).