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What's Inside

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<u>*EMPLOYMENT AGREEMENTS*</u>

Court upholds provision shortening statute of limitations

by Michael Futterman and
Jaime Touchstone

Can a bankrupt corporation collect money from its executives? The trustee of a bankrupt corporation filed suit against its executives for corporate malfeasance. The executives asked the court to dismiss the lawsuit, claiming they didn't receive timely written notice of the trustee's claim as required by their employment agreements. The California Court of Appeal agreed with the executives, holding that because neither the company nor the trustee properly notified them within one year of discovering the claim, the lawsuit was time-barred.

Bankruptcy trustee files suit against execs

e4L, Inc., was a direct marketing company that promoted products via television, radio, and the Internet. Stephen Lehman was e4L's chairman/CEO, and Eric Weiss was its vice chairman/COO. In March 2001, e4L filed for bankruptcy, and in November 2002, a bankruptcy trustee was appointed.

In December 2005, the trustee sued Lehman and Weiss for breach of fiduciary duty, alleging they controlled and dominated e4L and operated it for their own personal benefit by issuing misleading press releases and causing or allowing the company to engage in improper billing procedures that artificially inflated its earnings and net worth. The trustee charged that the executives concealed those wrongful acts and omissions.

Lehman and Weiss asked the court to dismiss the case on the grounds that the claim was time-barred. Specifically, their employment contracts included provisions stating that if an executive or e4L had "any claim" against the other, the claiming party had to present the claim in writing to the other party within one year of the date the claiming party knew or should have known about the facts leading to the claim. Failure to provide timely written notice would bar the claim. The executives asserted they didn't receive written notice from e4L or the trustee of a potential claim against them for breach of fiduciary duty until the lawsuit was filed and that the notice was untimely. The trial court agreed and dismissed the case without a trial. The trustee appealed.

Parties can agree to shorter statute of limitations

The court of appeal observed that California law gives parties substantial freedom to modify the length of a statute of limitations. Courts will enforce an agreement to shorten the limitations period provided it is reasonable—i.e., it allows sufficient time for the effective pursuit of the claim and/or doesn't give one party an advantage over the other.

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For example, in home inspection contracts, which involve professionals or skilled experts, potential claims against an inspector may be difficult to detect because of the hidden nature of a home's mechanical and electrical systems. In that situation, for a shortened statute of limitations to be enforceable, the written agreement should provide that the claim accrues (i.e., the period of limitations begins to run) only when the aggrieved party discovers or should have discovered the problem. This is the "delayed discovery" rule.

In this case, the bankruptcy trustee argued that the one-year written notice provision in the employment agreements, which shortened California's four-year statute of limitations, was unreasonable and invalid. The court of appeal rejected that argument because the contract provision contained language adopting the delayed discovery rule. Specifically, the agreements required e4L and the executives to present claims in writing "within one year of the date the claiming party knew or should have known of the facts giving rise to the claim." Thus, the court concluded that the shortened statute of limitations was valid.

The bankruptcy trustee also argued that a one-year notice provision can't be included in an employment agreement as opposed to another type of contract. The executives countered that their employment agreements were negotiated with e4L's compensation committee and approved by the board of directors. An agreement requiring the parties to file a timely statement of claims helps ensure prompt settlement and prevent the secret accumulation of claims. It doesn't violate public policy, and thus, there is no reason it can't be included in an employment agreement.

Execs not properly notified of claim

The trustee claimed that contrary to the executives' assertion, e4L provided them with timely notice of the breach of fiduciary duty claim. The court rejected that assertion. When the trustee was appointed in November 2002 and discovered the facts and circumstances surrounding the executives' alleged breach of fiduciary duty, she had one year to notify the executives in writing of e4L's claim. Unfortunately for the bankruptcy estate, the trustee never gave proper notice to the executives, who learned of the claim three years later when the trustee filed her lawsuit.

The trustee argued that the one-year notice provision shouldn't apply to her because she didn't learn about the provision until she reviewed e4L's corporate records and located the employment agreements. The court of appeal found that argument unpersuasive. First, the law doesn't excuse ignorance of a contractual limitations period. Second, the trustee didn't attempt to obtain e4L's corporate records until 2005. Given that delay, her ignorance was a poor excuse for failing to comply with the notice provision. The trustee "stands in the shoes of the debtor" and is therefore bound by the contractual notice period to the same extent as e4L.

Therefore, the employment agreements required the trustee to give written notice to the executives that e4L had a breach of fiduciary duty claim against them within one year after she discovered or should have discovered the facts giving rise to the claim. Because she failed to do so, her lawsuit against the executives was "waived and forever barred." *Zamora v. Lehman* (California Court of Appeal, Second Appellate District, 3/7/13).

Bottom line

It's common for employers to negotiate detailed written employment agreements with their top executives. California courts are likely to uphold

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those agreements provided the employer is represented by counsel and its decisions are approved by disinterested directors. Courts also are more likely to uphold clauses like this shortened statute of limitations clause if they are mutual—i.e., the benefits and burdens apply to both parties.

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