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Bound to Arbitrate

In certain situations, a party not originally a signatory to an arbitration agreement can be compelled to resolve its claims before a neutral, explains Jon Sylvester of Golden Gate University School of Law.

Jon Sylvester

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When can arbitration be compelled by a party who did not sign the agreement containing the arbitration provision? This question was raised recently in a well-publicized and ongoing San Francisco Superior Court lawsuit alleging gender bias and discrimination at the Silicon Valley venture capital firm Kleiner Perkins Caufield & Byers.

Junior partner Ellen Pao filed the suit in May, and the firm sought to compel arbitration. KPCB's counsel argued that each of the firm's investment funds is managed by a separate limited liability company and partner compensation, which is central to Pao's claim for damages, is governed by each LLC's operating agreement. KPCB says these operating agreements contain mandatory arbitration clauses that bind Pao and other partners. Pao, on the other hand, argues that her claim is not against the LLCs but against KPCB — with whom she has no arbitration agreement.

At a July 10 hearing, Judge Harold Kahn agreed with Pao, tentatively ruling that "There is no arbitration agreement between plaintiff and defendant." This might seem to have ended KPCB's efforts to get out of court, since "arbitration agreements are purely matters of contract" — at least according to the legislative history of the 1925 Federal Arbitration Act and myriad cases right up to the present. But Kahn invited further briefing and argument, and KPCB's lawyers took the position that even though KPCB was not a party to the LLC agreements containing the arbitration provisions, KPCB could nonetheless invoke those provisions and compel Pao to arbitrate her claims based on equitable estoppel and third-party beneficiary theories.

Kahn rejected these additional arguments on July 20, but his decision may be headed for appeal. No matter what happens with this particular case, however, lawyers interested in arbitration might also be interested in these theories and others that, under certain circumstances, allow a nonsignatory either to invoke an arbitration provision or be bound by one. Courts have employed six such theories: (1) incorporation by reference, (2) assumption, (3) agency, (4) piercing the corporate veil/alter ego, (5) third-party beneficiary and (6) equitable estoppel. The KPCB litigation has involved the last two. The first four also warrant a brief explanation, however, both for the sake of completeness and because the six theories are not as independent as their separate enumeration might imply.

Incorporation by Reference

A nonsignatory can invoke an arbitration provision against a party to the agreement containing that provision if the two have entered into a separate contract that incorporates the arbitration provision by reference. The reverse can also be true: Rhe party to the original arbitration provision could invoke it against the nonsignatory whose contract incorporates the arbitration provision by reference.

This is entirely unsurprising, and easily understood if one keeps in mind an old-fashioned phrase used for incorporation by reference: "The parties hereby agree to [xyz], the terms of which are incorporated by this reference as if fully set forth herein." In other words, the document or obligation that is effectively incorporated by reference is literally and in fact a part of the new agreement. Thus, if the first contract (or just the arbitration provision in the first contract) is expressly incorporated into the second contract, the parties to the second contract are bound by the arbitration provision just as though they had written it out anew.

Assumption

A nonsignatory can be bound to arbitrate if its conduct evidences assumption of the duty to arbitrate. One case frequently cited for this conclusion involved union representation of flight attendants bargaining with United Airlines. After the union hired counsel, formed a committee and represented the flight attendants through the arbitration process, the flight attendants were deemed to have assumed the duty to arbitrate their claims and were bound by the decision of the arbitrators. If you think this resembles estoppel, you are not alone.

Agency

Traditional principles allow an agent to bind his or her principal to a contract. If the contract contains an arbitration provision, the principal might argue that it did not sign, but it is still likely to be bound by the arbitration provision. Thus, if an HR official signs an employment contract on behalf of an employer, the employer is bound by the contract's arbitration provision and can also invoke the provision in the event of a subsequent lawsuit by the employee.

Moreover, if the employee sues the employer and also names an individual manager as an additional defendant, the manager may be able to compel arbitration pursuant to the arbitration provision because the manager is an agent of the employer — albeit a different agent from the one who bound the employer in the first place. This, too, is relatively uncontroversial, because it really amounts to seeing the agent as an extension of the principal, and vice versa — at least for certain purposes.

Piercing the Corporate Veil

Piercing the corporate veil and the alter ego theory also amount to viewing two arguably distinct persons (whether natural or juridical) as one — at least for certain purposes. These theories can be used, for example, to require a nonsignatory individual to arbitrate pursuant to a provision in a contract signed on behalf of a corporation that functioned as the alter ego of the individual, or to require a parent corporation to arbitrate pursuant to a provision in a contract signed by a subsidiary. Of course, such veil piercing is not automatic; it involves the same fact-specific determinations required to pierce the veil for other purposes — notably attribution of liability and recovery of damages. Again, however, when these theories are successfully invoked, the alleged nonsignatory is effectively collapsed into one of the parties to the arbitration provision.

This brings us to the theories argued on behalf of KPCB.

Third-Party Beneficiary

A non-signatory can be bound by an arbitration provision in a dispute with a signatory if the nonsignatory's claims are based on the contract containing the arbitration provision and the nonsignatory is an intended third party beneficiary of that contract. Although this statement of the rule puts the nonsignatory on the defensive, it is merely the obverse of the more general rule governing whether and when a third party can enforce contractual rights. Subject to vesting requirements not at issue here, a third-party beneficiary can generally enforce a contractual right if the third party's benefit is direct and intended by the parties to the contract. The same applies to nonsignatory enforcement of an arbitration provision in a contract.

In Pao's suit against the Kleiner Perkins firm, KPCB argued that (1) it is the direct and intended beneficiary of several express provisions in the LLC agreements to which Pao is bound, (2) each of these agreements contains a provision requiring arbitration of "any controversy or claim," and (3) "California courts have compelled arbitration in response to motions by third-party beneficiaries in circumstances less compelling than the facts here." Kahn rejected this argument, concluding that Pao's employment relationship with KPCB is separate from the relationship between the fund management LLCs and the partners, and that the "agreements that are cited as the basis of the arbitration claim are not employment agreements."

Before turning to the sixth theory — upon which KPCB placed primary reliance — it is worth noting that the five theories above do very little violence to the foundational premise that "arbitration agreements are purely matters of contract." Indeed, the first of them, incorporation be reference, is really not an exception at all. It simply recognizes that the parties' contract is not a document, but rather the totality of the legal obligations between them, from whatever source, including incorporation by reference. And each of the other four theories mentioned has the effect (to put it somewhat inelegantly) of placing the nonsignatory "into the shoes" of one of the contracting parties.

Thus, while it is useful and may be correct to characterize the above theories as exceptions to the basic rule, there is nothing particularly radical about any of them. The sixth theory has proven to be the most controversial.

Equitable Estoppel

A nonsignatory can use the doctrine of equitable estoppel to compel a signatory to arbitrate if the claims at issue are intimately intertwined with the obligations in the contract containing the arbitration provision. KPCB argued that this requirement is met in the present case because Pao's claim for damages relates primarily to alleged discrimination in the allocation of carried interest and other benefits available to her only as a result of having entered into the LLC agreements containing the arbitration provisions. Kahn also rejected this argument for compelling arbitration, finding it "extremely odd that [the parties] would agree to arbitrate employment disputes in such a tangential, circuitous manner." He added, "The parties here are very sophisticated. They could, if they wished, have included in their employment agreements an arbitration clause. They didn't."

Conclusion

Employers most frequently cite relative speed and cost in explaining their general preference for arbitration over litigation with employees or former employees. Privacy is also a factor, however, and in this case one suspects that privacy is a major consideration for KPCB — which no doubt wishes to protect both its reputation and the contents of the LLC agreements, which were filed with the court under seal. Pao's attorney says his client is looking forward to telling her story in front of a jury. KCPB has vowed to appeal.

Jon Sylvester is a professor and associate dean for graduate programs at Golden Gate University School of Law.

In Practice articles inform readers on developments in substantive law, practice issues or law firm management. Contact Vitaly Gashpar with submissions or questions at vgashpar@alm.com.

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