Rights and Obligations of Nonsignatories in Arbitration: Part II

Judge Abraham J. Gafni (Ret.)

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Generally, a party that has not consented to arbitration may not be forced to submit to it.

However, as Part I of this article reflected, circumstances may arise under which a party that has signed an agreement to arbitrate may compel a nonsignatory to resolve their dispute through arbitration. As was indicated at that time, the circumstances under which an arbitration agreement may be imposed upon a nonsignatory include:

• When the nonsignatory has incorporated by reference the arbitration provisions into a second contract.

• When there is clear evidence of the intent to bind the nonsignatory agent as well.

• When the nonsignatory is the alter ego of the signing party and/or exercises control over it.

• When the nonsignatory is estopped from objecting to the arbitration by reason of having received a direct benefit from the transaction.

• When the nonsignatory is a third-party beneficiary to the agreement.

But what about the flip side of this situation? What if it is the nonsignatory who is seeking to enforce a contractual obligation to arbitrate upon one who has signed the agreement? Under what circumstances will a court be similarly prepared to compel arbitration upon the request of a party who was not a signatory to that agreement?

A case from the U.S. District Court for the Eastern District of New York, *Moss v. BMO Harris Bank*, 24 F. Supp. 3rd 281(E.D. N.Y. 2014), reflected the bases upon which nonsignatories might require submission to an arbitration agreement by its signatories.

This class action arose out of five payday loans received by borrowers from various lenders. These loans bore very high interest rates that are illegal in some states. The borrowers' action involved Racketeer Influenced and Corrupt Organizations Act claims arising out of such allegedly unlawful loans. The defendant banks in this class action (which were not the lenders) were to facilitate these loans, including electronic fund transfers from the borrowers' bank accounts; moreover, they were allegedly able to charge higher fees because of the "risks inherent in online payday lending."

The loan agreements contained an arbitration provision for the resolution of any disputes relating to these loans. They additionally provided that the borrowers must arbitrate "not only with the lenders, but also with the lenders' 'agents' and 'servicers.'" Moreover, although the banks were not signatories, their anticipated involvement in electronic bank transfers is fully reflected in the loan agreements.

The borrowers elected not to sue the lenders but only the banks that facilitated the bank transfers connected with the loans. The banks opposed court litigation. They contended that the class action should be arbitrated, as they were "agents" and "servicers" within the meaning of the arbitration provisions, and, therefore, the borrowers should be estopped from resorting to litigation and be required to submit to arbitration pursuant to the agreement. The borrowers disagreed, contending that the loan documents did not put them on notice that they were agreeing to arbitrate with the banks as well as the lenders.

There are, of course, circumstances where the arbitration agreement itself specifically contemplates that the nonsignatory may be entitled to compel arbitration. For example, in *Sherer v. Green Tree Servicing LLC*, 548 F.3d 379 (5th Cir. 2008), a party to an arbitration agreement had agreed to arbitrate any claim from the "relationships, [which] result from th[e] agreement." The court there found that such a relationship existed between a loan servicing company (a nonsignatory) and the party who was the lender.

Here, in *Moss*, the court similarly noted (as have courts in numerous other jurisdictions) that in accordance with the strong federal policy in favor of arbitration, many courts have allowed nonsignatories to compel arbitration under a doctrine of estoppel, particularly where the nonsignatory was explicitly and implicitly mentioned in the agreement.

But even in the absence of such specific reference, the court recognized that district courts in the Second Circuit (based upon rulings of their court of appeals) have formulated a two-part test (which has been replicated in other jurisdictions in comparable formulations) "under which they examine whether: (1) the signatory's claims arise under the subject matter of the underlying agreement, and (2) whether there is a close relationship between the signatory and the nonsignatory party."

In this case, the court rejected the plaintiffs' argument that the causes of action did not arise under the loan agreements. It was apparent that the claims against the banks required a finding that the loan agreements were invalid, and that the goal of the alleged conspiracy of the defendant banks "is directly related to the agreements; otherwise defendants would have had no loans to facilitate." Otherwise stated, the entire case against the banks depended on the contents of the loan agreements and whether their terms were unlawful.

The court recognized, however, that the primary dispute between the parties arose under the second prong to the equitable estoppel test, i.e., how close is the relationship between the signatory and the nonsignatory seeking arbitration.

The court emphasized that this inquiry will always be fact-specific, requiring a showing that there is "a relationship among the parties which either supports the conclusion that [the signatory] had consented to extend its agreement to the [nonsignatory], or, otherwise put, made it inequitable for the [signatory] to refuse to arbitrate on the ground that it had made no agreement with the [nonsignatory]."

Here, the borrowers had agreed to arbitrate with the lenders' agents and servicers. Moreover, it was foreseeable that the banks would be included among such agents and servicers, as the language of the agreements included authorizations for the lenders to receive payment via electronic funds transfers through an unnamed network and affiliated entities.

In short, by specifically agreeing to arbitrate with agents, servicers or a network, and recognizing that these would be employed in the electronic fund transfers, "it would be inequitable for the plaintiffs to avoid arbitration" with these agents, servicers and network whose participation was clearly foreseeable and who performed a crucial function with respect to the loans.

What should be apparent from the above discussion, however, is that allowing a nonsignatory to enforce an arbitration agreement against a signatory will not occur in the absence of very clear evidence that it was understood by the signatory that the nonsignatory was to perform a "crucial function" with respect to the transaction that was clearly contemplated by the agreements themselves. It will not apply to nonsignatories whose activities are not mentioned in the agreements and who provide no function or service relating to their operation.

An additional interesting issue raised in this dispute was whether because the loan agreements contained usurious loans, the banks had unclean hands and, therefore, should be barred from seeking equitable estoppel relief. The court rejected this argument noting that there was no direct challenge to the validity of the arbitration provisions, and that such provisions are severable from the remainder of the contract. To assert that the party seeking arbitration has unclean hands, it must be shown that the hands were unclean with respect to the making of the agreement to arbitrate itself, and not just to the legality of the loans.

As these two articles have shown, nonsignatories will not always be barred from either demanding or being subject to arbitration. Much will depend on their relationship to the transaction and the parties, and the extent to which their participation could be foreseen and understood. In drafting such agreements, therefore, counsel should take note of who might be considered to be an integral part of the agreement such that their right or obligation to arbitrate may unexpectedly be asserted at a later date.

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