Rights and Obligations of Nonsignatories in Arbitration: Part I

Judge Abraham J. Gafni (Ret.)

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It is generally understood that the obligation to submit to arbitration (unless mandated by statute or court rule) arises by reason of a written (and occasionally oral) contractual obligation entered into by the parties.

Disputants are often surprised, therefore, to discover that they may be ordered to submit to arbitration by reason of an agreement that they never signed and to which they never agreed. Conversely, others, who had agreed to arbitration, are equally surprised when compelled to arbitrate a dispute against adversaries who were not signatories to that agreement.

In this article, attention is given to situations in which a nonsignatory may be compelled to arbitrate. In a following article, the right of nonsignatories to compel parties to submit to arbitration will be considered.

A case from the Southern District of New York, *McKenna Long & Aldridge v. Ironshore Specialty Insurance*, 1:14-cv-06633, No. 39 (S.D.N.Y. Jan. 12, 2015), reflects the factors that may require a nonsignatory to submit to arbitration.

The matter involved a loan obtained by Eidos LLC from Stairway Capital Management II LP to fund a patent enforcement litigation program. McKenna Long & Aldridge served as Eidos' counsel. A

condition of the loan required that Stairway obtain a contingent loss reimbursement policy. Vincent W. Sedmak, a corporate officer of Eidos, assisted in the securing of this policy from Ironshore Specialty Insurance Co. and made representations regarding the due-diligence documents. McKenna Long authored and signed policy application documents reflecting that it would serve as counsel in the patent enforcement litigation.

The policy issued by Ironshore to Eidos contained an arbitration clause that was signed by neither McKenna Long nor Sedmak. Eventually, Ironshore refused a demand by Stairway and Eidos for payment pursuant to the policy. Arbitration commenced, and Ironshore sought to have both McKenna Long and Sedmak added as respondents.

McKenna Long and Sedmak filed motions for summary judgment seeking a declaration that the claims against them were not arbitrable as they were not parties to the arbitration agreement.

In denying these motions, the court first noted that it, rather than the arbitrator, had the authority to determine arbitrability in this situation where there was no clear evidence of an agreement to arbitrate as neither respondent had signed the agreement to arbitrate or was named as an insured or loss payee. Moreover, in the absence of an express, written arbitration agreement, the general presumption of arbitrability is reversed.

Nonetheless, the court recognized "limited theories under which [it] is willing to enforce an arbitration agreement against a nonsignatory." (The opinion does not discuss one theory, assumption, as it was not raised by Ironshore as a basis for arbitrability.) They are:

• **Incorporation by reference:** This involves a separate agreement in which a nonsignatory incorporates an existing arbitration clause from a prior contract. Ironshore's argument that incorporation applied because McKenna Long had signed documents as part of the prior request for the Ironshore policy was rejected because incorporation only applies when the reference relates to an earlier agreement containing an arbitration provision; it does not relate to an earlier document not containing an arbitration provision being incorporated into a later agreement containing one.

• **Agency:** Generally, an agent signing on behalf of a disclosed principal is not bound by the terms of the agreement, including the agreement to arbitrate, absent clear evidence of the agent's intention to be so bound (although an agent charged with misconduct relating to the agreement may be entitled to seek arbitration).

Here, despite authoring and signing certain documents (not including the policy), McKenna Long never evidenced an intent to be subject to the arbitration clause.

Similarly, Sedmak in signing the policy as a corporate officer was not evidencing acceptance of any contractual responsibility. Moreover, accusations against him of personally misappropriating some of the loan funds were not within the scope of the arbitration clause, which was only concerned with insurance coverage and "claims arising in connection with the policy."

• **Veil-piercing/alter ego:** "A nonsignatory may be bound to arbitrate where it exercised complete control over a signatory and employed that domination to injure another signatory to the agreement," the opinion said. In identifying "complete control," courts have looked to numerous factors relating to disregard of corporate formalities, inadequate capitalization, intermingling of funds and property, overlap in offices, management personnel and telephone numbers, and whether the dealings between the entities were at arm's length and treated independently.

That Sedmak allegedly misused the loan proceeds to benefit himself was insufficient to warrant a finding of such complete control.

• **Direct-benefit estoppel:** A party may be estopped from denying an obligation to arbitrate when it receives a direct benefit from the contract as opposed to the benefit being a mere consequence of the contract.

Nonsignatories may have direct benefits under three circumstances:.

• Receiving a direct benefit specifically contemplated by the parties.

• Suing as a third-party beneficiary under the agreement.

• Receiving a tangible benefit, typically financial, such as legal fees, cheaper insurance or licensing fees or the issuance of an insurance policy.

Estoppel will not apply, however, based on an indirect benefit "where the nonsignatory exploits the contractual relation of parties to an agreement but does not exploit (and thereby assume) the agreement itself" regardless of how close the affiliation may be between the parties. It is also indirect "when the parties to the agreement with the arbitration clause would not have originally contemplated the nonsignatory's eventual benefit," the opinion said.

Here, the court found a direct benefit to McKenna Long because, as a condition precedent, the policy and loan were issued for the express purpose, in part, of paying McKenna Long's legal fees from the patent enforcement program.

Moreover, McKenna Long's benefit was specifically contemplated by the parties as the policy application indicated that McKenna Long would serve as counsel to the program. McKenna Long, therefore, was not only a facilitator but also a direct beneficiary of the policy.

With respect to Sedmak, his association with Eidos alone was insufficient to estop him from denying an obligation to arbitrate. However, his receipt of millions of dollars was viewed by the court as the obtaining of a direct, tangible financial benefit from the policy through direct exploitation in a manner indistinguishable from the fees received by McKenna Long.

• **Third-party beneficiary:** Finally, if the contract had at least a partial purpose of benefiting a third party who accepts that benefit, the party may not disclaim the duty to arbitrate under the agreement that provides those benefits.

It was clear that McKenna Long was a third-party beneficiary of the policy that was necessary to fund the patent litigation as McKenna Long was identified in it as lead counsel and accepted the resulting benefits.

There was nothing to suggest, however, that Sedmak, notwithstanding his subsequent receipt of millions of dollars, was ever intended by Ironshore to receive the benefits of the policy or the loan.

Accordingly, both McKenna Long and Sedmak, as direct beneficiaries, and McKenna Long as a third-party beneficiary of the agreement, could be compelled to submit to arbitration.

Courts have set out other formulations as to when arbitration agreements may be imposed on nonsignatories and the difficulties often encountered in seeking to do so. (See, e.g., *Griswold v. Coventry First LLC*, 762 F. 3d 264 (Third Circuit, 2014).) But, ultimately, the greater the connection, the more direct the result, and the more specific the intent to relate the contract and its benefits to the nonsignatory, the more likely will be a ruling that the nonsignatory must submit to arbitration.

In summary, the contracts and agency principles first learned in our law school classes are those that will control whether and when nonsignatories may be required to arbitrate rather than litigate.

Next: When may parties who had earlier signed an agreement to arbitrate be compelled to arbitrate by a nonsignatory?

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