ARBITRATING WITH PEOPLE WHO ARE NOT PARTIES TO THE AGREEMENT

The Courts Have Held that Non-parties to an Arbitration Agreement May be Ordered to Arbitrate if the Dispute is Sufficiently Proximal to the Agreement. Such Cases Include Claims Involving Employees, Successors or Affiliates of a Contracting Party or When a Non-party Would be Equitably Estopped to Deny Arbitration.

By Matthew Farley *

With the expanded use of arbitration since the mid-eighties, a thoughtful body of case law has evolved deciding when persons and entities who are not signatories to an arbitration agreement may nevertheless be compelled to arbitrate. This article addresses the topic, not only from the perspective of securities and financial services dispute resolution, but also for general business and commercial litigation purposes.

PRELIMINARY

Under the United States Supreme Court’s decision in the Moses H. Cone case, it is beyond dispute that the Federal Arbitration Act (FAA) creates a body of federal substantive law that requires federal and state courts to stay litigation pursuant to FAA Section 3, and to compel arbitration pursuant to FAA Section 4, whenever the controversy being litigated is referable to arbitration under a contract involving commerce.

Public policy strongly favors resolution of disputes by arbitration, and the Supreme Court has instructed the lower courts to have a “healthy regard for the federal policy favoring arbitration.” This favorable policy generally applies to agreements signed by at least two parties. Difficulties arise, however, when some kind of arbitration agreement subsists, but it is uncertain which persons and entities are bound by it. It has been held that whether an arbitration clause may be interpreted to cover a given dispute is to be resolved in favor of arbitration “unless it may be said with positive assurances that the arbitration clause is not susceptible of an interpretation that covers the asserted dispute.”

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2 H. Prang Trucking Co. Inc. v. Local Union 469, 613 F. 2d 1235, 1239 (3d Cir. 1980).
5 Bristol Farmers Market & Auction Co. v. Arlen Realty & Development Corp., 589 F.2d 1214, 1219 (3d Cir. 1978).
it generally remains true that a party may not be compelled to arbitrate a dispute that it did not agree to arbitrate. Hence, broad endorsements of the general obligation to arbitrate will seldom be sufficient to impose the obligation on a particular party; there must first be an agreement at least between two parties, which starts the substantive analysis of what non-signatories, if any, may also be bound by the arbitration clause or may invoke the clause against a signatory who has gone to court.

**AGENTS, EMPLOYEES, AND REPRESENTATIVES**

One body of case law in this area concerns litigants who are parties to arbitration agreements with business entities, but who attempt to sue in court individual employees, agents, or representatives of the entity bound to arbitrate. Not surprisingly, the cases almost uniformly hold that such employees are implicitly within the scope of the agreement to arbitrate. Indeed, in cases in which personal liability of such employees is claimed, to hold otherwise would seriously weaken the arbitration agreement since a corporation or partnership acts through its employees and agents and, in such cases, it is their very acts or omissions which allegedly give rise to the liabilities at issue. For example, in the *Hartford Financial* case, general partners who attempted to sue were held bound by an arbitration agreement in which only the partnership entity was the named party and signatory.

Again, in the *Letizia* case, a customer and party to an arbitration obligation with the brokerage firm sought to sue only an individual broker who allegedly churned the account. The court had no trouble finding that the broker, not a party to the agreement, was within the scope of the customer’s agreement to arbitrate disputes with the employing firm. In the *Lee* case, the court upheld the inclusion of an employee broker within the firm’s arbitration obligation, although the broker was not a party to the agreement.

Similarly in *Garfinkel*, individual doctors of a medical group who were sued by a former colleague were held to have standing to compel arbitration pursuant to the plaintiff’s contract with the professional corporation.

While courts sometimes invoke the contract principle of “third-party beneficiary” to reach these results, the more compelling rationale is that a commitment to arbitrate in a written agreement with an entity implicitly includes, within the scope of that obligation, concurrent obligations to arbitrate disputes with the entity’s agents and employees claimed to have personal liability.

Customers of brokerage firms, for example, could hardly


10 *Lee v. Chica*, 985 F.2d 883 (8th Cir. 1993).


be held to have intended to bind themselves only to the firm, but not with regard to the employed individuals – those whose very acts or omissions give rise to the claim.

In an Ohio case, the action against the corporate representative was deemed to be within the scope of the arbitration clause notwithstanding the fact that the clause specifically referred to disputes between the “parties” to the agreement. The appellate court held that arbitration cannot be avoided simply because the claim names “non-signatory agents or signatory agents in their individual capacity . . . to find to the contrary, contradicts the strong federal and Ohio policies in favor of arbitration.”

In such cases, in which the plaintiff seeks judicial rather than arbitral remedies, creative efforts to distinguish the sued individuals from the related entity generally fail. For example, in Letizia (discussed above), the customer’s argument that the salesman’s churning was for a personal and selfish benefit “unrelated” to the employing brokerage firm’s legitimate goals and objectives was easily rejected. Plaintiffs frequently have undercut their own efforts to distinguish individual defendants by such routine allegations that identify the individuals as “officers, directors, employees, and agents” of the business entity who were “at all times acting under its authority . . .” Thus, the practical desire to involve the corporation for the alleged misbehavior at issue implicates principles that preclude the customer from arguing some sort of “individual capacity” that allows claims outside the arbitration obligation. In a Texas case, allegations that the claims against the employee were only for acts prior to and leading up to the contract, were addressed and rejected.

While there may be scenarios that would warrant separate suit against the employee (e.g., an automobile accident in a shopping center parking lot with a signatory corporation’s employee), if the relevant events derive from a relationship governed by an agreement containing an arbitration clause, the defendant-entity’s agents and representatives should be held to fall within the scope of the clause notwithstanding such individuals’ failure to be “parties” to the actual written agreement.

DERIVATIVE AND SUCCESSOR ISSUES

Where the claims at issue derive from personal rights and interests of actual parties to arbitration agreements, the courts have generally, but not always, held that the original arbitration obligation continues to bind those who succeed to the interests of a party to the agreement. For example, in Seborowski, beneficiaries of deceased employees who were part of a collective bargaining unit were deemed to fall within the scope of the collective bargaining agreement’s arbitration provisions. Similarly, in Gwertzman, the court held that representatives of the signatory’s estate were bound by the deceased signatory’s arbitration obligations with his former firm.

In a Third Circuit case, the named beneficiaries of a former employee’s deferred compensation plan brought suit when the brokerage firm looked to the employee’s interest in the plan to satisfy personal obligations that he owed the firm. The employer was bound to arbitrate employment disputes with his employees through his regulatory filings and otherwise. The court found that the plan’s designated beneficiaries (the employee’s wife and children) were subject to arbitration because their claim derived exclusively from the former employee’s employment relationship and his interest in the plan.

In a New Jersey case, beneficiaries of a deceased customer’s KEOGH and IRA accounts were held bound to arbitrate with the brokerage firm even where the claims concerned the administration, not the investment results, of the accounts. The decision was in part

14 Id. at 14.
15 See, e.g., Carroll v. LeBoeuf, Lamb, Greene and MacRae LLP, 374 F. Supp. 2d 355 (S.D.N.Y. 2005) holding non-signatories within duty to arbitrate where plaintiff pleaded they were agents and co-conspirators with signatory, and lumped them all together in a common defined term.
17 We distinguish and do not discuss herein expressly derivative claims such as insurance subrogation and contractual assignments, e.g., Lumbermen’s Mutual Casualty v. Borden Co., Inc., 268 F. Supp. 303, 313 (S.D.N.Y. 1967) and Fisser v. International Bank, 282 F.2d 231, 233 (2d Cir. 1960).
predicated upon the actual text of the arbitration provisions (where the decedent had agreed that it "shall be binding upon my heirs, executors, successors, administrators..."). But the court also favorably cited and relied upon the Mississippi Supreme Court's then-recent decision in the Henry case. In that case, a deceased customer's daughter's lawsuit for breach of fiduciary duty to the estate and negligent conversion of funds in a brokerage firm were deemed to arise out of or related to the decedent's accounts; for that reason, the arbitration clause was also held binding upon the decedent's heirs.

Other cases reaching similar results include Herbert, where an arbitration clause in a group healthcare plan was deemed to bind non-signatory adult heirs to arbitrate their wrongful death claims on behalf of the decedents. In Javitch, a receiver for a corporation was held to the corporation's contractual agreement to arbitrate. Likewise, the Collins case held that non-signatory heirs and successors were bound by an arbitration provision whose terms expressly bound successors and assigns. Finally, the Gardner case held that a trust beneficiary was required to arbitrate pursuant to the trustee's contractual obligation.

CONSTRUCTIVE AGREEMENT

The court's decision in Brodene created an obligation out of estoppel and reasonable "expectancy" principles. The case concerned a customer who received, but did not sign, new account documentation that contained an arbitration clause. Notwithstanding plaintiff's testimony that he had not read the arbitration provisions and the undisputed fact that he had not signed the account documentation, the court enforced the defendant's expectation of arbitration because the brokerage firm would not normally have accepted the account without the documentation being signed, except inadvertently. Perhaps more importantly, the court took the view that the customer was on notice that the brokerage firm anticipated arbitration of any disputes as a condition of its accepting the account. In lieu of a signed agreement, the court held that the very acts of creation and of utilization of the account relationship were deemed to constitute an agreement by the customer to the new account's documentation terms.

In the Hightower case, the employer had an internal Dispute Resolution Program that was characterized as the company's "exclusive method" of dispute resolution. The employee's receipt of materials relating to the program, coupled with his continued employment for several months, was deemed by the court sufficient to establish an agreement to arbitrate. The Fourth Circuit's decision reversed the trial court's denial of the employer's motion to compel arbitration.

In a North Carolina case, an account application was signed by only one of two "co-guardians" of an incompetent family member. The state Court of Appeals reversed the trial court's determination that the non-signatory was therefore free to bring suit even though both guardians' approval of any action was required by law. The court noted that both guardians dealt with the brokerage firm in the course of events giving rise to the claim, and that "well-established common-law principles" (i.e., equitable estoppel) bound the non-signatory guardian to the account documentation's arbitration clause, for the predicate claims derived from the relationship covered by the arbitration provision. The court noted that the claims asserted were supported by factual allegations indicating that the "[non-signatory guardian] was equally involved in and a recipient of the services provided by defendants...." The court held, further, that "we do not believe that both guardians should be allowed to assert a claim for alleged damages arising out of an agreement while simultaneously suggesting that one portion of the agreement should not be enforced due to the absence of one guardian's signature."

On the other hand, in another case, the Alabama Supreme Court refused to find a customer bound by an arbitration clause that governed an account in the name of a third person into which plaintiff had placed her funds for purposes of effecting securities transactions. She had done so in order to trade on margin in the third-party account, because the source of her funds, an IRA...

22 Smith Barney, Inc. v. Henry, 775 So. 2d 722 (Miss. 2001).
24 Javitch v. First Union Securities, 15 F3d. 619 (5th Cir. 2003).
account, would not have been permitted margin privileges. The court rejected the broker’s argument that she was a “third-party beneficiary” of the actual customer’s account relationship; the court could find no basis for inferring that the broker intended third-party benefits to be conferred, especially when it was unaware of the underlying events.

**CORPORATE PARENTS, SUBSIDIARIES, AFFILIATES**

Compelling arbitration of related entities poses slightly different and sometimes more difficult issues. Such suits often parallel an arbitration proceeding and are sometimes clearly for the purpose of obtaining otherwise unavailable discovery, harassment, or both. Similar to the analysis of employees and agents, however, the core issue is whether one party, having agreed to arbitrate with another, may fairly be compelled to arbitrate with all, especially as to claims that relate directly to the arbitrable claims. For the most part, arbitration results.

Thirty years ago, the Fifth Circuit developed its analysis in the *S.A. Eteco* case. On the strength of Eteco’s signature to the arbitration agreement, the court held that claims against the signatory corporation’s parent and successor corporations were also arbitrable because:

> The charges against these two defendants were based on the *same operative facts* and were *inherently inseparable* from the claims against Eteco [the subsidiary corporation].

The court went on to observe that:

> If the parent corporation was forced to try the case, the arbitration proceedings would be rendered meaningless and the federal policy in favor or arbitration effectively thwarted.

Taking only a slightly different approach, the Eleventh Circuit invoked principles of equitable estoppel to bring non-signatories within the arbitration obligation and on two separately sufficient bases. First, a non-signatory may compel arbitration on equitable estoppel grounds where the signatory “rel[ies] on the terms of the written agreement in asserting [its] claims” against the non-signatory. Arbitration was deemed to be “appropriate.”

> [w]hen each of a signatory’s claims against a non-signatory "makes reference to" or "presumes the existence of" the written agreement [containing an arbitration obligation], the signatory’s claims arise[] out of and relate[] directly to the written agreement..."[35]

Second, a non-signatory may compel arbitration through equitable estoppel where the signatory’s allegations as to the non-signatory are "of...substantially interdependent and concerted misconduct by both the non-signatory and one or more signatories to the contract."[36]

Other circuit courts and district courts have ruled similarly. In *Grigson*,[37] the Fifth Circuit followed reasoning of the Eleventh and Seventh Circuits,[38] to hold that "We agree with the intertwined-claims test formulated by the Eleventh Circuit...[T]o not apply this intertwined-claims basis to compel arbitration would fly in the face of fairness." A similar case, *Brown*,[39] held that issuers of variable annuity products were within the customer’s obligation to arbitrate with the brokerage firm.

In *J.J. Ryan & Sons, Inc.*,[40] the Fourth Circuit ruled that "When the charges against a parent company and its subsidiary are based on the same facts and are inherently inseparable, a court may refer claims against the parent to arbitration even though the parent is not formally a

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31 *Sam Reisfeld & Son Import Co. v. S.A. Eteco*, 530 F.2d 679 (5th Cir. 1976).

32 Id. at 681 (emphasis added).

33 Id. (citations omitted).

34 *MS Dealer Serv Corp. v. Franklin*, 177 F.3d 942 (11th Cir. 1999).


38 *Hughes Masonry Co. v. Greater Clark County School Bldg. Corp.*, 659 F.2d 836, 841 n.9 (7th Cir. 1981).


party to the arbitration agreement." In Hughes Masonry, the court held that because the signatory's claim against the non-signatory related to duties and responsibilities derived from a contract containing an arbitration obligation, the signatory was equitably estopped from arguing that the dispute against the non-signatory was not subject to arbitration. Similarly, in Smith/Enron Cogeneration, the court held that "when a non-signatory seeks to compel arbitration with a signatory," a signatory may be estopped from "avoiding arbitration with a non-signatory when the issues the non-signatory is seeking to resolve in arbitration are intertwined with the agreement that the estopped party has signed."

The Third Circuit ruled comparably in Pritzker, holding that an arbitration agreement "should be read to include all the named defendants even though only one defendant signed [it]." The Pritzker court invoked "agency logic [which] has been applied to bind non-signatory business entities in arbitration agreements," noting the affiliated relationship between the related corporations. The Pritzker court also cited its own recent decision in the Paiiwonsky case (non-party subtenant bound by arbitral award adverse to primary tenant).

The Third Circuit recently revisited Pritzker in the Dupont case. Here, however, the factual setting was reversed: a signatory to an arbitration agreement tried to compel a non-signatory to arbitrate. Holding that Pritzker was "inapposite," the court declined to do so. But the court acknowledged that a signatory may be compelled to arbitrate with a non-signatory "at the non-signatory's insistence because of the 'close relationship between the entities involved....and [the fact that] the claims were intimately founded in and intertwined with the underlying contractual obligations.'" Although the facts in Dupont did not involve an application by a non-signatory to compel arbitration, the Third Circuit's implicit reaffirmance of Pritzker could not have been clearer.

The Third Circuit's decision in Dupont may be compared with decisions under New York law that compelled non-signatory parent or affiliated corporations to arbitrate over objection. In PromoFone, the non-signatory corporation Falconwood's claims were compelled to be arbitrated (along with concededly arbitrable claims of other parties) where the other disputes were "inextricably interwoven" with the claims of Falconwood. The court found that Falconwood was "closely related" to the signatories and was alleged to have engaged in substantially the same improper conduct. The PromoFone decision was cited favorably in General Re Corp. where the court compelled a non-signatory parent to arbitrate because it was found to be a "closely related" entity that was "involved in the negotiations that led up to the execution of the Agreements" and was "an integral participant in the events underlying the arbitrable dispute." On the other hand, in the Merrill case, arbitration with a broker's affiliated advisory firm was enjoined where there was no showing of agency with the party to the arbitration agreement.

In Conwill, another New York case, the plaintiff tripped on his own allegations when he made judicial claims against two accounting firms sounding in malpractice but pleaded that the accounting firms were "working in concert" with a defendant as to which there was an arbitration obligation and that all of the defendants "singly and in concert, directly or indirectly, engaged in a common plan, transaction and course of conduct." The state court held that "under federal substantive law, having alleged that the defendants acted in concert to defraud them, and to market and implement the allegedly fraudulent and illegal tax strategy, plaintiffs cannot escape the consequences of those allegations by arguing that the defendants lack the requisite close relationship or that their claims are not

41 Hughes Masonry Co. v. Greater Clark County School Bldg. Corp., 659 F.2d 836, 841 n.9 (7th Cir. 1981).
42 Smith/Enron Cogeneration Ltd. Partnership Inc. v. Smith Cogeneration Int'l, 198 F.3d 88, 98 (2d Cir. 1999).
43 Pritzker v. Merrill, Lynch, Pierce, Fenner & Smith, 7 F.3d 1110, 1112 (3d Cir. 1993).
48 Merrill v. Optibase, Ltd., 337 F.3d 125 (2d Cir. 2003).
connected." Conwill may be compared with EDS Investment Company, where a California court denied an expansive reading of the arbitration obligation because the party to the contract containing the arbitral provision was not a defendant and the plaintiff had not made allegations of unified actions on the part of the non-signatory defendants with the contractor’s party.

In the Fitzgerald case, however, the plaintiff was unsuccessful in bringing into arbitration the Employment Retirement Income Security Act (ERISA) and employment termination claims against not only his direct employer, H&R Block Financial Advisors, Inc., but also the H&R Block Severance Plan established by HRB Management, Inc., itself an indirect subsidiary of H&R Block. The Plan covered certain managerial employees of H&R Block subsidiaries, including the broker/dealer where the plaintiff had been employed. The court determined that only the broker/dealer was within the securities industry’s mandatory arbitration obligations; it did not find that the benefit plan and its corporate sponsor were so “inherently inseparable” from the claims that arbitration as to them should be ordered as well. Plaintiff also argued an alternative “agency” theory based on the fact that the covering plan and the benefits were derived from the ultimate parent, H&R Block, and ran down to qualified managers of its several subsidiaries. The court rejected this theory, holding that the parent sponsor in setting up the plan clearly was not an agent of the broker/dealer, the only subsidiary contractually obligated to arbitrate.

But the decision in FTN Financial Capital Markets compelled a non-broker bank affiliate to participate in an NASD arbitration because of the non-member’s entity immersion in the underlying controversy and the relationship between the two firms. Similarly, in the Gates case “where the plaintiff alleges joint misconduct by affiliated companies, some of which are NASD members ... and some of which are not ... the non-NASD member is sufficiently immersed in the controversy for it to be considered a ‘certain other’ party under the NASD Code.” The reference was to NASD Rule 10101, which relates to disputes, claims, or controversies not only between or among members, or members and associated persons, but also under subsection (c) “between or among members or associated persons and public customers, or others” (emphasis added). The court’s decision, while perhaps correct on an equitable basis, lacks a logical nexus between the NASD’s arbitration rules, to which its membership and their employers subscribed, and how those rules reach non-members.

In Merrill Lynch, the court refused to compel arbitration of the claims brought by a corporation set up by two discharged employees where the claims were premised upon alleged disparaging misstatements in the regulatory filings relating to the employees. Despite the obvious fact, and some might call it pretext, that the claim of resulting financial damage brought by the corporate plaintiff was a simple repackage of the purported reputational damage claims of the former employees that were undeniably subject to an arbitration obligation, the court noted correctly that the corporate plaintiff was not an NASD member and not obligated thereby or pursuant to Forms U-4 or U-5 to arbitrate the disputes at issue. Although Merrill Lynch contended that “direct benefits estoppel” was a controlling principle, the court observed that estoppel required that the non-signatory be “seeking benefits” from the contract containing the arbitration obligation, and noted that Merrill Lynch could not point to benefits to the plaintiff in the contractual provisions of Forms U-4 or U-5. Citing to In re Kellogg Brown & Root, Inc., the court determined that if the non-signatory’s claims could stand independently of the contract at issue (in this case the Forms U-4 and U-5), then arbitration would normally not be compelled.

The New York Court of Appeals, however, in TNS Holdings, reversed rulings compelling arbitration with a non-signatory on the factual showing before it that the alter ego/corporate veil piercing premise for the lower courts’ orders was insufficient as a matter of law. While acknowledging the favorable public policy that arbitration generally enjoys, the court found "equally important" a policy that does not casually find "unintentional waiver of the benefits and safeguards

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which a court of law may provide...." A similar holding issued in the *Mag Portfolio* case.\(^{57}\)

**CONCLUSION**

The *Pritzker, DuPont*, and *TNS Holdings* decisions demonstrate a seemingly asymmetrical nature of the outcomes depending on who seeks to compel arbitration. A signatory may be – and frequently is – bound to arbitrate with persons and entities that may never have been contemplated when the agreement was signed. Yet the same signatory generally may not compel arbitration with parent and affiliated entities who are not parties to the agreement.\(^ {58}\)

But the seeming inconsistency does not exist upon further consideration. The signatory has usually consented to an arbitral resolution of "any and all disputes," and it is not unfair to hold the signatory to its commitment when it tries to evade its obligation with lawsuits against related but non-signatory individuals and entities.

On the other hand, a mere affiliate or parent to a signatory usually has not itself consented or agreed to arbitration or anything else. It may even have little or no knowledge of what the subsidiary or affiliate is contracting for. It is therefore a much more serious consequence to inflict a totally involuntary obligation upon the non-signatory notwithstanding whatever efficiencies and economies may be perceived.

\(^{57}\) *Mag Portfolio Consult, GmbH v. Merlin Biomed Group, LLC*, 268 F. 3d 58 (2d Cir. 2001).

\(^{58}\) Why a parent or affiliate would want to leave itself exposed to litigation is generally a case-by-case tactical decision.