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Bulletin #80, Can You Be Bound By an Arbitration Agreement You Didn't Sign? (September 29, 2004)

Imagine – a developer and a general contractor (GC) arbitrate a dispute regarding a nonconforming HVAC system that you installed. You assist the GC in its defense of the arbitration. Ultimately, the arbitrator finds in favor of the developer. The GC then brings suit against you in court because you performed all the work on the HVAC system. The GC asks the judge to enforce the arbitration award against you and the judge does so, even though you were not a party to the arbitration and do not have an arbitration agreement with either the developer or GC. Think it can't happen? Think again!

Morris Case

In 1984, Morris Mechanical Enterprises found itself in this exact situation. Villgreen, the owner, hired Cecil's Inc. to serve as the general contractor on an apartment complex construction project. Cecil's subcontracted with Morris Mechanical for installation of the HVAC system. Following construction of the complex, several disputes arose between Villgreen and Cecil's. Among them was a dispute concerning the HVAC system. Under the contract between Villgreen and Cecil's, the disputes were submitted to arbitration. The arbitration panel found that the HVAC system did not conform to the contract and it awarded Villgreen damages.

Cecil's sued Morris Mechanical for the amount of the damages awarded by the arbitration panel. Cecil's asked the judge to enforce the arbitration award against Morris Mechanical arguing that the contract between it and Morris Mechanical required indemnification of any damages that arose from the installation of the HVAC system. Morris Mechanical argued that it should not be bound to the result of an arbitration to which it was not a party. The court disagreed.

Morris Mechanical was kept apprised of all stages of the arbitration process. Jerry Morris, the owner, even testified at the arbitration hearing. The court said Morris Mechanical made no attempt to join the arbitration and was not intentionally or completely excluded from participating. Morris Mechanical was aware of its potential liability and allowed Cecil's to defend alone. Because of Morris' knowledge of the arbitration and its failure to join, the court found it fair to be bound by the results. Cecil's, Inc. v. Morris Mechanical Enterprises, Inc.,735 F.2d 427 (11th Cir. 1984).

History

Since the passage of the Federal Arbitration Act (FAA) in 1922, courts have favored agreements to arbitrate as an efficient and inexpensive means of resolving disputes. Individual states have adopted similar policies with forty–nine jurisdictions adopting some form of the Uniform Arbitration Act. Arbitration is also a favored form of dispute resolution in the construction industry. With courts increasingly burdened

with overflowing criminal dockets and with the increasing popularity of Alternative Dispute Resolution (ADR)[1], courts have wholeheartedly embraced arbitration. Indeed, many states create a strong presumption in favor of arbitration.

Many standard form construction agreements contain mandatory arbitration clauses. A "mandatory" arbitration clause means that everyone participating in the project must agree to submit disputes to arbitration. Some agreements also contain clauses that bar or limit addition (also called "joinder") of nonsignatory third parties to an arbitration proceeding absent specific written consent.

The Trend

Generally, unless you have agreed in writing to submit disputes to arbitration, state or federal court is the location where your claims will be resolved. It is a basic tenant of American law that a party cannot be compelled to submit a dispute to arbitration unless there is a contractual agreement to do so. However, principles of efficiency and economy seem to be wearing down this time–tested rule. There is now an emerging trend toward expanding the scope of the enforceability of arbitration awards against nonparties to the arbitration or nonsignatories to the agreement even without the party's specific written consent.

Because of the enthusiasm for arbitration, there is an increasing danger that a party will either be bound by the results of an arbitration to which it was not a participant or that it will be forced to arbitrate a dispute when it never signed an arbitration agreement. There are five basic situations in which someone who did not sign an arbitration agreement may still be forced to arbitrate a dispute:

1. Arbitration agreements that are incorporated by reference into another contract;

2. Arbitration agreements that have been assigned or assumed by another party;

3. Arbitration agreements entered into by the party's alter ego [2] or situations in which it is appropriate to pierce the corporate veil[3];

4. Estoppel[4], i.e. where a party takes an inconsistent position and wants to force arbitration on the one hand and avoid arbitration on the other, or situations involving the misconduct of the nonsignatory party – in these situations, the party will not be allowed to argue against arbitration; or

5. Where a party acts as an agent for another entity in signing an arbitration clause, thus binding the non–signing party.

A. Ness & D. Peden, *Arbitration Developments: Defects and Solutions*, Construction Lawyer, Summer 2002.

Furthermore, as seen in the case involving Morris Manufacturing, nonparties who simply provide assistance in arbitration proceedings may be bound by an award, as well. This includes situations in which a party's conduct indicates intent to participate in the proceedings or situations in which a party's interests are directly related to the interests of the party who signed the agreement.

For example, in 1975, James Associates Architects agreed to provide architectural and construction management services for the Greater Clark County School Building Corporation ("Clark County") for the construction of two middle schools. James Associates hired J.A. Construction to manage the construction

projects at both sites. Clark County also contracted with Hughes Masonry Company for masonry services for both sites. J.A. Construction was listed in Hughes' Masonry contract as the construction manager.

After construction began, several disputes arose between the parties. Clark County cancelled its contract with Hughes Masonry and hired another masonry contractor to finish the work. As a result of the increased cost of the project, Clark County filed an arbitration demand against Hughes Masonry. Hughes Masonry turned around and filed two lawsuits – one against Clark County and one against J.A. Construction. J.A. Construction attempted to force the dispute to arbitration. Hughes Masonry argued that it could not be forced to arbitrate any dispute with J.A. Construction because J.A. Construction did not sign an arbitration agreement with Hughes Masonry. J.A. Construction sought to rely on an arbitration agreement between Hughes Masonry and Clark County.

The court said estoppel (fairness) applies to this situation. Hughes Masonry sued J.A. Construction for breaching duties outlined in the contract between Hughes Masonry and Clark County, essentially attempting to hold J.A. Construction to the terms of Hughes Masonry's agreement with Clark County. Hughes Masonry was trying to enforce the contract against J.A. Construction but would not allow J.A. Construction the benefit of the arbitration clause in the same contract. The court said a party cannot rely on a contract to its advantage and repudiate a contract when it is at a disadvantage. A party cannot have it both ways. Hughes Masonry Company, Inc. v. Greater Clark County School Building Corp., et. al., 659 F.2d 836 (7th Cir. 1981).

In a case similar to the Morris decision, another party found itself bound by an arbitration decision even though it was not a party to the arbitration and did not sign an arbitration agreement. Bared Jewelers was a subtenant of ARI Corporation, who rented space from Sharp Properties. The lease between ARI and Sharp contained an arbitration provision. After it prevailed in arbitration, Sharp was allowed to enforce the arbitration award against Bared Jewelers. The court did not allow Bared Jewelers to argue that enforcing the award was a violation of Bared's due process rights. Bared Jewelers did not ask the court to postpone the arbitration proceedings and did not ask to be included as a party to the arbitration. In addition, Bared Jewelers was a witness in the arbitration. Finally, Bared Jewelers' interests were similar to ARI's interests and, consequently, were represented in the arbitration proceedings. Isidor Paiewonsky Associates, Inc. v. Sharp Properties, Inc., 998 F.2d 145 (3rd Cir. 1993).

What Now?

You may be wondering how far these decisions reach. Will subcontractors be forced to honor arbitration awards when they had only minimal involvement in arbitration proceedings? At this point that is unlikely to be the case. However, the construction industry is the prime place for such a situation to arise. Consequently, subcontractors should be cautious. (A. Zarlenga & M. Smith, *Can a Nonsignatory or Nonparty Be Bound by an Arbitration Award? A Warning for the Unwary*, The Construction Lawyer, Summer 2004.) If forced to assist with a dispute, a subcontractor may find itself actively involved in arbitration even though it was not a signatory to an arbitration agreement or a party to the arbitration itself. Subcontractors should be cautious when assisting in the defense of arbitration lest they unwittingly waive their right to a full defense on the merits.

Conclusion

The *Contracts Bulletins* mantra is to carefully read contracts. Unfortunately, court rulings are binding parties to arbitrations even if contracts do not contain arbitration clauses. This means that (at least in this case) carefully reading the contract may not be enough. The lesson to be taken from these cases is that, even if you are asked to assist in arbitration, you should consult with your attorney to determine whether you need to commence a lawsuit, refuse to participate, or otherwise act to preserve your legal rights. If not, you may be forced to live with the results of an arbitration you never agreed to or wanted.

SMACNA wants the Contracts Bulletins to serve our members. Your feedback or topic suggestions are welcomed by contacting Steve Yoch (e-mail: syoch@felhaber.com; telephone 651 312 6040) or Tom Soles

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[1] Arbitration and mediation are the most common forms of ADR. What's the difference between arbitration and mediation?

Generally, "arbitration" means submitting a dispute between parties to a binding decision by an arbitrator (either an individual judge or panel of judges) who will make a decision which is enforceable. Put another way, arbitration is an agreement to hire a judge (or judges) that will make a binding decision, which in virtually every state is as enforceable as those made by a state or federal judge in a civil proceeding.

In contrast, "mediation" is merely an attempt to negotiate a settlement with the assistance of a "mediator." Mediations are usually administered by an experienced individual who engages in "shuttle diplomacy" in attempting to encourage the parties to settle the case. Mediations are almost always "non−binding;" that is, the parties can refuse to settle and proceed with either arbitration or with the trial in state or federal court.

[2] An "alter ego" is an individual or entity which is found to be legally the same as the party signing an agreement to arbitrate.

[3] For a general discussion of the pitfalls of failing to follow corporate formalities resulting in piercing of the corporate veil, or being personally liable as an "alter ego," see *Contracts Bulletins 68*, *69*, and *70*.

[4] "Estoppel" is often described as "fundamental fairness." That is, courts look at the general factual situation and determine whether "fundamental fairness" requires a certain decision.

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