# LICENSING LAW AND BUSINESS REPORT

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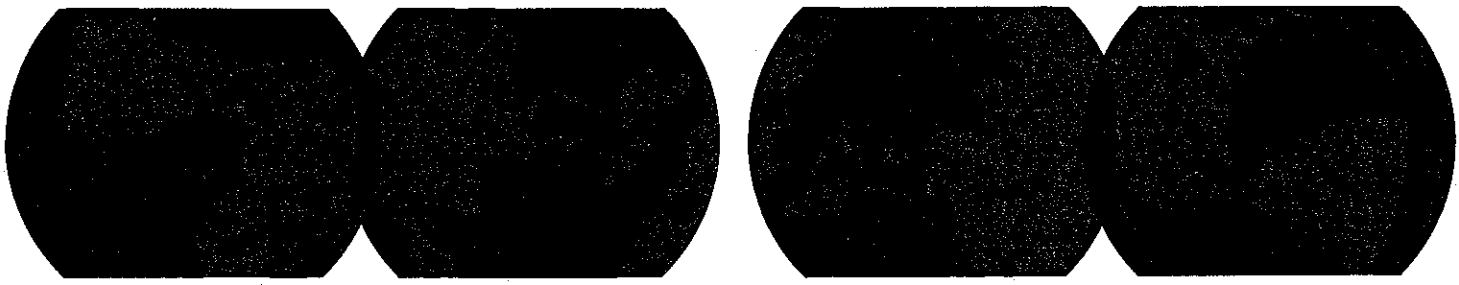

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## ARBITRATING LICENSING DISPUTES: PUTTING THE "BINDING" IN BINDING ARBITRATION

**(Part Two of a Two-Part Article)**

**by John R. Ackermann, Jr.***

- **Responding to a Refusal to Arbitrate**
- **Joinder of Nonsignatories to Avoid Arbitration**
- **Fraud as a Basis for Avoiding Arbitration**
- **Punitive Damages in Arbitration**
- **Allegedly Nonarbitrable Claims**

### 7. Introduction to Part II

Part I of this article discussed the advantages of arbitration as a means of resolving disputes in licensing agreements, and set out the statutory scheme and private rules that make arbitration a workable tool. Part I also described a "defensive" arbitration clause that makes an agreement to arbitrate more likely to survive attack. For your convenience, this arbitration clause is included as Appendix A at the conclusion of Part II of the article.

Part II addresses the details of enforcing arbitration clauses through motions to stay litigation and to compel arbitration, and discusses some of the tactics plaintiffs use to try to avoid arbitrating their claims.

The reader should not take references to the plaintiff as this article's villain as an indication of the author's bias. It is simply very uncommon to encounter a situation where the defendant in a lawsuit has violated an arbitration obligation owed to the plaintiff.

### 8. Responding to a Refusal to Arbitrate

#### [a] Procedure

It should be no surprise by now that you cannot count on the other side to take note of an arbitration provision and proceed voluntarily to arbitration. Counsel may be

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unaware of the existence of the provision (particularly where numerous documents reflect the parties' relationship), or—more often—may choose to believe that the clause does not mean what it says.

NCR's practice when confronted with threats of litigation is to point out the parties' agreement to arbitrate and the advantages of arbitration to both sides, provide cites to some of the cases outlining the binding nature of arbitration provisions, and, if settlement seems unlikely, request that the plaintiff voluntarily proceed to arbitration.

The many cases upholding binding arbitration may be sufficient to support a motion for sanctions under Fed. R. Civ. P. 11 if the plaintiff files an action despite notice of the arbitration provision. No reported decision has considered whether intentional violation of an arbitration provision warrants the application of Rule 11 sanctions, but it may be a good tactical move to warn the plaintiff that he may face such sanctions if he gambles and loses. The NCR arbitration clause includes a provision requiring a party who challenges arbitration and loses to pay the other side's reasonable attorney's fees, and is intended to accomplish the same purpose.

Sometimes reminding the other side of its promise to arbitrate works, but frequently the filing of a summons and complaint is the next event in the dispute. In that case the defendant's initial response should be the filing of pleadings seeking to stay the litigation and to compel the plaintiff to file an arbitration demand.

Of course, other early motions, such as any appropriate challenge to jurisdiction or joinder, should also be considered. In particular, if the action is filed in a state court, consider whether removal to federal court is possible. As noted below, some state courts are hostile to arbitration and the federal forum may provide a friendlier atmosphere in which to bring an arbitration motion. Such motions are not likely to be considered the sort of substantive involvement in litigation that would waive the right to arbitrate.

Although arbitration may be raised as an affirmative defense to a complaint, *see, e.g., Knorr Brake Corp. v. Harbil, Inc.*, 556 F. Supp. 489 (N.D. Ill. 1983), such a defense will not bring the court to an early consideration of the arbitration issue. The best course is to file a motion pursuant to Federal Arbitration Act (FAA), 9 U.S.C. § 3, for a stay of proceedings pending arbitration. Although the § 3 motion by itself will be enough to stop the action from moving forward, as a practical matter the motion should also seek to compel arbitration of the dispute as provided by 9 U.S.C. § 4.

NCR normally files a single pleading, styled as a "Motion to Stay Litigation and Compel Arbitration." As noted in Part I, § 3 governs actions in both state and federal courts where the contract containing the arbitration agreement involves commerce among the states, and therefore any court with jurisdiction must hear a motion to stay based on that Section. *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 26 n.34 (1983).

It is not so clear that § 4 obligates state as well as federal courts to compel arbitration, but some state courts have so held. Although the United States Supreme Court has not directly ruled on this issue, *Moses H. Cone* implies that such decisions are correct. *Id.* at 26 n.35. Section 2(a) of the Uniform Arbitration Act contains a provision similar to 9 U.S.C. § 4, but assured access to the FAA's mechanism to compel arbitration is a good reason to consider removal from state to federal court if possible.

There is no need to file an answer on the merits during the pendency of either motion. Although motions under § 3 and § 4 are not among those which automatically stay the time to answer under Fed. R. Civ. P. 12(a), "federal courts have traditionally entertained certain types of pre-answer motions not specifically provided for in the Federal Rules of Civil Procedure. Included among these are motions to stay proceedings pending arbitration." *Smith v. Pay-Fone Sys., Inc.*, 627 F. Supp. 121, 122 (N.D. Ga. 1985). *See also* 5 Charles A. Wright & Arthur R. Miller, *Federal Practice and Procedure* § 1360 (1969).

To avoid any possibility of a finding that you have waived your right to arbitrate by filing an answer on the merits (as discussed in Section 11 below), consider responding to the complaint by filing *only* a motion to stay litigation and compel arbitration, unaccompanied by a substantive pleading. To avoid any possibility of default, the motion should include an explicit request to extend the time to answer until the later of 20 days after decision on the motion, or the conclusion of the arbitration proceeding.

**[b] Staying Discovery**

Although it would be sensible to conclude that a motion to stay litigation pending arbitration implies a stay of discovery as well, not all plaintiffs see things that way, and a few courts have permitted discovery to continue pending arbitration because § 3 permits the court only to "stay the *trial* of the action." 9 U.S.C. § 3 (emphasis added). *See, e.g., International Ass'n of Heat & Frost Insulators and Asbestos Workers, Local 66 v. Leona Lee Corp.*, 434 F.2d 192, 194 (5th Cir. 1970) (a troublesome decision that summarily characterizes an order permitting discovery "to the extent necessary for presentation of matters submitted for [arbitration]" as effectuating the policy favoring arbitration).

Fortunately, most judges have given more reasoned thought to this issue than did the *Leona Lee* court, and the nearly universal conclusion is that a § 3 stay should also stay discovery: "To allow discovery to proceed even though the claims have been referred to arbitration would

invite undue interference with the arbitrator's power. The purpose of arbitration is to provide a less expensive method of resolving disputes quickly. Accordingly, the arbitrator is given the power to narrow the issues and to limit discovery." *Schacht v. Hartford Fire Ins. Co.*, No. 91 C 2228, 1991 U.S. Dist. Lexis 16430, at *11-*12 (N.D. Ill. 1991). *See also Corpman v. Prudential-Bache Sec.*, 907 F.2d 29 (3d Cir. 1990); *Suarez-Valdez v. Shearson Lehman/Am. Express, Inc.*, 858 F.2d 648 (11th Cir. 1988); *Mediterranean Enter., Inc. v. Ssangyong Corp.*, 708 F.2d 1458 (9th Cir. 1983); and *American Home Assurance Co. v. Vecco Concrete Constr. Co.*, 629 F.2d 961 (4th Cir. 1980).

Of course, given the language of § 3, a plaintiff might not agree that a stay of litigation includes a stay of discovery. Rather than coming back to court again to argue the issue, it is best to include a request to stay discovery as part of the motion.

### 9. Fraud as a Basis for Avoiding Arbitration

Fraud and misrepresentation are common substantive claims in computer and software licensing disputes, and plaintiffs often use such allegations to support a refusal to arbitrate. Their theory is that a fraudulently induced purchase or license agreement is void, and therefore so is the arbitration clause it contains. This argument, though easy to make, should be very difficult to win since the Supreme Court has made it clear that plaintiffs may not avoid agreements to arbitrate under the FAA by a simple claim of fraud.

Unfortunately, things are not quite so simple because the circuits interpreting the Court's ruling on this subject have done so in some surprising ways.

#### [a] The *Prima* Doctrine

*Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967), is the decision from which all the later analysis on this point springs. Confronted with a claim that an agreement containing an arbitration clause was induced by fraudulent representations about one party's ability to perform, the Court held that fraud in the inducement of a contract, where there is no evidence that the parties intended to withhold claims of fraud from arbitration, will not void an otherwise valid arbitration agreement.

The Court looked to the Federal Arbitration Act to resolve the issue:

> Under § 4, with respect to a matter within the jurisdiction of the federal courts save for the existence of an arbitration clause, the federal court is instructed to order arbitration to proceed once it is satisfied that 'the making of the agreement for arbitration or the failure to comply [with the arbitration agreement] is not in issue.' Accordingly, if the claim is fraud in the inducement of the arbitration clause itself—an issue which goes to the 'making' of the agreement to arbitrate—the federal court may proceed to adjudicate it. But the statutory language does not permit the federal court to consider claims of fraud in the inducement of the contract generally.... We hold, therefore, that in passing upon a § 3 application for a stay while the parties arbitrate, a federal court may consider only issues relating to the making and performance of the agreement to arbitrate.

*Id.* at 403-04 (footnotes omitted) (alteration in original).

*Prima* seems clear enough: arbitration clauses must be considered separately from the agreements of which they are a part. Unless the challenge is to the making of the arbitration agreement itself and not to the making of the contract as a whole, a claim of fraud will not avoid the duty to arbitrate. However some courts have given *Prima* a narrow reading that leaves some room for avoiding arbitration through artful pleading. The circuits have differed in interpreting the rule, and at least two inconsistent lines of cases have appeared.

#### [b] The Majority View

The Third, Fifth, Sixth, Seventh, and Eleventh Circuits interpret *Prima* broadly, and will order arbitration where a claim of fraud in the inducement pertains to the principal agreement and not solely to the arbitration provision. These courts will not attempt to separate fraud relating to the arbitration agreement from fraud alleged generally. *See, e.g., Arnold v. Arnold Corp.*, 920 F.2d 1269, 1278 (6th Cir. 1990) (allegation that arbitration provision was "fraudulent device intended to deny . . . discovery" not sufficient to meet *Prima* test); *Bhatia v. Johnston*, 818 F.2d 418 (5th Cir. 1987); *Bitkowski v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 866 F.2d. 821, 823 (6th Cir. 1987) ("Only if the allegation pertains to the arbitration clause, standing independently of the overall agreement,


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may the court address the issue"); *Driscoll v. Smith Barney, Harris, Upham & Co.*, 815 F.2d 655 (11th Cir. 1987), *vacated on other grounds*, 484 U.S. 909 (1987) *and cert. denied*, 484 U.S. 914 (1987); *Coleman v. Prudential Bache Sec.*, 802 F.2d 1350 (11th Cir. 1986); *Schacht v. Beacon Ins. Co.*, 742 F.2d 386 (7th Cir. 1984).

Small slices have been cut out of this broad interpretation. In *Cancanon v. Smith Barney, Harris Upham & Co.*, 805 F.2d 998 (11th Cir. 1986), a case driven by hard facts and sympathetic plaintiffs, the court held that where there was an allegation of fraud *in the factum* (*i.e.*, ineffective assent) such that no contract was ever formed, arbitrability was an issue for the court to decide. In short, the plaintiffs claimed that the broker took advantage of them as a result of their unfamiliarity with English, and that their signatures to a securities agreement were "furtively obtained." Under these circumstances, the court found it and not the arbitrator should determine whether a contract was ever formed: "where the allegation is one of fraud in the factum . . . the issue is not subject to resolution pursuant to an arbitration clause contained in the contract documents." *Id.* at 1000.

A Third Circuit case dealt with another question going to the existence of the contract: whether an arbitrator or the court should determine arbitrability when the allegation is that the employee who signed the agreement lacked his employer's authority to do so. In *Par-Knit Mills, Inc. v. Stockbridge Fabrics Co.*, 636 F.2d 51 (3d Cir. 1980), the answer was that this issue belonged to the court and not the arbitrator: "[t]he mere execution of a document, however, even assuming that it is executed by a corporate agent, does not negate the factual assertion that such signature was not intended to represent a contractual undertaking." *Id.* at 54-55.

These cases should be viewed as anomalies driven by unique (and sometimes very difficult) facts. They do not weaken the general rule in the majority of courts that *Prima* means what it says.

### [c] The Second Circuit

If the Eleventh Circuit and Third Circuits have cut out some narrow slices from *Prima*, the Second has cut out its heart. There, the rule appears to be that the court and not the arbitrator must decide *all* fraud claims directed at *both* the overall agreement and the arbitration provision.

If the court determines that the allegation fails to make a *prima facie* claim of fraud with respect to the making of the arbitration clause, then and only then will the matter be referred to the arbitrator, who will rule on the issue of fraud in the inducement of the contract as a whole. To establish the *prima facie* claim, the plaintiff will normally have to prove the elements necessary for rescission of the contract under the governing substantive law.

The leading case for this view is *Rush v. Oppenheimer & Co.*, 681 F. Supp. 1045 (S.D.N.Y. 1988). On remand from the Second Circuit to consider Rush's claim of fraud in the inducement of a contract containing an arbitration provision, the district court rejected the broad interpretation of *Prima* because it "would require a federal court to relinquish its jurisdiction, and its obligation, under § 4 of the Act to determine that 'the making of the agreement for arbitration . . . is not in issue.'" *Id.* at 1049 (alteration in original). *Rush* criticized courts taking a more liberal view for relying "on an interpretation of . . . *Prima Paint* that . . . reaches beyond its holding," *id.* at 1052, and concluded that "*Prima Paint* requires a federal court to resolve allegations of fraud that pertain to both the principal agreement as a whole and the arbitration agreement in particular." *Id.* at 1053.

The opportunities for creative pleading afforded by the *Rush* interpretation of *Prima* are obvious. All the plaintiff need do is allege that the fraud extended to the arbitration provision, and the Second Circuit will retain jurisdiction to determine arbitrability. *Rush* significantly undercuts the practical meaning of *Prima*, but some other courts have adopted its view nevertheless. *See, e.g., C.B.S. Employees Fed. Credit Union v. Donaldson, Lufkin & Jenrette Sec. Corp.*, 912 F.2d 1563 (6th Cir. 1990); *Hercules & Co. v. Shama Restaurant Corp.*, 613 A.2d 916 (D.C. 1992). However, since *Bitkowski*, which predates *C.B.S. Employees*, and *Arnold*, which follows it, come to the opposite conclusion, it is doubtful that *C.B.S. Employees* represents the law of the Sixth Circuit.

The moral of these cases is that although most courts have remained faithful to *Prima*, a minority have made it easier for a plaintiff to retain the right at least to a hearing on the arbitrability issue, and to presumably conduct some discovery until that hearing.

The NCR arbitration clause makes the plaintiff's task in avoiding arbitration a bit harder. The clause embraces claims "based on contract, tort, statute or other legal theory *(including but not limited to any claim of fraud or misrepresentation)*" (emphasis added) arising out of the agreement, so there can be no doubt that the parties intended fraud claims to be arbitrable. But contract language can do only so much in the face of claimed fraud, and this split between the circuits makes certainty in the arbitrability of such allegations more a goal than a reality.

## 10. When Must Nonsignatories Arbitrate?

Another very common tactic used in the attempt to avoid arbitration is the joinder of parties who have some nexus with the dispute, but who have not signed the arbitration agreement, as additional plaintiffs or—more often—defendants. Courts have often held that such nonsignatories may be bound by, or take advantage of, the agreement where they have an appropriate legal relationship with one of the parties that did agree to arbitrate.

If a plaintiff "can avoid the practical consequences of an agreement to arbitrate by naming nonsignatory parties as [defendants] in his complaint, or signatory parties in their individual capacities only, the effect of the rule requiring arbitration would, in effect, be nullified. Again, to allow a plaintiff to sidestep the arbitration process in this manner would effectively eviscerate the federal policy in favor of arbitration." *Arnold v. Arnold Corp.*, 668 F. Supp. 625, 629 (N.D. Ohio 1987), *vacated and remanded*, 860 F.2d 1078 (6th Cir. 1988), *order of clarification aff'd*, 920 F.2d 1269 (6th Cir. 1990).

There may be another motive behind the inclusion of additional defendants—the plaintiff may be attempting to destroy diversity jurisdiction. By doing so he could force any motion to compel arbitration into state court, and thus into a forum that may not be as sympathetic to (or as knowledgeable about) arbitration as the federal courts. The legislature and the state courts of Texas have been particularly hostile to arbitration.

For example, the Texas Deceptive Trade Practices Act purportedly forbids waiver of the right to judicial determination of claims arising under that Act. The Texas legislature responded to decisions holding that, at least where interstate commerce is involved, the waiver provision is preempted by the FAA and therefore unenforceable, *see, e.g., Ommani v. Doctor's Assocs.*, 789 F.2d 298 (5th Cir. 1986), by broadening the Act in 1989 to allow "consumers in transactions exceeding $500,000 who are represented by legal counsel, are not in significantly disparate bargaining positions, and who, *along with their attorneys*, sign express waivers in written contracts" to waive the right to a court hearing. *Jack B. Anglin Co. v. Tipps*, 842 S.W.2d 266, 270 n.7 (Tex. 1992) (emphasis added). *Anglin* is the first Texas Supreme Court decision acknowledging that the FAA preempts the DTPA's anti-waiver language. In such a circumstance, where the addition of parties destroys diversity and brings the dispute into a forum hostile to arbitration, the only recourse is to determine whether the additional parties are shams subject to dismissal or severance under Fed. R. Civ. P. 21.

Even if it is not possible to force all the nonsignatories to arbitrate, consider moving to stay the litigation with the nonarbitrating parties pending arbitration: "[F]ederal law *requires* piecemeal resolution when necessary to give effect to an arbitration agreement. Under the Arbitration Act, an arbitration agreement must be enforced notwithstanding the presence of other persons who are parties to the underlying dispute but not to the arbitration agreement." *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 20 (emphasis in original) (footnote omitted).

In such cases, the district court, "as a matter of its discretion to control its docket," may stay litigation among the nonarbitrating parties pending the outcome of the arbitration. *Id.* at 20 n.23. The prospect of preparing and conducting a trial *after* going through an arbitration may chill the plaintiff's desire to include extraneous parties.

Remember that if the civil action precedes the arbitration, or is contemporaneous with it, discovery performed there will as a practical matter be available in the arbitration. A stay is the only way to prevent this and, as noted above, to avoid any doubt the motion to stay should specifically request a stay of discovery.

Careful drafting can blunt these attempts to avoid arbitration by naming nonsignatories. For example, the NCR clause extends the duty to arbitrate to anyone "making or defending any claim which would otherwise be arbitrable." An opponent could argue that such a provision is unsound because it attempts to bind third parties without their consent. However, in most cases those third parties are aligned with the defendant and are probably more than willing to arbitrate, and an argument based on due process is less than convincing when the "victims" do not support it. At a minimum, this provision very clearly expresses the parties' intent that arbitration govern any dispute related to the agreement, and this may be pivotal. *See, e.g., Arnold*, 920 F.2d at 1282.

Discussed below are some of the theories by which nonsignatories may be brought under the scope of an arbitration clause, and some classes of nonsignatories who are frequently made parties in the attempt to avoid arbitration. Because these tactics turn largely on state common-law principles, the cases cited here are illustrative only; your state digest will likely be the best place to find a defense. Unfortunately, many of these cases do little more than cite a common-law principle and announce whether or not that principle applies to the facts of the case; they frequently lack detailed analysis.

**[a] Basic Theories**

**[i] Agency.** Most of the theories for including nonsignatories under an arbitration clause's umbrella come down ultimately to applying agency law. "In determining who is bound by an arbitration agreement, federal courts look to state-law contract principles," *Hartford Fin. Sys. v. Florida Software Servs.*, 550 F. Supp. 1079, 1086-87 (D. Me. 1982), and "[a]n agreement containing an arbitration clause covers nonsignatories under common law contract and agency principles." *Asset Allocation and Management Co. v. Western Employers Co.*, No. 88 C 4287, 1988 U.S. Dist. LEXIS 14531, at *14 (N.D. Ill. 1988). Since the additional parties have to have *some* relationship to both the transaction and to one of the primary players, it is natural to analyze that relationship in terms of agency.

The basic rules of agency in arbitration are straightforward. Fundamentally, a party cannot take advantage of agency for one purpose, and disavow that relationship when it comes to arbitration. *Amoco Transport Co. v.*

*Bugsier Reederei and Bergungs*, 659 F.2d 789, 795-96 (7th Cir. 1981). Thus, if the plaintiff alleges that the nonsignatory acted as an agent for the purposes of liability, it will be very difficult to sustain a claim that he is not entitled to the protection of the arbitration clause. *See, e.g., Kahn v. Peak*, No. 91 C 7148, 1992 U.S. Dist. LEXIS 8710, at *8-*9 (N.D. Ill. 1992).

A nonsignatory principal may enforce an arbitration agreement entered into between its agent and a third party, *Interbas Cayman Co. v. Orient Victory Shipping Co.*, 663 F.2d 4, 6-7 (2d Cir. 1981), and likewise he may be bound by it, *A/S Custodia v. Lessin Int'l*, 503 F.2d 318, 320 (2d Cir. 1974). An agent who signs an arbitration agreement on behalf of a disclosed principal may not be compelled to arbitrate under that agreement. *Flink v. Carlson*, 856 F.2d 44, 46 (8th Cir. 1988). *See also Interocean Shipping Co. v. National Shipping and Trading Corp.*, 523 F.2d 527, 538 (2d Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976). But, as several of the cases discussed below intimate, it is likely that an agent who *wants* to arbitrate under his principal's agreement will be allowed to do so. *See, e.g., Nesslage v. York Sec.*, 823 F.2d 231, 233 (8th Cir. 1987).

**[ii] Third Party Beneficiary.** Third party beneficiary theories also frequently appear in the nonsignatory analysis. State law determines whether a third party beneficiary relationship exists. *Mutual Benefit Life Ins. Co. v. Zimmerman*, 783 F. Supp. 853, 867-68 (D.N.J. 1992). Once such a relationship is found, the beneficiary will be required to arbitrate where the contract whose benefit is claimed contains an arbitration provision: "The law is clear that a third party beneficiary is bound by the terms and conditions of the contract that it attempts to invoke. 'The beneficiary cannot accept the benefits and avoid the burdens or limitations of a contract.' " *Interpool Ltd. v. Through Transport Mutual Ins. Assoc. Ltd.*, 635 F. Supp. 1503, 1505 (S.D. Fla. 1985) (citation omitted).

At least one case in this area has required employee third party beneficiaries to arbitrate only where they actively seek the benefit of the contract, *Flink*, 856 F.2d at 46, but as discussed in more detail below, both the facts and the reasoning of *Flink* are unusual.

**[iii] Relationship Between the Parties.** Some cases focus on the relationship between the signatory and nonsignatory parties, rather than on a legal theory, in determining who is bound by an agreement to arbitrate. This is particularly true where the nonsignatories *want* to arbitrate.

For example, in *Barrowclough v. Kidder, Peabody & Co.*, 752 F.2d 923 (3d Cir. 1985), an employee sued his former employer over claims concerning a deferred compensation plan. He included as additional plaintiffs his contingent beneficiaries under the plan, and as additional defendants his employer's board of directors, the compensation plan, and a number of individuals involved in its administration. None of these additional parties had signed an arbitration agreement.

The Third Circuit upheld the district court's order that all the parties were subject to arbitration. As to the additional plaintiffs, it found that because of their "related and congruent interests with the principals to the litigation . . . [t]heir inchoate and derivative claims should not entitle them to maintain separate litigation in a forum that has been waived by the principal beneficiary." *Id.* at 938-39. Since, "[t]he additional defendants, who are directly tied to [the employer], do not object to arbitration," *id.* at 938, the court held that it was proper to include them in the arbitration as well.

Although the court made reference to contract and agency principles and cited a number of cases dealing with nonsignatories, *Barrowclough*'s analysis is based much more on an equitable determination of who should be required to arbitrate, than on any specific legal theory.

**[b] Employees and Officers of a Signatory**

Perhaps the most common tactic for plaintiffs to avoid arbitration is to join the defendant's employees or officers as codefendants, usually raising noncontractual claims against them. Arbitration of claims against the employees as well as the employer is generally ordered in such circumstances, though there appears to be some uncertainty whether the theory is based on agency, third-party beneficiary, or "relationship" (as in *Barrowclough*) principles.

**[i] Employees.** In *Letizia v. Prudential Bache Sec.*, 802 F.2d 1185 (9th Cir. 1985), an investor brought an action against his broker and two of the broker's employees. He signed a customer agreement that contained an arbitration clause; the broker signed the agreement, but the individual employee-defendants did not. The court found that, "[i]n virtually every case, [other courts have] held the brokerage firm employees bound by the arbitration agreement," *id.* at 1188, and joined this majority, agreeing that nonsignatories "closely related" to parties agreeing to arbitrate are likewise bound to arbitrate. *See also Nesslage v. York Sec.*, 823 F.2d at 233 (arbitration of claims against employee ordered on both third-party beneficiary and agency theories); *Steinberg v. Illinois Co.*, 635 F. Supp. 615, 617 (N.D. Ill. 1986) (employee was employer's disclosed agent and therefore under umbrella of employer's arbitration agreement with plaintiff).

But as noted above, *Flink* disapproved *Letizia* and similar cases on the ground that an employee's status as a third party beneficiary of an agreement between the employer and its customer does not bind the employee unless the employee seeks to enforce the agreement. *Flink*, 856 F.2d at 46. In *Flink* the employer was attempting to recover indemnity or contribution from its employee and to compel the employee to arbitrate those claims against his will. Though employee and employer

had each agreed to arbitrate disputes with the customer, they had never agreed to arbitrate with each other. This situation is somewhat unusual and in most cases the closer alignment between the employee's and his employer's interests makes this issue unlikely to arise. No reported decision has followed *Flink*'s reasoning on this point.

In *Vic Potamkin Chevrolet, Inc. v. Bloom*, 386 So. 2d 286 (Fla. Ct. App. 1980), auto salesmen were named as additional defendants in a suit against their employer alleging fraud and deceit in the sale of an automobile. The customers, who signed a purchase invoice containing an arbitration clause, claimed that the inclusion of the individual employees, who were not signatories, as additional defendants meant that the customers did not have to arbitrate against *any* of the defendants. The court found that the purchase invoice's language requiring arbitration of "[a]ny controversy or claim arising out of, or relating to this agreement . . . [was] broad enough to include persons within the respondeat superior doctrine," *id.* at 288, and ordered arbitration of the claims against all the defendants.

**[ii] Officers.** Corporate officers who are named individually as defendants may take advantage of an arbitration agreement made by the corporation, at least where the claims arise from actions taken by the officers in their corporate capacities. In *Arnold*, 920 F.2d at 1282, the plaintiff named seven individuals, all either officers or members of the board of the defendant corporation, as additional defendants. The court ordered arbitration of the claims against the individuals, finding that "[a]ll of [the] alleged wrongful acts relate to the nonsignatory defendants' behavior as officers and directors or in their capacities as agents of the Arnold Corporation. . . . [T]he language of the arbitration agreement indicates that the parties' basic intent was to provide a single arbitral forum to resolve all disputes arising under the stock purchase agreement. We believe that Arnold Corporation is entitled to have the entire dispute arbitrated, where, as here, the individual defendants . . . wish to submit to arbitration." *Id.*

In *Kahn*, 1992 U.S. Dist. LEXIS 8710, at *8-*9, the plaintiff brought claims against both Peak Financial Corporation, and James Peak, its president. The court pointed out that the claims against James Peak were based solely on his activities as president of Peak Financial, and ruled that where the plaintiff has alleged that a corporate officer is the corporation's agent for purposes of liability, he cannot deny the agency in order to deny the officer's right to arbitrate.

### [c] Affiliated Corporations

Does one corporation's agreement to arbitrate require arbitration of claims against its parent, subsidiary, or "sibling"? In *Ketchum v. Almahurst Bloodstock IV*, 685 F. Supp. 786, 793-94 (D. Kan. 1988), the court ordered arbitration of claims against a nonsignatory affiliate where: (1) the affiliate consented to arbitration; (2) the plaintiff's claims against both affiliates were identical; (3) the claims all arose out of the same transactions; and (4) the claims all fell within the scope of the arbitration clause.

Applying a similar rule, in *Knorr Brake Corp. v. Harbil, Inc.*, 556 F. Supp. 489, 493 (N.D. Ill. 1983), the court required the plaintiff to arbitrate its claims against the defendant's affiliated companies because: (1) all the issues in dispute involved the rights and obligations of the two signatories to the agreement; (2) those rights and obligations were arbitrable; and (3) the results of the arbitration would impact conclusively on the affiliated companies. The *Knorr* opinion mentioned in a footnote the close involvement of the affiliated companies with the transaction in question and that they were "surely in privity with the contracting parties, with all the legal consequences that flow from that status." *Id.* at 493 n.6.

Additionally, the common-law theory of "piercing the corporate veil" also has application to arbitration of claims involving nonsignatory corporations, particularly where the plaintiff brings suit in the guise of an entity other than the one that signed the arbitration agreement. This is common in data-processing contracts where an expensive computer system purchased by one company may provide services to various affiliates; when things don't work as planned, claims are often brought by the affiliates rather than the contracting entity.

The veil may be pierced to enforce an arbitration obligation just as any other contract clause.

> [I]t is clear that the consequence of applying the *alter ego* doctrine is that the corporation and those who have controlled it without regard to its separate entity are treated as but one entity, and at least in the area of contracts, the acts of one are the acts of all. There is no reasonable basis for distinguishing between the parent's obligation to respond in damages for its instrumentality's breach of contract and its obligation to arbitrate the measure of those damages. In neither instance does the parent consent to a contractual obligation; to the contrary it carefully avoids any such agreement, express or implied in fact.

*Fisser v. International Bank*, 282 F.2d 231, 234 (2d Cir. 1960) (emphasis in original) (citations omitted). *See also Hartford*, 550 F. Supp. at 1092; *Interocean Shipping*, 523 F.2d at 539.

However, absent a finding of fraud, a corporation is "entitled to a presumption of separateness from a sister corporation . . . even if both are owned and controlled by the same individuals." *Wren Distrib. v. Phone-Mate, Inc.*, 600 F. Supp. 1576, 1579 (E.D.N.Y. 1985) (alteration in original). Use of the corporate form simply to shield an individual or entity from liability is not sufficient to justify piercing the veil. *Itel Containers Int'l Corp. v.*

*Atlanttrafik Express Serv. Ltd.*, 725 F. Supp. 1303, 1310 (S.D.N.Y. 1989), *aff'd in part and vacated in part on other grounds*, 909 F.2d 698 (2d Cir. 1990). "To warrant piercing the corporate veil, a plaintiff must demonstrate that the corporation is a sham for its stockholders, directors, or officers who are in reality carrying on business in their individual capacities for personal rather than corporate ends." *Loomcraft Textile and Supply Co. v. Jay Yang Designs, Ltd.*, No. 92 Civ. 1757, 1992 U.S. Dist. LEXIS 14345, at *6 (S.D.N.Y. 1992). *See also Keystone Shipping Co. v. Texport Oil Co.*, 782 F. Supp. 28, 32 n.2 (D.N.J. 1991); *Kashfi v. Phibro-Salomon, Inc.*, 628 F. Supp. 727, 735 (S.D.N.Y. 1986).

**[d] Partners**

In *Hartford*, 550 F. Supp. 1079, the court held that an arbitration agreement executed by a partnership bound all the partners. "Individuals may be bound contractually though not named in the contract but merely described by a trade or partnership or association name or otherwise." *Id.* at 1087, *citing* 17 Am. Jur. 2d *Contracts* § 295 at 712 (1964).

A partner is jointly liable on all contractual obligations of the partnership, Uniform Partnership Act (UPA) § 15, and withdrawal from, or dissolution of, the partnership does not terminate the partners' duty to fulfill existing contractual obligations, UPA §§ 29, 36. UPA § 17 makes newly added partners liable for partnership obligations as if they had been partners at the time the obligations were incurred. *Hartford* applied these principles to the arbitration obligation and concluded that partners—even after termination of the partnership—must individually honor the partnership's agreements to arbitrate. *Id.* at 1089.

**[e] Subcontractors**

A subcontractor's agreement with the general contractor may bind it to the general contractor's arbitration obligation. A subcontract may incorporate an agreement to arbitrate by reference to an arbitration provision in the general contract. *J. S. & H. Constr. Co. v. Richmond County Hosp. Auth.*, 473 F.2d 212, 216-17 (5th Cir. 1973); *Bigge Crane & Rigging Co. v. Docutel Corp.*, 371 F. Supp. 240, 243 (E.D.N.Y. 1973); *Maxum Found., Inc. v. Salus Corp.*, 779 F.2d 974 (4th Cir. 1985), *appeal after remand*, 817 F.2d 1086 (4th Cir. 1987).

**[f] Guarantors**

A guarantor may be bound by the underlying contract's arbitration clause where it "is applicable by its own terms to all disputes and is not limited to those arising between the [signatories to the contract]." *Compania Espanola de Petroleos v. Nereus Shipping*, 527 F.2d 966, 973 (2d Cir. 1975), *cert. denied*, 426 U.S. 936 (1976).

In *Merrill Lynch Commodities, Inc. v. Richal Shipping Corp.*, 581 F. Supp. 933 (S.D.N.Y. 1984), the court ordered arbitration of claims against the guarantor where there was a broad arbitration clause and a broad guaranty. It distinguished *Taiwan Navigation Co. v. Seven Seas Merchant Corp.*, 172 F. Supp. 721 (S.D.N.Y. 1959), where the arbitration clause was found not to bind the guarantor, because in that case the arbitration agreement was limited to disputes between "Owners and Charterers" and the guaranty was limited strictly to "performance." *Richal*, 581 F. Supp. at 940 n.17.

**[g] Claims Based on the Statute of Frauds**

The preceding paragraphs have dealt with cases where *someone* has signed a valid arbitration agreement and the question has been to what extent nonsignatories may ride on—or be forced to ride on—the coattails of that agreement. Although Section 2 of the FAA requires the arbitration clause to be "a written provision . . . in a contract," this does not mean there must be a signed agreement in place among all the parties.

For example, it may be claimed that no contractual agreement was reached, either because of alleged forgery of a party's signature, or because no signed copy of the agreement was ever returned to the other party. A number of courts considering such claims have nevertheless enforced the agreement to arbitrate. The FAA "contains no built-in Statute of Frauds provision but merely requires that the arbitration provision itself be in writing. Ordinary contract principles determine who is bound by such written provisions and of course parties can become contractually bound absent their signatures." *Fisser*, 282 F.2d at 233 (footnotes omitted).

In *First Citizens Mun. Corp. v. Pershing Div. of Donaldson, Lufkin & Jenrette Sec. Corp.*, 546 F. Supp. 884, 887 (N.D. Ga. 1982), the plaintiff never returned a signed copy of the operative agreement to the defendant, and argued this as a basis for avoiding arbitration. The court rejected this claim, noting that "an agreement to arbitrate need not be signed by the party to be charged in order to be enforceable. . . . Like any other contract, a contract containing an arbitration provision may be binding on the parties based upon their course of conduct." *Id.* (citations omitted) Because the plaintiff never objected to the terms of the agreement, and continued to do business with the defendant after receiving the new agreement with notice that it superseded any other agreement, the court ordered the plaintiff to arbitrate. *Id.* at 887-88.

In *Ketchum*, 685 F. Supp. at 790-91, the plaintiff alleged that some of the signatures on the agreement containing an arbitration clause were not authentic. The court found that, even if this assertion was true, the plaintiff by his conduct had acquiesced in the terms of the contract. The court further noted that an allegation that the forged signatures invalidated the agreement as a whole brought the matter squarely under *Prima Paint*, *supra*, and that therefore the arbitrator would have to determine the validity of the signatures.

**11. Waiving the Right to Arbitrate**

Arbitration may be waived by conduct inconsistent with the arbitration agreement, but compelling facts are required to support waiver: "While arbitration is a waivable contract right, a 'waiver of arbitration is not lightly to be inferred.' The essential question is whether, under the totality of the circumstances, the defaulting party acted 'inconsistently' with the arbitration right." *Dickinson v. Heinold Sec.*, 661 F.2d 638, 641 (7th Cir. 1981) (citations and footnote omitted).

*Knorr*, 556 F. Supp 489, provides a *tour de force* of the ways a party can risk its right to compel arbitration. Although the defendant Harbil managed to survive Knorr's claims of waiver, it is obvious that Harbil's counsel thought of arbitration much too little and quite too late.

Harbil raised arbitration as an issue only orally during a preliminary injunction hearing, but before filing its answer. The court found the oral statement was sufficient to put the issue of arbitration before it, but Knorr alleged that Harbil's later filing of an answer waived the right to arbitrate. Although some courts have found that filing an answer on the merits can result in waiver, *see, e.g.*, *Galion Iron Works & Mfg. Co. v. J. D. Adams Mfg. Co.*, 128 F.2d 411, 413 (7th Cir. 1942), newer cases indicate that courts should follow a more liberal rule.

For example, in *Midwest Window Sys. v. Amcor Indus.*, 630 F.2d 535, 537 (7th Cir. 1980), a more modern Seventh Circuit noted that such a result should not be obtained "rigidly or mechanically" and found no waiver in the filing of an answer. *See also Clar Prod. v. Isram Motion Pictures Prod. Serv., Inc.*, 529 F. Supp. 381, 383 (S.D.N.Y. 1982) (no waiver found although arbitration was not raised until seven months after suit was commenced, but before discovery or a response on the merits).

Knorr also alleged that Harbil waived its right to arbitrate by engaging in discovery prior to raising arbitration. This is perhaps the procedural activity most likely to create a waiver. Since one of the underlying goals of arbitration is to reduce the length and expense of litigation by limiting the discovery process, courts do not look kindly on those who use discovery as an offensive weapon and then hide behind arbitration as a shield.

The judge in *Knorr* found that Harbil's use of discovery did not waive the right to compel arbitration, although unfortunately the opinion does not describe how extensive that discovery was. The court pointed out that prejudice is the critical element of the waiver doctrine, *see Midwest Window*, 630 F.2d 535, and found that Harbil's activities did not result in prejudice to Knorr. The mere fact of delay without other concrete prejudice is not sufficient to support a finding of waiver. *Dickinson*, 661 F.2d at 641. *See also Rush v. Oppenheimer & Co.*, 779 F.2d 885, 887 (2d Cir. 1985) ("waiver of the right to compel arbitration due to participation in litigation may be found only when prejudice to the other party is demonstrated").

Although the court—in its desire to rid its docket of what appears to have been a very unpleasant case—was able to brush off Harbil's answer and discovery activity quite easily, Harbil did two other things that gave pause: it filed a counterclaim, and it converted Knorr's Rule 12(b)(6) motion to dismiss into a Rule 56 summary judgment motion. These activities were troublesome because "Harbil's counterclaim maneuvers were essentially offensive rather than defensive in character." *Knorr*, 556 F. Supp. at 492. But the court ultimately found that no prejudice had resulted from the mere filing of the counterclaim, and was unwilling to use that action to support a finding of waiver. Relying on *Dickinson*, 661 F.2d 638, the court went on to find that filing a summary judgment motion likewise did not necessarily require a finding of waiver. *Knorr*, 556 F. Supp. at 493.

*Dempsey & Assoc. v. S.S. Sea Star*, 461 F.2d 1009, 1018 (2d Cir. 1972) supports this view: "[m]erely answering on the merits, asserting a counterclaim (or cross-claim) or participating in discovery, without more, will not necessarily constitute a waiver." Similarly, the *Knorr* court found that Harbil's "going for a knockout punch on one set of issues [by moving for summary judgment] does not necessarily reflect abandonment of its right to arbitration on the others." *Knorr*, 556 F. Supp. at 493.

Despite Harbil's numerous activities tending toward waiver, the court still permitted Harbil to enforce Knorr's agreement to arbitrate: "Even if Harbil's counterclaim and surrounding tactics are viewed as pointing toward waiver, they must still be appraised as part of a total picture. After all Knorr Brake and Harbil did voluntarily enter into an arbitration clause that clearly embraces their current dispute. . . . [P]ublic policy strongly favors enforcement of arbitration agreements." *Id.* (footnote omitted). The court found that "Harbil, in the totality of the circumstances, ha[d] not acted 'inconsistently' with the arbitration right." *Id.*

Note, too, that court action by a subsidiary corporation generally will not waive the parent corporation's right to arbitrate third party claims. *NCR Credit Corp. v. Underground Camera, Inc.*, 581 F. Supp. 609 (D. Mass. 1984).

A recent software case shows that, despite the policy favoring arbitration (and the lengths the *Knorr* court reached to support that policy), it *is* possible to waive the right to arbitrate. In *Com-Tech Assoc. v. Computer Assoc. Int'l.*, 938 F.2d 1574 (2d Cir. 1991), CAI lost its right to arbitrate a dispute through its extensive involvement in the litigation process.

Under contract to develop a software program for Com-Tech, CAI failed to complete the program on schedule, but convinced Com-Tech to give it more time. Com-Tech later sued, claiming that CAI had made intentional

misrepresentations to induce Com-Tech's agreement to the extension, and further misrepresented financial information to Com-Tech. *Id.* at 1575-76.

Rather than raising arbitration early in the proceedings, CAI filed an answer raising numerous defenses (but not arbitration), answered an amended complaint without raising arbitration as a defense, and engaged in discovery for nearly two years, taking ten depositions. Additionally, during the lengthy period between its first answer and its filing of a motion to compel arbitration, CAI was sanctioned three times for failing to comply with discovery requests. Finally, eighteen months after filing its answer, and only four months before trial, CAI moved to compel arbitration. Even then, the arbitration demand was part of an "omnibus" motion raising numerous other issues which Com-Tech was forced to defend. *Id.* at 1576.

The Second Circuit was not impressed with CAI's claimed right to arbitrate:

> The protracted litigation which preceded the motion to arbitrate compels us to affirm the district court's holding that defendants waived their contractual right to compel arbitration. . . . These maneuvers [participating in litigation] put plaintiffs to considerable additional expense, and further delayed the proceedings. To permit litigants to participate fully in discovery, make motions going to the merits of their opponent's claims, and delay assertion of a contractual right to compel arbitration until the eve of trial defeats one of the reasons behind the federal policy favoring arbitration: that disputes be resolved without "the delay and expense of litigation."

*Id.* at 1576-77 (citations omitted).

The court found that Com-Tech had in fact been prejudiced by CAI's delay in raising arbitration:

> Here, plaintiffs were put to the expense not only of engaging in extensive depositions, but also of defending motions for judgment on the pleadings and partial summary judgment. In addition, the defendants did not move to compel arbitration until eighteen months after they filed their answer. . . . The proximity of trial, as well as defendants' full participation in discovery, including the deposition of seven plaintiffs, support the district court's conclusion that defendants had forfeited their contractual right to compel arbitration.
>
> Had the defendants claimed their contractual right to arbitrate promptly after the complaint was filed in 1987, this dispute probably would have been resolved before now with less trouble and expense to all parties. To permit litigants to exercise their contractual rights to arbitrate at such a late date, after they have deliberately chosen to participate in costly and extended litigation would defeat the purpose of arbitration.

*Id.* at 1577-78.

Although Harbil managed to enforce its right to arbitrate where CAI failed, these decisions show the cardinal rule to avoid waiver: raise arbitration early and often. As noted in Section 8 above, the first response to a lawsuit in derogation of an arbitration agreement should be a motion to stay the proceedings under Section 3 of the FAA and to compel arbitration under Section 4 of the FAA, or alternatively under parallel state arbitration provisions. Additionally, any answer should plead arbitration as an affirmative defense, and that defense should be vigorously pursued.

Weigh carefully any desire to conduct discovery against the risk of waiver that could result from doing so. Remember that arbitration is the antithesis of pretrial discovery. Engaging in discovery may significantly reduce your moral authority to enforce arbitration, particularly if the court perceives that you are attempting to get the best of both worlds by taking advantage of the courtroom at the same time you are trying to get out of it.

For further references, *see generally* Joel E. Smith, *Defendant's Participation in Action as Waiver of Right to Arbitration of Dispute Involved Therein*, 98 A.L.R. 3d 767 (1992), *and* E. L. Kellett, *Delay in Asserting Contractual Right to Arbitration as Precluding Enforcement Thereof*, 25 A.L.R. 3d 1171 (1992). For a view of waiver from a different perspective, *see* D. J. Penofsky, *Participation in Arbitration Proceedings as Waiver of Objections to Arbitrability*, 33 A.L.R. 3d 1242 (1992).

**12. Punitive Damages in Arbitration**

As noted in Part I, American Arbitration Association (AAA) Commercial Rule 43 specifically allows arbitrators to award "any remedy or relief that the arbitrator deems just and equitable." Courts have held this language broad enough to include an award of punitive damages. *See, e.g., Lee v. Chica*, 983 F.2d 883, 887, n.6 (8th Cir. 1993). Reading a contract that contained a broad arbitration agreement together with a provision incorporating the AAA Rules, one court held that "it is clear that the parties by their contract have authorized the arbitrators to award punitive damages. The contract purports to place no limits on the remedial authority of the arbitrators, nor should one be implied to exclude the authority to award punitive damages. The parties certainly had the power to limit the arbitrator's ability to fashion appropriate remedies, but they chose not to do so." *Willoughby Roofing & Supply Co. v. Kajima Int'l*, 598 F. Supp. 353, 357 (N.D. Ala. 1984) (citation and footnote omitted), *aff'd*, 776 F.2d 269 (11th Cir. 1985).

Although under federal law an express agreement permitting punitive damages is generally sufficient to support such an award, where the parties less clearly express their intent the outcome is less clear. Some courts view the arbitrator as having broad inherent powers, and will permit an award of punitive damages unless the arbitration agreement expressly forbids it. *Raytheon Co. v. Automated Business Sys.*, 882 F.2d 6 (1st Cir. 1989); *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378 (11th Cir. 1988); *Baker v. Sadick*, 162 Cal. App. 3d 618, 630, 208 Cal. Rptr. 676, 684 (Ct. App. 1984). Others find

additional persuasion to uphold an award of punitive damages where the arbitration agreement incorporates the AAA rules, including Rule 43 and its broad language governing relief. *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056, 1062-63 (9th Cir. 1991).

A few courts narrow the power of the arbitrator by looking to the parties' choice of law. If the agreement provides that the law of a particular state applies, and that state does not permit arbitrators to award punitive damages, those federal courts will not uphold an arbitrator's award of punitive damages in derogation of state law. *Fahnestock & Co. v. Waltman*, 935 F.2d 512, 518 (2d Cir. 1991), *cert. den.*, 112 S. Ct. 380 (1991), and *cert. den.*, 112 S. Ct. 1241 (1992) (New York law does not permit commercial arbitrators to award punitive damages, *citing Garrity v. Lyle Stuart, Inc.*, 40 N.Y.2d 354, 353 N.E.2d 793 (1976)).

In *Fahnestock* the agreement included no explicit choice of law, but the court applied New York law because federal diversity jurisdiction had been invoked in that state. *Id.* at 518. In *Barbier v. Shearson Lehman Hutton, Inc.*, 948 F.2d 117, 122 (2d Cir. 1991), the court held that where the agreement expressly invoked New York law to govern its interpretation, the issue was even more clear: the parties' choice of law included New York's rules regarding punitive damages in arbitration.

This narrow reading has little support in the other federal circuits, however. One court has noted that in *Fahnestock* there was no incorporation of the AAA's rules granting broad authority to the arbitrator. *Lee*, 983 F.2d at 888 n.7. Another has expressly rejected the idea that a choice-of-law provision makes the question one of state law. *Todd Shipyards*, 943 F.2d at 1061-62.

At least one state court has held that punitive damages are available only where the arbitration agreement specifically authorizes them. *Belko v. AVX Corp.*, 204 Cal. App. 3d 894, 251 Cal. Rptr. 557 (Ct. App. 1988). However, *Belko* was an employment termination case, and the California court relied on a long series of cases dealing with the punitive damages issue in the context of labor arbitrations; for policy reasons, such damages are beyond the power of a labor arbitrator unless the collective bargaining agreement expressly permits them. *See, e.g., Howard P. Foley Co. v. International Bhd. of Elec. Workers, Local 639*, 789 F.2d 1421 (9th Cir. 1986).

No federal case, applying federal law, has held that punitive damages are unavailable to an arbitrator where the agreement expressly permits them, but as noted above a number of state courts have done so, including those of Arkansas, *McLeroy v. Walker*, 21 Ark. App. 292, 731 S.W.2d 789 (Ct. App. 1987); District of Columbia, *Shahmirzadi v. Smith Barney, Harris Upham & Co.*, 636 F. Supp. 49 (D.D.C. 1985); Florida, *Complete Interiors, Inc. v. Behan*, 558 So. 2d 48 (Fla. Dist. Ct. App. 1990), *rev. den.* 570 So.2d 1303 (1990) (where agreement does not expressly grant arbitrator power to award such damages); Indiana, *United States Fidelity & Guar. v. DeFlutier*, 456 N.E.2d 429 (Ind. Ct. App. 1983); New York, *Garrity*, 353 N.E.2d 793; *Washington, Kennewick Educ. Assoc. v. Kennewick School Dist.*, 35 Wash. App. 280, 666 P.2d 928 (Ct. App. 1983) (recovery of punitive damages is contrary to public policy of state; note also that punitives generally not permitted in labor arbitrations); and West Virginia, *Anderson v. Nichols*, 359 S.E.2d 117 (W. Va. 1987). *See generally* Timothy E. Travers, *Arbitrator's Power to Award Punitive Damages*, 83 A.L.R. 3d 1037.

In any event, there is no case holding that an arbitrator can award punitive damages in the face of an arbitration agreement prohibiting them, and dicta suggests that the federal courts would honor such a prohibition. *Bonar*, 835 F.2d at 1387 n.16 (citing *Willoughby Roofing*, 598 F. Supp. at 364). Therefore, if the goal is to preclude an award of punitive damages, inclusion of limiting language in the agreement (as in the NCR clause) should accomplish this goal.

### 13. Allegedly Nonarbitrable Claims

Even though the FAA "was designed to 'overrule the judiciary's long standing refusal to enforce agreements to arbitrate,' " *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468, 474 (1989), *quoting Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 219-20 (1985), the early view of arbitration under the FAA held that it was not an appropriate remedy for many claims based on statute. For example, in *Wilko v. Swan*, 346 U.S. 427 (1953), the Supreme Court ruled that claims under the Securities Act of 1933 were not arbitrable because arbitration would not provide the securities investor, in an inferior bargaining position, with the same advantages as he would have in court.

But with increased experience in arbitration, and the recognition that civil litigation has disadvantages of its own, that attitude has changed: "[W]e are well past the time when judicial suspicion of the desirability of arbitration and of the competence of arbitral tribunals inhibited the development of arbitration as an alternative means of dispute resolution." *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 626-27 (1985). The cases denying arbitrability of statutory claims or public policy issues are being superseded by decisions holding that arbitration is an appropriate forum for resolving such disputes.

A series of recent Supreme Court decisions establishes the arbitrability of antitrust claims, *Mitsubishi Motors*, 473 U.S. 614, claims under the 1933 Securities Act, *Rodriguez de Quijas v. Shearson/Am. Express Inc.*, 490 U.S. 477 (1989) (*overruling Wilko*, 346 U.S. 427), and 1934 Securities Exchange Act claims and RICO claims, *Shearson/Am. Express Inc. v. McMahon*, 482 U.S. 220 (1987).

Additionally, as noted in Part I, patent disputes are arbitrable under 35 U.S.C. § 294, patent interferences under 35 U.S.C. § 135(d), and copyright disputes under *Saturday Evening Post Co. v. Rumbleseat Press, Inc.*, 816 F.2d 1191 (7th Cir. 1987). Finally, it is clear that no state statute can deny arbitration of a dispute that falls under the FAA. *Southland Corp. v. Keating*, 465 U.S. 1 (1984).

To the extent that there may still be claims that are not subject to arbitration, the question arises how to treat actions that include both nonarbitrable and arbitrable claims. Before 1985, the rule in several circuits was that a party could not compel arbitration of arbitrable claims if they were factually intertwined with nonarbitrable ones. For example, a plaintiff might bring an action including both tort and breach-of-contract claims, where the contract involved contained an arbitration clause. If the arbitration clause was not worded broadly enough to cover the tort claims, and the facts of the case wrapped the two claims tightly enough together, the plaintiff could avoid arbitration of the entire dispute in these circuits.

The Supreme Court rejected this "intertwining" doctrine in *Byrd*, 470 U.S. at 213 (1985). Under *Byrd*, a mix of arbitrable and nonarbitrable claims does not avoid arbitration, but instead requires—if the parties have the stomach for it—separate adjudications of the arbitrable claims before an arbitrator, and the nonarbitrable ones before a court.

## 14. Conclusion

Arbitration is a practical way to reduce the expense and burden of commercial litigation. Unfortunately, some parties—or their attorneys—devise creative reasons why they should not have to honor their agreements to arbitrate. You can usually defeat these attempts with a carefully drafted arbitration clause, and knowledgeable argument in a motion to compel arbitration.

"In order finally to remove any doubt that may still linger, we now make explicit what has long been true: we simply do not countenance the attempt of a party to a properly formed arbitration agreement to avoid its obligations to submit to arbitration. Litigants will save time and effort for themselves and for the courts by keeping that in mind." *National R.R. Passenger Corp. v. Consolidated Rail Corp.*, 892 F.2d 1066, 1072 (D.C. Cir. 1990).

## Appendix A: The Defensive Arbitration Clause

### Section ___: Arbitration; Choice of Law

[a] Any controversy or claim, whether based on contract, tort, statute, or other legal theory (including but not limited to any claim of fraud or misrepresentation), arising out of or related to this Agreement, or any subsequent agreement between the parties, shall be resolved by arbitration pursuant to this section and the then-current Commercial Rules and supervision of the American Arbitration Association. The duty to arbitrate shall extend to any officer, employee, shareholder, principal, agent, trustee in bankruptcy or otherwise, affiliate, subsidiary, third-party beneficiary, or guarantor, of a party hereto making or defending any claim which would otherwise be arbitrable hereunder.

[b] The arbitration shall be held in the headquarters city of the party not initiating the claim before a single arbitrator who is knowledgeable in business information and electronic data processing systems. The arbitrator's decision and award shall be final and binding and may be entered in any court having jurisdiction thereof. The arbitrator shall not have the power to award punitive or exemplary damages, or any damages excluded by, or in excess of any damage limitations expressed in, this Agreement or any subsequent agreement between the parties.

[c] In order to prevent irreparable harm, the arbitrator may grant temporary or permanent injunctive or other equitable relief for the protection of intellectual property rights.

[d] Issues of arbitrability shall be determined in accordance with the federal substantive and procedural laws relating to arbitration; all other aspects of this Agreement shall be interpreted in accordance with, and the arbitrator shall apply and be bound to follow the substantive laws of, the State of _____. Each party shall bear its own attorney's fees associated with the arbitration and other costs and expenses of the arbitration shall be borne as provided by the rules of the American Arbitration Association.

[e] If court proceedings to stay litigation or compel arbitration are necessary, the party who unsuccessfully opposes such proceedings shall pay all associated costs, expenses and attorney's fees which are reasonably incurred by the other party.

[f] The arbitrator may order the parties to exchange copies of non-rebuttal exhibits and copies of witness lists in advance of the arbitration hearing. However, the arbitrator shall have no other power to order discovery or depositions unless and then only to the extent that all parties otherwise agree in writing.

[g] Neither a party, witness, or the arbitrator may disclose the contents or results of any arbitration hereunder without prior written consent of all parties, unless and then only to the extent required to enforce or challenge the award, as required by law, or as necessary for financial and tax reports and audits.

[h] No party may bring a claim or action regardless of form, arising out of or related to this Agreement, including any claim of fraud or misrepresentation, more than one year after the cause of action accrues, unless the injured party cannot reasonably discover the basic facts supporting the claim within one year.

[i] Notwithstanding anything to the contrary in this Section, in the event of alleged violation of a party's intellectual property rights (including but not limited to unauthorized disclosure of confidential information), that party may seek temporary injunctive relief from any court of competent jurisdiction pending appointment of an arbitrator. The party requesting such relief shall simultaneously file a demand for arbitration of the dispute, and shall request the American Arbitration Association to proceed under its rules for expedited hearing. In no event shall any such temporary injunctive relief continue for more than 30 days.

[j] If any part of this section is held to be unenforceable, it shall be severed and shall not affect either the duty to arbitrate hereunder or any other part of this section.