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Litigation Update

Arbitration Covenant Upheld

The Supreme Court of Puerto Rico has recently evidenced again its support for contractual arbitration covenants. In doing so, it has underscored that litigants are not free to circumvent those covenants by initiating judicial proceedings against the directors of a corporation rather than against the corporation who executed with plaintiff the contract containing the arbitration clause.

In Rivera Sanfeliz, et. al. v. Junta de Directores de First Bank Corporate, et. al., 193 DPR ____ (2015), an employee dismissed from a bank in the Island initiated a law suit for wrongful termination. The written employment contract of this employee contained an arbitration clause, submitting to that alternative dispute resolution method any controversy arising under the contract. The contract detailed the conditions under which the employee could be dismissed from employment.

Eventually the bank dismissed the employee. The same initiated an action in court. The defendant raised the arbitration clause as a jurisdictional argument. The court dismissed the case on that basis but prior to said dismissal the employee filed a separate action (which included members of his family as additional plaintiffs), against the members of the Board of Directors of the financial institution.

This new complaint alleged that the members of the Board of Directors had been negligent in the discharge of their duties as such. Plaintiff claimed that the directors did not adequately prevent the improper dismissal of plaintiff. The other members of plaintiff's family claimed on account of their emotional damages arising from the dismissal. Again, the basis for all liability was alleged to be the negligence of the directors which according to the complaint made them jointly liable with the bank for the damages caused.

Defendants alleged that the financial institution was an indispensable party without which the case could not be heard. They also alleged that plaintiffs lacked standing to bring an action for the supposed failure of the directors to discharge their fiduciary duties towards the corporation.

The Court of First Instance dismissed the complaint deciding that only the shareholders of the institution were entitled to bring an action against the directors for failure of the latter to discharge their fiduciary duties. It also ruled that the financial institution was an indispensable party. Finally it decided that even with the financial institution as a party, the inability of plaintiffs to initiate what amounted to a derivative action, was fatal.

Plaintiff appealed to the Court of Appeals. Eventually, the Court of Appeals reversed the Court of First Instance holding that plaintiff should have been allowed



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to amend the complaint and bring in as a defendant the financial institution itself. With regards to the action against the directors, the Court of Appeals indicated that they could be held liable for gross negligence and that it was very early in the case to dismiss such an action.

The case came eventually before the Supreme Court of Puerto Rico. The court begins by restating fundamental corporate law principles such as the separate identity and personality of the corporation, its governance through directors and officers, and the role of shareholders as owners.

The court goes on to recognize that the directors have a fiduciary duty towards the corporation. They must always act in pursuant of the best interests of the same. A director must act within the parameters of his authority, it owes a duty of diligence and responsibility and a duty of loyalty to the corporation. The corporate's act itself indicates that only gross negligence in the discharge of the duties and responsibilities of a director would create liability. In essence, the business judgment rule applicable to these cases exempts from liability a director acts pursuant to any reasonable commercial justification.

But most importantly, the court indicates that this duty not to act with gross negligence does not create a responsibility *erga omnes*, that is before any person. The only entity that, if damaged, can claim against the director for breach of a fiduciary duty is the corporation itself, towards which the fiduciary duty flows.

The court recognizes that the derivative action exists precisely for the vindication of the rights of a corporation when the persons that should normally act on its behalf refuse to do so. It is essential for said action that the rights alleged and the remedy sought be claimed for the benefit of the corporation and not the benefit of any other party.

Based on the above, it is clear to the court that a non-shareholder has no standing to initiate a derivative action on behalf of the corporation. Since plaintiff in this case was not a shareholder, his actions against the corporation could not proceed.

In essence, the court understood the judicial action against the individual directors of the corporation to be a strategy to circumvent the arbitration covenant existing between the former employee and its corporate employer. The court showed itself unwilling to allow this kind of stratagem. Since the allegations were all based in the supposed breach of the employment contract, it was evident to the court that the action was one between the employee and its employer and subject to arbitration. The court reversed and ordered the case dismissed.

Well drafted arbitration clauses are favored and generally upheld by the courts. They should be considered at the beginning of many commercial undertakings.

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