



# REPORT FROM WASHINGTON

## The Supreme Court Hears Argument Concerning the Ability of Non-Signatories to Arbitration Agreements to Stay Claims under the Federal Arbitration Act

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### INTRODUCTION

On March 3, 2009, the United States Supreme Court heard oral argument in *Arthur Andersen, LLP v. Carlisle*, No. 08-146, a case involving the ability of non-signatories to an arbitration agreement to stay court claims in favor of arbitration under the Federal Arbitration Act (“FAA”). Specifically at issue here is: (i) whether a party to a litigation can obtain a stay of claims against it under section 3 of the FAA when the party is not a signatory to the written agreement providing for arbitration; and (ii) whether federal appellate courts have jurisdiction to review an appeal of the denial of such motion under section 16 of the FAA. The significance of this case is highlighted by a circuit split relating to these precise issues.

### BACKGROUND

Plaintiffs sought the advice of the defendants (including Arthur Andersen LLP) to minimize taxes arising from the sale of their construction equipment business. The defendants allegedly recommended that plaintiffs invest in a tax shelter referred to as a “leveraged option strategy,” which required plaintiffs to create limited liability corporations (“LLCs”) in order to implement the strategy. These LLCs then entered into investment management agreements with one of the defendants that is no longer a party to the action. The agreements contained an arbitration clause, providing that “[a]ny controversy arising out of or relating to this Agreement or the breach thereof, shall be settled by arbitration conducted in New York, New York, in

accordance with the Commercial Arbitration Rules of the American Arbitration Association.”

The IRS determined that the recommended “leveraged option strategy” was unlawful and offered amnesty to taxpayers who had previously invested in them, under certain conditions. The defendants had allegedly failed to inform plaintiffs of this development, and, as a consequence, plaintiffs were forced by the IRS to pay more than \$25 million in taxes and penalties.

Plaintiffs then sued, asserting claims against all defendants for fraud, negligence, civil conspiracy, and breach of fiduciary duty, among others. Before trial, the defendant that had entered into investment management agreements with the LLCs moved to stay the action under section 3 of the FAA pursuant to the arbitration clause in its written agreement with plaintiffs, which the district court granted. The remaining defendants had not entered into a written agreement with the plaintiffs containing an arbitration clause, but they likewise moved to stay the action. Defendants argued that plaintiffs’ claims should be stayed under principles of equitable estoppel because finding otherwise would allow plaintiffs to avoid arbitration under their agreement with the defendant signatory to the arbitration clause by permitting the same claims to proceed in court against the non-signatories to the arbitration agreement.

Rejecting their equitable-estoppel argument, the district court denied defendants’ motion to stay. Defendants appealed the denial to the United States Court of Appeals for the Sixth Circuit, claiming that the appellate court had jurisdiction to review the interlocutory appeal under section 16 of the FAA.

The Sixth Circuit disagreed, and dismissed the appeal. The Sixth Circuit’s reasoning was twofold:

First, the Sixth Circuit looked to the plain language of section 3, which required a stay only when the issues involved in the litigation are “referable to arbitration under an agreement.” This language, according to the court, would provide for a stay only if there were a written agreement between the *parties to the litigation*. Absent such an agreement between the parties, a defendant could not claim that the issues involved are referable to arbitration under the agreement, as required by section 3.

Second, the court noted that jurisdictional rules should be clear, predictable, bright-line rules that may be applied with a fair degree of certainty. The court reasoned that basing jurisdiction on whether the parties are signatories to a written agreement is more consistent with such criteria than allowing courts to stay claims against non-signatories based on, for instance, defendants’ theory of equitable estoppel. The latter necessarily would entail a multifactor inquiry to determine whether the issues to be litigated by the non-signatory and signatory are sufficiently intertwined with the issues subject to arbitration. The court accordingly found that delving into the merits of a case before deciding whether a court has jurisdiction was an “unattractive prospect.”

The Sixth Circuit expressly recognized a split among the circuit courts, singling out a decision by the Second Circuit – *Ross v. American Express Co.*, 478 F.3d 96 (2d Cir. 2007) – upon which defendants heavily relied in their argument. In *Ross*, the Second Circuit found that a stay of claims against a non-

signatory was warranted under section 3, stating, “[w]here a party is deemed bound by a written arbitration agreement because of principles of equitable estoppel, that written agreement *alone* creates, defines, and provides procedures . . . for implementing the arbitration obligation.” The Second Circuit’s finding that the literal language of the statute had been satisfied, coupled with the strong federal policy favoring arbitration, led the court to hold that a motion to stay based on equitable estoppel is properly made under section 3 of the FAA. The Second Circuit also observed that, “[w]ere the [plaintiffs] to prevail, parties seeking to delay arbitration or to introduce mischievous complexities that would be grounds for judicial appeals would have ample opportunity to do so.”

#### SUMMARY OF THE ARGUMENT

At oral argument this week, defendants argued that if a non-signatory has the right under state law to enforce an arbitration agreement, then that party should be entitled to a section 3 stay. Defendants explained that section 3 of the FAA is merely a procedural device designed to implement the substantive law outlined in section 2 of the FAA. Section 2, in turn, provides that substantive rights under arbitration agreements are governed by state law, under which non-signatories have the right to enforce arbitration agreements in certain circumstances. Framed in this manner, defendants argued that section 3 should be construed to allow a non-signatory to an arbitration agreement (who could enforce such agreement as a matter of state law) to make a motion to stay an action, and, if the motion is denied, appeal that denial under section 16. To rule otherwise “would wipe out six decades of FAA case law

recognizing that nonparties have arbitration rights.”

Justice Souter expressed doubts about whether state law controlled how the Supreme Court should interpret section 3, emphasizing that the issue in the case concerned the *procedural* right to seek an appeal under a federal statute. “To say that is a question of state law strikes me as a stretch.” Justice Breyer, however, tempered Justice Souter’s argument, and acknowledged that “state law is relevant, but not always determinative.”

Justice Alito and Justice Ginsburg both questioned defendants as to why they argued the merits of the motion to stay under section 3 at all. The Sixth Circuit dismissed defendants’ appeal because it held that it did not have subject matter jurisdiction under section 16. Justice Ginsburg observed that all that is required to trigger jurisdiction under section 16 is a request for a stay under section 3, and a denial of that request, which alone is enough to reverse the Sixth Circuit’s decision. She stated: “[I]f you interpret, as you do, the word ‘parties’ [in section 3] to mean parties to the litigation, then for purposes of jurisdiction the only thing is, is this person a party to the litigation? Yes. End of case; they can move for a stay.”

While defendants agreed with Justice Ginsburg’s reasoning, they further explained that the rationale underlying the Sixth Circuit’s holding was the conclusion that, as a matter of law, a non-signatory cannot make a section 3 motion to stay. Defendants claimed that this conclusion had to be rejected for the Court to properly rule on the jurisdictional question. With that said, however, defendants cautioned the Court that they were not asking it to decide whether their theory of moving for a stay under FAA section 3 should prevail.

They simply were asking the Court to reverse the Sixth Circuit and hold that, at least at times, a non-signatory to an arbitration agreement can enforce the agreement by making a section 3 motion.

Plaintiffs principally argued that state law does not apply; rather, the express language of section 3 controlled. Plaintiffs averred that defendants' motion to stay under section 3 was "so far outside" what the language in section 3 permitted such that it cannot be classified as a motion under section 3 at all. Consequently, there was no appellate jurisdiction to review the denial under section 16.

Plaintiffs emphasized that section 3 requires a stay only when the issues involved in the lawsuit are "referable to arbitration *under* an agreement in writing for such arbitration." Plaintiffs claimed that this language - particularly the word "under" - makes clear that in order for there to be a stay under section 3, the issues must be referable to arbitration pursuant to, or because of, the terms of the agreement. In other words, the right to enforce the agreement must "flow from" the agreement itself. Defendants' equitable estoppel theory, however, is premised on the idea that equitable principles - and not the agreement - are the justification for a stay pending arbitration. Therefore, the language of section 3, according to plaintiffs, precludes a motion based on this theory from being granted, and therefore from ever being reviewed on interlocutory appeal. Plaintiffs argued that Defendants' motion to stay should instead be construed as a motion made pursuant to the court's inherent power to manage its docket in its discretion, which cannot be immediately appealed under section 16.

Justice Souter and Justice Breyer questioned plaintiffs as to whether the Sixth Circuit's opinion went too far by holding that only a signatory has a right to a stay under section 3, thereby precluding non-signatories from enforcing the agreement even though it may have been the intention of the parties to the agreement to allow enforcement by non-signatories. Plaintiffs responded by distinguishing motions under section 3 based on an assignment or assumption of right under a contract (where the rights are "pursuant to" or "flow from" the contract) from defendants' motion based on equitable estoppel. From the perspective of the signatories' intentions as expressed in the agreement, plaintiffs argued that the Court could "interpret the contract until the cows come home, you will never find the [defendants] in it." Justice Breyer expressed concern about this position, explaining that he would "hate to write the words 'equitable estoppel is never relevant.'"

In contrast, Justice Souter suggested that "it is sensible as a matter of Federal policy to say, we're not going to stop this trial in mid-track for arbitration unless you who are asking for it to be stopped signed an arbitration agreement yourself . . ." When pressed by Justice Stevens on this point, however, plaintiffs responded that they were "concerned" about the argument that "parties" as used in section 3 of the FAA refers to parties to a contract, rather than parties to litigation, noting that Congress used the term "parties" to mean different things throughout the FAA.

On rebuttal, defendants made two points. First, they highlighted plaintiffs' apparent admission that non-signatories to

an arbitration agreement could move under section 3 to stay the action, and claimed that such admission "decides the case." Second, defendants stressed that the theory of equitable estoppel presupposes the existence of a written arbitration agreement that plaintiffs were unfairly circumventing, and therefore makes the issues referable to arbitration "under" (or "because of") the agreement. Thus, to the extent the Court finds that the language of section 3, rather than state law, controls, defendants' theory of equitable estoppel is consistent with that language.

### IMPLICATIONS

The Supreme Court could decide the appeal on the narrow ground suggested by Justice Ginsberg, which would leave open whether non-signatories to an arbitration agreement could make a motion under section 3 of the FAA to seek a stay of court litigation pending an arbitration by the signatories.

On the other hand, the Court's decision could have significant implications by clarifying whether, and to what extent, non-signatories to arbitration agreements can invoke the FAA. The case is one of several arbitration-related disputes that the Court has addressed in the past year, including *Hall Street Associates LLC v. Mattel Inc.*, 128 S. Ct. 1396 (2008) (holding that the FAA trumped state

law regarding the reversal of arbitration awards), *Preston v. Ferrer*, 128 S. Ct. 978 (2008) (holding that the FAA supersedes state laws that vest state administrative agencies with exclusive jurisdiction over the claims), and *Vaden v. Discover Bank*, No. 07-773, a case in which the Court heard argument in October of 2008 to address the circumstances under which federal courts have jurisdiction to decide petitions to compel arbitration.

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