SIMPSON THACHER

REPORT FROM WASHINGTON

The Supreme Court Allows Non-Signatories to Arbitration Agreements to Seek to Stay Claims under the Federal Arbitration Act

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INTRODUCTION

Yesterday, in *Arthur Andersen, LLP, et al. v. Carlisle, et al.*, No. 08-146, the United States Supreme Court held that non-signatories to an arbitration agreement may obtain a stay of claims in favor of arbitration under section 3 of the Federal Arbitration Act ("FAA"). In reaching its decision, the Court found that an arbitration agreement may be enforced pursuant to a section 3 motion to stay by any party entitled to enforce its terms under state law. The Court also held that, under section 16 of the FAA, parties may immediately appeal a trial court's denial of a motion to stay, regardless of whether or not such party is eligible for the stay.

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

"By its clear and unambiguous terms, §16(a)(1)(A) entitles any litigant asking for a §3 stay to an immediate appeal from that motion's denial—regardless of whether the litigant is in fact eligible for a stay."

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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 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 meaning of the 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."

At oral argument on March 3, 2009, defendants argued that, if a non-signatory has the right under state law to enforce an arbitration agreement, such a non-signatory 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. Plaintiffs, on the other hand, principally argued that state law does not determine whether section 3's requirements are satisfied, as that is a federal question that must be answered in light of federal policy disfavoring interlocutory appeals. Moreover, the express language of section 3—which states that the action be "referable to arbitration *under* an agreement in writing

"'[S]tate law,' therefore, is applicable to determine which contracts are binding under §2 and enforceable under §3 'if that law arose to govern issues concerning the validity, revocability, and enforceability of contracts generally.'"

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for such arbitration"—requires the parties seeking the section 3 stay to be signatories to the written arbitration agreement.

SUMMARY OF THE DECISION

In an opinion delivered by Justice Scalia and joined in by Justices Kennedy, Thomas, Ginsburg, Breyer, and Alito, the Supreme Court yesterday reversed the decision of the United States Court of Appeals for the Sixth Circuit. The Court held that the Sixth Circuit had jurisdiction to review the denial of defendants' request for a section 3 stay, reasoning that the plain language of section 16 required this result. The Court also addressed the merits of defendants' section 3 motion, holding that litigants that are not signatories to an arbitration agreement may nevertheless enforce such agreement under section 3 to the extent permitted under state law.

As an initial matter, the Court found that section 16's "clear and unambiguous terms" provide that "any litigant who asks for a stay under §3 is entitled to an immediate appeal from denial of that motion—regardless of whether the litigant is in fact eligible for a stay." The Court observed that the courts that had declined jurisdiction over section 3 appeals had conflated the question of jurisdiction with the merits of the appeal, and warned courts in the future to focus on the category of the order being appealed.

The Supreme Court then rejected plaintiffs' argument that section 3 motions to stay may be brought only by signatories to a written arbitration agreement. According to the Court, "'[s]tate law' . . . is applicable to determine which contracts are binding under §2 and enforceable under §3 'if that law arose to govern issues concerning the validity, revocability, and enforceability of contracts generally.'" The Court stated: "[W]e think § 3 adds no substantive restriction to § 2's enforceability mandate." In other words, if an arbitration agreement is enforceable by a third party under state law, such party may use section 3 to enforce the agreement. The Sixth Circuit's holding—that non-parties are never entitled to section 3 relief—was therefore erroneous given traditional principles that state law may provide for contracts to be enforceable by or against parties other than the original signatory.

Justice Souter, joined by Chief Justice Roberts and Justice Stevens, dissented based on the concern that the Court's holding "fails to read §16 in light of the 'firm congressional policy against interlocutory or 'piecemeal appeals.'" According to Justice Souter, an "obvious way" to give effect to that policy is to read the language of section 16 "as calling for a look-through to the provisions of §3, and to read §3 itself as offering a stay only to signatories of an arbitration agreement." Noting that Federal Rule of Appellate Procedure 38—which grants appellate courts authority to sanction "frivolous" appeals—does not apply to "far-fetched" appeals, the dissent was obviously concerned about "savvy parties who seek to frustrate litigation by gaming the system."

IMPLICATIONS

The Supreme Court's decision clarifies the extent to which non-signatories to arbitration agreements can invoke the FAA and, in doing so, resolves the circuit split on the issue. The Court expressly held that non-signatories to agreements have all the rights available to signatories to seek to stay claims against them afforded under the section 3 of the FAA, as long as the arbitration agreement is enforceable

as to them under state law. It is now clear that all parties entitled to enforce arbitration agreements may invoke the FAA's protections to stay claims subject to arbitration pending in court.

The Court also held that any party whose section 3 motion to stay has been denied is entitled to an interlocutory appeal of the district court's denial pursuant to section 16, allowing immediate review of any disputes concerning arbitrability of claims regardless of their merit.

Furthermore, this case is one of several arbitration-related disputes in which the Court has upheld the strong federal policy of encouraging arbitration 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*, 129 S. Ct. 1262 (2009) (holding that federal courts may "look through" a petition to compel arbitration to determine whether the underlying dispute between the parties is subject to federal subject matter jurisdiction).

"An obvious way to limit the scope of such an extraordinary interruption would be to read the §16 requirement that the stay have been denied 'under section 3' as calling for a look-through to the provisions of §3, and to read §3 itself as offering a stay only to signatories of an arbitration agreement."

JUSTICE SOUTER, DISSENTING

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