March 2013

From the Colorado Bar Association Business Law Section

Two Important Cases—Colorado Trust Fund Statute and Forum Selection Clauses for Securities Claims

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On Feb. 4, the Colorado Supreme Court issued two important decisions for business lawyers. One addresses the impact of the Colorado Trust Fund Statute on the personal liability of an LLC manager, and the other upholds a forum selection clause requiring litigation to be brought in Texas even though the claims are under the Colorado Securities Act.

***Yale v. AC Excavating, Inc.*, No. 10SC709 2013 CO 10 (Feb. 4, 2013)**

In AC Excavating, Inc., the Court of Appeals held Donald Yale, a 44 percent owner of a limited liability company ("Antelope"), liable to an excavation contractor that had provided services to a real estate development. In doing so, the Court of Appeals applied the Colorado Trust Fund Statute ("CTFS," found at C.R.S. § 38-22-127), which provides that any funds disbursed to a contractor must be held in trust for payment to subcontractors, laborers, or material suppliers who could place a lien on the property. Antelope had entered into an excavating contract with AC Excavating and paid AC Excavating $150,000 of the $190,680.30 AC Excavating had charged for its services. AC Excavating then performed additional work for which it charged (but did not receive) $7,707.50.

Mr. Yale was not manager of the LLC at that time, but soon replaced the former sole manager. Upon becoming manger, Mr. Yale realized there was $100,000 in Antelope's bank account yet Antelope owed unpaid invoices exceeding $250,000, including the amount due to AC Excavating. In an effort to save the project, Mr. Yale loaned Antelope $157,500 of his own money and, as manager, applied the proceeds to general business expenses and some of the outstanding subcontractor invoices. While some of the money went to AC Excavating, the company was not paid in full. The Supreme Court noted that "the record establishes that Yale's general practice over the years in lending money to the LLC was to finance general operations, not specific construction work," and Mr. Yale's advancement of the $157,500 was consistent with his prior practice of making loans to Antelope for its general business purposes.

AC Excavating sued Mr. Yale for violation of the CTFS, alleging that Mr. Yale had diverted funds from Antelope to repay himself (on Antelope's loan obligations to him) and to make other non-CTFS expenditures. The trial court dismissed the action after finding the CFTS inapplicable because the funds were not disbursed on a construction project, but rather were a "survival loan" to capitalize the company. A panel of the Colorado Court of Appeals reversed, holding that Mr. Yale's loans to the LLC were disbursed on a construction project and should have been held in trust pursuant to the CTFS.

The Colorado Supreme Court reversed the Court of Appeals, holding the funds Mr. Yale had deposited into the LLC's bank account "were not trust funds under section 38-22-127(1) because, under the circumstances of this case, Yale's voluntary injection of his own money as a "survival loan" to the LLC did not constitute "funds disbursed to any contractor ... on [a] construction project." The Supreme Court noted that a holding to the contrary would discourage developers from trying to save their companies with financial injections. Notably, the Supreme Court carefully limited its holding to "the circumstances of this case." Attorneys should be aware there may be other cases where the managers of an LLC may find themselves liable under the CTFS for failing to hold money in trust for disbursement with respect to construction projects.

***Cagle v. Mathers Family Trust*, No. 11SC496 2013 CO 7 (Feb. 4, 2013)**

This is another in the long line of cases involving joint venture interests in oil and gas drilling programs issued by HEI Resources, Inc. (some of which I have discussed previously in September 2012 and May 2012.) HEI was incorporated in Texas and is based in Colorado. In this case, plaintiffs from California, Illinois, and Vermont had entered into joint venture agreements with HEI for ventures in Alabama, Mississippi, and Texas. The agreements provided that any disputes would be resolved in Dallas, Texas, in accordance with Texas law.

Apparently concerned about whether Texas law would treat the joint venture interests as securities, the plaintiffs brought legal action against HEI and a number of other defendants in Colorado under the Colorado Securities Act, §§ 11-51-101, *et seq*., as well as the securities acts of California, Illinois and Vermont. (The complaint included other common law claims, as well, such as fraud, misrepresentation, concealment, negligence, and breach of fiduciary duties by the defendants.) HEI and the other defendants filed motions to dismiss on the grounds the plaintiffs' lawsuit breached the forum selection clause in the joint venture agreement; the trial court granted the defendants' motions. On appeal, a panel of the Colorado Court of Appeals reversed, holding the "anti-waiver" provision of the Colorado Securities Act (found at § 11-51-604(11)) voids any private agreements that waive compliance with the Colorado Securities Act.

In a long discussion, the Colorado Supreme Court (without dissent) found the anti-waiver provision was not applicable in this case and that the Colorado Securities Act does not require claims under the Colorado Securities Act be brought in Colorado. Instead, the Court held the anti-waiver clause applied to substantive rights under the Colorado Securities Act and not to procedural rights. In analyzing the validity of forum selection clauses, the Colorado Supreme Court discussed *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 482-483 (1989) in which the U.S. Supreme Court reasoned arbitration clauses were "in effect, a specialized kind of forum-selection clause" and held they should not be prohibited under the similar provision in Section 14 of the Securities Act of 1933 because "arbitration clauses did not undermine a substantive right under the Securities Act and parties did not waive compliance with the Securities Act by agreeing to an arbitration clause."

Specifically addressing the validity of the forum selection clause, the Colorado Supreme Court discussed 14D Wright & Miller, *Federal Practice & Procedure*§ 3803.1 (citing the "substantial number" of cases holding that a forum selection clause is presumed valid) and Restatement (Second) of Conflict of Laws § 80. The Colorado Supreme Court also cited *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 10 (1972) in which the U.S. Supreme Court stated forum selection "clauses are prima facie valid and should be enforced unless enforcement is shown by the resisting party to be 'unreasonable'' under the circumstances." The U.S. Supreme Court's conclusion was consistent with what the Colorado Supreme Court described as the prevailing trend in the law to honor the parties' choice of forum unless that choice was unfair or unreasonable. The Colorado Supreme Court built on the Bremen Court's conclusion that a forum selection clause is presumptively valid unless the party seeking to void the clause shows:

1. The clause was unreasonable and unjust;
2. The clause was the product of fraud or overreaching; or
3. Enforcement of the clause would contravene a strong public policy of the forum in which suit is brought.

The Colorado Supreme Court accordingly reversed the Court of Appeals and ordered the Court of Appeals to return the case to the district court to reinstate its order granting the motion to dismiss.