

GRAY AND ASSOCIATES, LLC,
Trustee under the Litigation Trust established
pursuant to the Reorganization Plan of
Sunterra Corporation and the Related
Debtors, et al,

Plaintiffs

v.

ERNST & YOUNG LLP

Defendant

* IN THE
* CIRCUIT COURT
* FOR
* BALTIMORE CITY
* Part 20
* Case No.: 24-C-02-002963
*

MEMORANDUM AND OPINION

I. Statement of the Case

On January 30, 2003 this Court entered an Order granting a temporary stay of arbitration until it determined whether a valid and enforceable arbitration agreement had been made by the parties in May, 1998. The Court then permitted the parties limited discovery and conducted an evidentiary hearing for the three days of May 21-23, 2003. The Court has had the opportunity to consider the testimony offered during the evidentiary hearing, the 91 exhibits admitted into evidence at the hearing and the 23 depositions submitted by the parties in support of their respective positions. Both parties have filed trial briefs as well, and the Court heard argument from counsel for both parties for several hours on May 20, 2003, the eve of the hearing. The Court is prepared to rule on the cross motions for a stay pending arbitration and for a stay of arbitration.

II. The Standards of Proof

Plaintiff's¹ amended complaint alleges at paragraph 61 that "[O]n or about May 20, 1998, through gross abuse of its fiduciary duties and egregious fraud and deceit, Ernst & Young ("E&Y") wrongfully induced Sunterra to enter into an arbitration agreement for which there was no consideration." In its January 30, 2003 Memorandum and Opinion, the Court found that these allegations were sufficient to present a threshold issue for judicial determination and that issue is whether the parties entered into a valid agreement to arbitrate Sunterra's claims on May 21, 1998.

In situations where courts have been called upon to address this threshold issue of a valid arbitration agreement, the proponents of the arbitration agreement bear the burden of establishing the existence of a valid arbitration agreement by a preponderance of the evidence. Messersmith v. Barclay Townhouse Associates, 313 Md. 652, 664 (1988). In the present case, however, plaintiff has advanced two theories, the first of which would have the Court determine that the arbitration provisions in the May 21, 1998 agreement are unenforceable and the second of which would require the Court to rescind the arbitration provisions as having been obtained by constructive fraud.

The first theory is that the defendant E&Y made material misrepresentations to plaintiff and/or concealed material facts and thereby induced plaintiff to enter into the arbitration provisions by fraud. In order to establish fraud or deceit under Maryland law the plaintiff must show, by *clear and convincing evidence*: (1) that the defendant made a false representation to the

¹ Hereinafter plaintiff, plaintiff corporation and Sunterra will be used interchangeably. The Court recognizes, however, that the named plaintiff is the Litigation Trustee as listed in the caption of the case.

plaintiff, (2) that its falsity was either known to the defendant or that the representation was made with reckless indifference as to its truth, (3) that the misrepresentation was made for the purpose of defrauding the plaintiff, (4) that the plaintiff relied on the misrepresentation and had the right to rely on it, and (5) that the plaintiff suffered compensable injury resulting from the misrepresentation. Environmental Trust v. Gaynor, 370 Md. 89, 97 (2002) and cases cited therein (emphasis added).

Plaintiff's second theory is premised upon its allegation that E&Y's engagement partner, Gibbs Vandercook, was acting as Sunterra's Chief Information Officer in May of 1998 when the contract containing the arbitration provision was presented to Charles Frey for his signature. Plaintiff asserts that, as CIO, Vandercook had a fiduciary duty that required disclosure of all material facts in order to avoid a breach of trust. Consequently, Maryland law requires plaintiff to establish the existence of a confidential relationship between Vandercook and Sunterra Corporation and thereby to raise a presumption of constructive fraud which must be rebutted by E&Y's showing that the arbitration provisions of the contract were freely, fairly and voluntarily entered into by Sunterra. Frederick Rd. Ltd. Pshp. v. Brown & Sturm, 360 Md. 76, 100 (2000); Desser v. Woods, 266 Md. 696, 708-09 (1972). Implicit in these authorities is the concept that the plaintiff's initial burden of establishing the fiduciary relationship and the defendant's consequent burden of disproving the fraud are met by the normal civil preponderance standard.

III. The Pending Motions

Plaintiff has moved for a stay of arbitration and defendant has moved for a stay of this litigation to permit the arbitration provisions of the parties' agreement to proceed. Both

motions are grounded upon the Maryland Arbitration Act, codified at MD. CODE ANN., [CTS. & JUD. PROC.], §3-201, *et. seq.* §3-207 (c) provides, “[I]f the court determines that the agreement exists, it shall order arbitration.” §3-208 (c) provides, “[I]f the court determines that existence of the arbitration agreement is in substantial and bona fide dispute, it shall try this issue promptly and order a stay if it finds for the petitioner.”²

Finally, as noted in the Court’s Memorandum and Opinion of January 30, 2003, §3-206 of the Act states that “A written agreement to submit any existing controversy to arbitration or a provision in a written contract to submit to arbitration any controversy arising between the parties in the future is valid and enforceable, and is irrevocable, except upon grounds that exist at law or in equity for the revocation of the contract.” The Court shall now examine whether grounds exist at law or in equity for revocation of the arbitration agreement entered into between the parties on May 21, 1998.

IV. Discussion of the Evidence

In granting the temporary stay of arbitration on January 30, 2003, the Court relied in part on the decision of the Court of Appeals of Maryland in Holmes v. Coverall N. Am., Inc., 336 Md. 534, 544 (1994), where the Court of Appeals said: “The court must determine that there are no infirmities in the *formation* of the *arbitration agreement itself*; that is, that there is a mutual exchange of promises to arbitrate.” (Emphasis added). The contract between the parties here, executed on May 21, 1998 is in evidence as plaintiff’s exhibit 90. It contains an engagement letter dated May 20, 1998 addressed to Mr. Chuck Frey and signed by him the

² Pursuant to MD. CODE ANN., [CTS. & JUD. PROC.], §12-303 (3)(ix), an order of this Court granting a petition to stay arbitration pursuant to §3-208 is one of the enumerated interlocutory orders from which a party may note an immediate appeal.

following day. The Terms and Conditions of the agreement and the Dispute Resolution Procedures contained in Annex 1 are incorporated by reference into the letter of understanding. On its face, this constitutes a valid and enforceable agreement, which contains a limitation on E&Y's potential liability and an express provision requiring mediation/arbitration (subject to the procedures set forth in Annex 1). The Court must, therefore, determine whether there is a basis in law or equity to set aside the mediation/arbitration provision in this agreement, which for the purposes of this limited determination, is otherwise deemed to be a valid agreement.

At the conclusion of the three full days of hearing on this issue, the Court had been presented with literally hundreds of exhibits (not all entered into evidence) and countless deposition designations, to support the parties' respective positions. As a practical matter, the Court's calendar will not permit it to take the time to include all of the arguably relevant evidence in its discussion here. The best that can be done is simply a distillation of the salient evidence offered on the two theories presented by plaintiff in an effort to avoid arbitration.

The uncontested evidence demonstrates that Sunterra Corporation announced to the Wall Street investment community in September, 1997 its intention to implement "Club Sunterra" or a points-based time share system by the end of 1998. In December of that year, Sunterra entered into an agreement with RCC to purchase the source code to a beta version of the Premier software for approximately \$3.5 million. At the instigation of the company's chief operating officer (COO), James Noyes, E&Y was hired to assist the company in implementing its Club Sunterra initiative by testing and developing the Premier software for use in support of the new time share system. This engagement was known as the SWORD Project and began in January, 1998. Although the remaining facts may be more or less contested by the parties, it is

clear to the Court that the Club Sunterra initiative, including the SWORD Project, created substantial time pressures, once the announcement was made that the program would be implemented by year-end 1998. So intense were these time pressures that the company's new chief information officer (CIO), Chuck Lisinski, fell out of favor almost immediately when he projected that it would take three years and \$40 million to complete the SWORD Project. He was relieved of his responsibilities by the end of February, 1998.

Plaintiff contends that E&Y used the time pressure to its own advantage. Essentially, Sunterra asserts that the evidence establishes that Gibbs Vandercook seized control of the SWORD Project, quickly adding more and more E&Y personnel to the team and concealing from the executive management of the company the important details concerning the SWORD technology. Viewing the evidence from plaintiff's perspective, Vandercook was in the unique position to do this because the growth of the SWORD Project team occasioned its removal to a separate site at Lake Eleanor, Florida and the departure of Chuck Lisinski in February, 1998 placed Vandercook in the position of Acting CIO of the company with authority over the entire Information Technology Division of Sunterra. Although he reported on a regular basis to Sunterra's senior executives (Noyes, Frey, Giannoni, DePatie and Shoobridge), no record of these presentations is available and plaintiff contends that these were high level, non-technical presentations aimed at demonstrating that the SWORD Project was "on-time and within budget."

Sunterra insists that the evidence establishes that Vandercook knew that the Premier software was in no condition to support the operations at Cypress Pointe, the designated beta site, or to meet a roll-out schedule to other resorts in time for substantial implementation of the "Club Sunterra" program before the end of 1998. Sunterra contends that Vandercook and his

team made no effort to advise their company counterparts or the senior executives of the company about their concerns that the Premier software lacked important modules and contained innumerable bugs and that the milestones established for the beta site and the subsequent roll-out were unreasonable and unachievable.

It is in this context, with superior knowledge of the technological deficiencies in the Premier software and the SWORD Project team's inability to meet the planned implementation schedule, that Sunterra contends Vandercook presented Chuck Frey with the May 20, 1998 engagement letter, containing the mediation/arbitration provision in question here. The conclusion that plaintiff would have the Court reach is that Vandercook and E&Y fraudulently misrepresented or withheld material information from Sunterra in an effort to obtain a written agreement, containing limitations of liability³ and an arbitration clause, prior to the implementation at Cypress Pointe, which they knew would reveal the technical deficiencies in the Premier software and E&Y's failure on the SWORD Project.

The principal evidence offered in support of plaintiff's fraud theory includes a Quality Advisor Program report entered into evidence as defendant's exhibit 59A. This report was accompanied by an e-mail from the E&Y Quality Advisor, John Farrell, to Gibbs Vandercook dated April 9, 1998 (defendant's exhibit 59). Farrell included in his report, which was not afterwards shared with Sunterra's executives, that the "Project team in (sic) concerned about managing client's expectations in terms of timing and solution. The schedule has no slack and no room for the inevitable problems." When confronted with this statement at his pre-trial

³ The limitation of liability provision in the agreement is separate and distinct from the arbitration clause and, therefore, not directly relevant to the issue now before the Court.

deposition, Gibbs Vandercook testified that in April of 1998 he thought that the immediate initiative of the first roll-out, the beta site, had absolutely no room for slack for inevitable problems and that the more long-term schedule was absurd.⁴ He further testified that he did not recall sharing this specific information with the executives at Sunterra at that time. The QA report also indicates that “Gibbs has positioned himself a key advisor to the COO and is basically functioning as the CIO.” It urges that “the negotiation of the payment terms (especially the issue surrounding the ‘in-kind’ payment) for the next phase of work (\$2.9 million) must complete it quickly. Having this behind us will position us for additional work.” Plaintiff also introduced exhibit 44, an organizational chart of Signature Resorts, Inc. (now Sunterra Corporation) for its Information Services and Technology Division, dated May 2, 1998. The document clearly indicates that Gibbs Vandercook (E&Y) holds the position of Chief Information Officer.

In addition to this evidence, plaintiff presented testimony from Colin Drummond, who was recruited to the full-time position of CIO by Gibbs Vandercook in June, 1998. Drummond testified that, upon his arrival at Sunterra, he noted that the company employees serving on the SWORD Project team were intimidated and considered by Gibbs Vandercook to be inferior to the E&Y personnel. He further testified that it was very difficult to obtain information from Vandercook, whose position remained unchallenged due to his personal relationship with Jim Noyes, the COO. Drummond contended that the deliverables from the E&Y controlled SWORD Project team were poor but that it was too high a risk at that particular time to attempt to terminate E&Y from the project. Only after Noyes’ executive position was

⁴ He backed away from this testimony at trial, claiming that he could not then have known enough to think the subsequent roll-out schedule was absurd.

altered and Steve Miller became CEO was he able to obtain permission to de-emphasize E&Y's involvement in the project. Drummond further testified that the status reports provided by E&Y for the SWORD Project team failed to indicate the level of incompleteness or the bugs that remained in the software system, as later revealed by a September 30, 1998 E&Y document.

While other witnesses were called to support plaintiff's fraud theory, the primary focus of the evidence was upon the testimony of Chuck Frey, the senior executive who was a signatory to the May 21, 1998 engagement letter, containing the mediation/arbitration clause. Frey described a company which grew exponentially and quickly following the IPO in August of 1996. He described the computer systems available to Sunterra at its various resorts as "a mixed bag." When the company's Board decided to go forward to a points-based system and to create "Club Sunterra," he said that Jim Noyes assumed the responsibility to pull together a team to implement the program. He described this as "a major undertaking." Frey described the Master Affiliation Agreement negotiated with RCI and the contract with RCC to purchase the Premier software package. He testified that Premier was new and was purchased on an "as-is" basis because it had not been beta-tested and did not contain a club module. Sunterra was interested in evaluating the new software because it was on "such a tight time frame." He said, "But nobody at the time had an idea exactly what it was." According to Frey, it fell to Vandercook and E&Y to evaluate the Premier software and prepare it for implementation. He described the Steering Committee meetings of Sunterra senior executives as high-level meetings during which Jim Noyes placed a major focus on obtaining up-dates and making "sure that his senior management team" was supporting Gibbs in anything that he needed. The inference to be drawn from his testimony is that the E&Y personnel dominated the SWORD Project team and that, although he

had reservations about the fees and rates being charged by Vandercook and E&Y, he was compelled to sign the engagement letter on May 21, 1998 at the instruction of his superior, Jim Noyes. Critically, Frey testified that Vandercook never advised him, prior to May 21, 1998, that the schedule had no slack and no room for inevitable problems and that the roll-out schedule beyond the beta site was absurd. He said that he would not have signed the contract if he had been aware of those facts but they did not come to light until the beta site test at Cypress Pointe at the end of June, 1998.

In the Court's judgment, plaintiff's evidence is insufficient to meet the clear and convincing standard of proof for fraud. In the final analysis, the material facts which plaintiff contends were either misrepresented or concealed here are the incompleteness of the Premier software in May, 1998, its unreadiness for beta site testing at Cypress Pointe in June, 1998 and its inability to support a roll-out at other scheduled resorts throughout the remainder of calendar year 1998. While these facts may meet the test for materiality established under Maryland law, *see, e.g., Gross v. Sussex*, 332 Md. 247, 258 (1993), the Court does not believe that the evidence is sufficient to establish that they were misrepresented to or concealed from the plaintiff. What the evidence does show is that the "Club Sunterra" and SWORD Project were deadline driven from the time that the company made its Wall Street announcement in September, 1997 for implementation by the end of calendar year 1998. According to the testimony of Chuck Frey, the company did not have the personnel to evaluate and implement the Premier software. E&Y and Gibbs Vandercook were brought on board to undertake that engagement as a part of a SWORD Project team which included Sunterra personnel in significant numbers and at significant positions throughout the duration of the project. Monthly status reports were provided by Sandy

Worthing of E&Y for the SWORD Project team and presented by Gibbs Vandercook to Sunterra's senior executive management team at Steering Committee meetings. It was the leaders of the plaintiff corporation, Jim Noyes, Chuck Frey and Gigi Giannoni, who orchestrated the dismissal of the CIO, Chuck Lisinski, and replaced him with Gibbs Vandercook. By Frey's own admission, the Premier software was an unknown quantity. If Sunterra's senior executive management team elected to delegate the technological aspects of its critical new SWORD Project to Gibbs Vandercook and his E&Y colleagues, while maintaining a "big picture" focus themselves, that evidence is insufficient to establish fraud on the part of the defendant. This is particularly true, when the evidence of fraud in the inducement of the arbitration provision is examined closely.

There is simply no evidence that the plaintiff's fraud theory is related specifically to the mediation/arbitration clause in the May 21, 1998 agreement, as distinguished from the other terms and conditions incorporated in that so-called "letter of understanding." A draft of the agreement, containing the same arbitration clause was provided to Chuck Frey in March, 1998 (defendant's exhibit 18). His hesitation about formalizing the agreement with E&Y related to what he thought were excessive rates, fees and expenses. Some delay in formalizing the agreement may be attributed to Sunterra's initiative to have E&Y accept time share arrangements as partial compensation for its services. When Chuck Frey was asked, however, whether he was aware of the alternative dispute resolution provisions in the May, 1998 agreement, he admitted that he was and that he had read it and that the provisions seemed to be of no consequence to him at that time. Even assuming that material facts were misrepresented or concealed from Frey and Sunterra by Vandercook, the evidence does not support a particularized purpose to obtain

Sunterra's agreement to submit future claims to arbitration.

In fact, the evidence demonstrated that Sunterra, during the relevant 1998 time period, had in-house counsel by the name of Scott Podvin, whose office was located near that of Chuck Frey at the Metro West office site. Although Frey testified that he didn't recall discussing the contract with Scott Podvin, he admitted he had regular access to him between March 30 and May 21, 1998. He explained, however, that this was Jim Noyes'⁵ contract to negotiate. The evidence further showed that Frey and Noyes may have had some discussions about the economic terms of the E&Y contract but there is no suggestion that either of them was confused or surprised by the arbitration clause.

This was neither the first nor the last agreement, executed by Sunterra Corporation with E&Y, containing an alternative dispute resolution provision. Chuck Frey testified that the company had entered into a 1996 contract with E&Y with a similar clause and the evidence indicates that Sunterra entered into a 1999 agreement with Vandercook and the E&Y engagement team and that agreement contained an identical mediation/arbitration agreement to the one at issue here.

There is no evidence that the plaintiff paid particular attention to the mediation/arbitration provision in the May, 1998 agreement or to any other term or condition of the agreement prior to the initiation of this lawsuit in May of 2002. Sunterra never sought to terminate its agreement with E&Y, as permitted under the terms of the contract. It never made

⁵ At deposition, Noyes denied that there was fraud committed in connection with E&Y's 1998 agreement. Hearing Transcript, p. 123. (Hearing 05/21/03).

any demand upon E&Y to “cure” deficiencies⁶ in the Premier software, as permitted under the terms of the contract. It raised no objection to the identical mediation/arbitration provision in the 1999 agreement with E&Y. Even if Sunterra believed that it would be “suicide” to terminate abruptly its relationship with E&Y before it was in a position to assume responsibility for the SWORD Project, the evidence fails to support that any discussion was ever undertaken to relieve the company of the arbitration provisions again contained in the 1999 agreement with E&Y. As defendant repeatedly asserted, plaintiff never sought to rescind or revoke any of the terms of the 1998 agreement prior to filing suit in this case. To the contrary, E&Y was fully paid for its services and retained by Sunterra for continued work on the SWORD Project under the 1999 agreement. The Court does not have to find, under Maryland law, that these facts establish waiver or ratification because it is patently obvious that the evidence cannot establish that the arbitration provisions in the 1998 agreement were fraudulently procured. In fact, what the evidence showed is that the parties have a dispute about the value of the services performed by E&Y under the 1998 agreement and this they are entitled to address in arbitration. During three full days of evidentiary hearing, however, there was almost no discussion as to how the arbitration provision in the 1998 agreement was obtained, other than that it is a part of a contract with which Sunterra is no longer satisfied. There is no direct evidence that the parties ever even gave independent thought to the arbitration provision, as opposed to any of the other terms or conditions of the 1998 agreement.

As to plaintiff’s second theory concerning constructive fraud and rescission of the

⁶ The agreement provided for reperformance of services which breached E&Y’s warranty of professional care and competence, upon 90 days written notice.

1998 contract, the Court finds that the plaintiff was able to establish that Gibbs Vandercook, E&Y's engagement partner on the SWORD Project, did assume the position of acting CIO at Sunterra from sometime in February, 1998 until Colin Drummond came on board in June, 1998. In that capacity, he may have had conflicting loyalties but, under Maryland law, the Court believes that he assumed a confidential relationship with plaintiff corporation. The difficulty with plaintiff's second theory, however, is that the same evidence addressed above which fails to prove by clear and convincing evidence that the *arbitration provision* was fraudulently obtained serves to meet defendant's burden of proof that the agreement to arbitrate was reached voluntarily and knowingly by Sunterra. There is simply no reasonable inference or conclusion to be drawn to the contrary.

The parties were sophisticated business entities contracting on equal footing with respect to their rights and responsibilities. The fact that Sunterra urged E&Y to participate in the Club Sunterra points program on behalf of its employees (negotiations which apparently delayed execution of the written agreement) evidences arms-length bargaining between a public company and one of the world's largest public accounting firms. Under such circumstances the courts have been reluctant to impose any disclosure requirements not contained in the agreement itself. See Martin Marietta Corp. v. International Telecommunications Satellite Org., 991 F.2d 94, 98 (4th Cir. 1992).

The confidential relationship created by Vandercook's service as Sunterra's acting CIO is not the type of situation which generally gives rise to tort duties of due care without evidence to establish that plaintiff corporation was "a peculiarly vulnerable party." *Id.*, 991 F.2d at 98. Most importantly, there is no record basis to connect any arguable violation of E&Y's

fiduciary duties to a particularized effort to obtain an arbitration agreement from plaintiff. Thus, Sunterra's second theory that the arbitration agreement should be rescinded due to constructive fraud fails as well.

The Court's determination that plaintiff has failed to establish that the mediation/arbitration provision in the May, 1998 agreement was obtained by fraud is not intended to dispose of any other claims plaintiff may have against defendant, if the dispute reaches arbitration. On January 30, 2003 this Court determined that plaintiff's allegations, as contained in the amended complaint, raised a substantial and bona fide dispute about the validity of the arbitration provision in the 1998 agreement, compelling the Court's threshold determination of arbitrability. Quoting Judge Calabresi in Garten v. Kurth, 265 F.3d 136 (2d Cir. 2001), the Court noted that it would be plaintiff's burden to establish a substantial relationship between the alleged fraud and the arbitration clause in particular, something more than a mere claim that the arbitration clause was an element of the scheme to defraud but, particularized facts specific to the arbitration clause indicating how it was used to effect the scheme to defraud. The evidence elicited during the three day evidentiary hearing failed to establish by a preponderance of the evidence or clear and convincing evidence the particularized facts specific to the arbitration clause which would satisfy this Court that that provision was fraudulently obtained. The Court is compelled to find, therefore, that the mediation/arbitration provision in the May 21, 1998 agreement is valid and enforceable. Accordingly, plaintiff's remaining contentions must

be resolved through those mediation/arbitration procedures.

ALBERT J. MATRICCIANI, JR.
Judge
June 11, 2003

cc: Arnold M. Weiner, Esquire
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