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A Guide To Drafting Enforceable Arbitration Clauses

By **John Shope and Kevin Conroy** (July 7, 2020, 4:34 PM EDT)

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Many businesses choose to include arbitration clauses in their agreements with their customers, vendors or employees. They do so because, as data increasingly shows, arbitration is on average a significantly faster and cheaper means of resolving a dispute in a confidential, flexible and expert manner. And, as courthouses have closed during the coronavirus pandemic, arbitration has become, in many jurisdictions, the only ongoing means of resolving disputes.

But all of those advantages can be lost if the arbitration clause doesn't bind a party to a transaction that at least one of the contracting parties thought would be subject to arbitration. The result can be parallel and duplicative, not to mention costly and potentially embarrassing, public proceedings.

Here are some examples:

- A consumer makes an account with a retailer including an arbitration clause. The consumer alleges that the retailer has misused her private data — and sues the vendor that the retailer used for its marketing campaigns. The consumer also sues the company's CEO, whose name appeared on the website under a statement that the company would respect its customer's privacy. Both assert common law or contractual rights of indemnification against the retailer.

- A company makes a contract with a construction contractor to construct a new operations center. The contract includes an arbitration clause. The plumbing subcontractor negligently fails to solder the pipes properly and a massive flood stops the company in its tracks for a week. The contractor is in financial distress, so the owner believes it must sue the subcontractor to obtain recovery.

- A company acquires another in a merger agreement including an arbitration clause. The acquirer sues the president of the acquired company, alleging that he misrepresented material facts on which the acquirer relied.

- A large public company engages an auditor to audit its books. A special-purpose vehicle in which the company has a controlling interest alleges that the auditor negligently failed to detect improper payments, and sues the auditor.

In each of these cases, the company that made an agreement to arbitrate may find that the party against whom it seeks recovery, or is affirmatively making a claim against the company, is unwilling to arbitrate.

As the U.S. Supreme Court has recognized, "arbitration is a matter of consent, not coercion."[1] Courts will not compel arbitration absent a party's prior agreement to submit the dispute to arbitration. Nevertheless, most jurisdictions recognize a narrow exception, referred to as arbitration by estoppel, in which the signatory is compelled to arbitrate their claim against a nonsignatory notwithstanding the lack of an express agreement to arbitrate the disputes.

The applicability and exact contours of arbitration by estoppel vary from jurisdiction to jurisdiction, but as a general matter, it will apply where the nature and circumstances of the claim make it inequitable to permit the signatory to take the benefit of the contract while refusing to comply with the arbitration clause contained within it. Estoppel theories will also, in some limited circumstances, permit a signatory to compel a nonsignatory to submit to arbitration where the nonsignatory has received a direct benefit from the relevant contract.

Agency law can provide another basis for a nonsignatory to compel arbitration. Many jurisdictions will allow an agent of a signatory to claim the protection of the arbitration clause negotiated by its principal. The scope of that agency can vary, leading to, for example, disparate results on the question of whether family members placing a loved one in a nursing home can bind him or her to an arbitration clause.

The Supreme Court, in its decision in GE Energy Power Conversion France SAS v. Outokumpu Stainless USA LLC issued just last month, confirmed that common law principles such as estoppel and agency may apply in the realm of international arbitration where a nonsignatory seeks to compel arbitration.[2]

Rather than relying on the uncertainty of estoppel or agency theories or risk facing different results in different jurisdictions, businesses should carefully consider the nature of claims that may be brought by or against nonsignatories, and negotiate and draft arbitration clauses to ensure or at least maximize the chances that they provide the desired protection.

Claims By or Against Friendly Nonsignatories

The easier case to address through drafting is claims that a counterparty may bring against a nonsignatory or that a nonsignatory may bring against the counterparty where the nonsignatory prefers to arbitrate (referred to here as a friendly nonsignatory).

Drafting the contract so as to make the friendly nonsignatories third-party beneficiaries of the contract will provide a basis for the nonsignatory to initiate claims it may have against the signatory in arbitration rather than in court. It also prevents the counterparty from making an end run around the arbitration clause by allowing the nonsignatory to compel arbitration in the event that it is sued by a signatory.

This can be accomplished by drafting the arbitration clause to expressly require arbitration of such disputes. In the first place, the clause should cover all claims arising out of or relating to the contract, but that by itself doesn't address the issue of nonsignatories. To do that, additional language is needed.

For example: "The right and obligation to arbitrate under this clause shall extend to all claims by or against any officer, director, employee, agent, shareholder, member, partner, affiliate, parent

corporation, subsidiary, joint venturer, or contractor of a party hereto."

Alternatively, the list of relevant nonsignatories could be included within the contract's general definitions of the parties, or within special definitions specific to the arbitration clause. In any event, if the contract contains a separate clause disclaiming the existence of any third-party beneficiaries for general purposes, the arbitration clause will need to be drafted so as to trump that disclaimer.

To the extent that specific relevant nonsignatories are known and identifiable at the time of drafting, identifying them specifically will serve to provide further certainty. However, in many cases a generic list will be necessary either because the relevant nonsignatories are not yet known or because they may change during the life of the contract.

Claims By or Against Adverse Nonsignatories

The trickier task is ensuring that claims that may be brought by or against a nonsignatory that prefers court to arbitration (referred to here as adverse nonsignatories) end up in arbitration rather than court. While the proposed language in the prior section nominally requires arbitration in such instances, a reviewing court may rightly question whether the nonsignatory can be bound by a contract to which it did not agree.

This raises questions of agency and the signatory's authority to bind the nonsignatory. To what extent does the named counterparty have the authority — actual, apparent or inherent — to bind other corporations or persons? The answer to that question will depend on the particular nature of the relationship between the nonsignatory and both of the signatories, and also on the relevant jurisdiction's nuances on agency law.

A representation in the contract by the signatory of its authority to bind the nonsignatory may bolster the case for enforcement, but is still unlikely to guarantee enforceability if the nonsignatory disputes having delegated such authority to the signatory. The agency argument will be particularly difficult in the case of sub-nonsignatories, such as subcontractors or vendors, that have no connection to the transaction or either party at the time of contracting.

A further possible solution is to require the signatory to indemnify the counterparty in the event that a related party refuses to arbitrate disputes arising out of or relating to the agreement.

While this may provide some comfort, it is an imperfect solution because it does not provide a mechanism to compel the nonsignatory to submit to arbitration. It only provides a potential remedy in the event that the nonsignatory refuses and pursues the claim in the courts. Furthermore, there may be difficulties in establishing the monetary damages caused by the nonsignatory's refusal to submit to arbitration and would require additional litigation to enforce.

A similar solution, with similar limitations, is to include representations that any contract a party enters into with its subcontractors include a provision requiring arbitration of any potential claims brought by or against the counterparty. Alternatively, the counterparty could be required to make any subcontractors, employees or other adjacent parties sign a joinder of the arbitration clause in the underlying contract.

If the provision is complied with, the counterparty will become a third-party beneficiary of the new contract. However, as with indemnification, there may be little practical or immediate recourse for

breach of such a provision.

Claims Between Nonsignatories

A final permutation that businesses and their attorneys should consider is the possibility that a dispute will arise between two nonsignatories. Such claims would generate potential liability for the signatory to the extent there are any applicable indemnification rights, but also raise the prospect that the signatory will become entangled with the litigation through the discovery process.

Bringing such claims within the scope of an arbitration clause requires language that both makes the friendly nonsignatory a third-party beneficiary of the arbitration clause and binds the adverse nonsignatory (or provides a remedy in the event the adverse nonsignatory cannot be compelled to submit to arbitration).

But all of these nuances don't mean that the game isn't worth the effort. Arbitration offers huge advantages. Rather than leaving the scope of an arbitration clause up to the vagaries of the courts — many of which don't like arbitration in the first place — contract drafters should pay careful attention to binding nonparties in order to maximize the likelihood that the arbitration clause will serve its intended purpose. The benefits can be very substantial.

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[1] Lamps Plus Inc. v. Varela, 139 S. Ct. 1407, 1415 (2019)

[2] GE Energy Power Conversion France SAS v. Outokumpu Stainless USA LLC, Dkt. No. 18-1048, 2020 U.S. LEXIS 3029 (June 1, 2020).