

U.S. Supreme Court Enforces Arbitration Rights: Potential Tool for Insureds?

Breaking Developments In London Market Law 05/11/09

On May 4, 2009, the U.S. 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"). The decision resolves a circuit split and allows non-signatory, third parties to benefit from a stay of litigation while an arbitration proceeds between a plaintiff and co-defendant. Such an intervening arbitration may further benefit third parties by possibly giving rise to preclusive effects on a plaintiff's claims.

Background

In *Arthur Andersen LLP v. Carlisle*, No. 08-146, investors sought tax advice from Arthur Andersen. The accounting firm linked the investors with an investment firm and law firm to assist in the development of a tax shelter referred to as a "leveraged option strategy." The investors formed limited liability corporations that entered into investment management contracts with another entity. Those investment management contracts contained expansive arbitrations clauses 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 Internal Revenue Service concluded that the "leveraged option strategy" was unlawful, but offered amnesty to the taxpayers under specified conditions. The plaintiff investors alleged that the defendants failed to inform them of this opportunity, thereby forcing them to incur more than \$25 million in taxes and penalties.

The investors filed suit against the various parties alleging numerous causes of action. The defendant, which was a party to the investment contracts, moved to compel arbitration and to stay the claims asserted against it in the court action. The request was granted. Similarly, Arthur Andersen moved to stay the claims against it based on Section 3 of the FAA. Despite the fact that Arthur Andersen was not a party to the contract containing the arbitration provision, Arthur Andersen argued on grounds of equitable estoppel that permitting the plaintiff investors to proceed on the same claims against the other defendants in the court action would effectively permit the plaintiffs to avoid arbitration. The district court denied the motion to stay. The Sixth Circuit Court of Appeals affirmed the denial of the stay and dismissed for lack of jurisdiction,

concluding that nonparties to a written arbitration agreement are ineligible for relief under Section 3 of the FAA.

Section 3 of the Federal Arbitration Act (FAA or Act) provides for a stay of litigation in any action that is "referable to arbitration under an agreement in writing." 9 U.S.C. Section 3. The Act further provides that "an appeal may be taken from . . . an order . . . refusing a stay of any action" under that provision. 9 U.S.C. Section 16(a)(1)(A). Relying on the plain language of these provisions, the Supreme Court reversed. In an opinion by Justice Scalia, the Supreme Court held (1) that a court of appeals has jurisdiction under Section 16(a) to review a denial of a stay requested by a litigant not a party to the arbitration agreement, and (2) that such a litigant is entitled to a stay under Section 3 if the relevant state contract law allows the litigant to enforce the agreement.

The six-Justice majority concluded that the only consideration relevant to the jurisdictional question is whether the interlocutory appeal is in fact an appeal of "an order . . . refusing a stay of any action under Section 3" and that the language of the FAA provision "unambiguously makes the underlying merits irrelevant." Given that the appeal indisputably stemmed from such an order, the Court concluded, jurisdiction existed without regard to the merits of the underlying motion.

The Court went on conclude that a non-signatory could seek to stay litigation and compel arbitration, confirming the long-established principle that Section 2 of the FAA places agreements to arbitrate on an equal footing with other types of contracts. To the extent that the state contract law allows an agreement to be enforced by nonparties to the agreement, those nonparties must be eligible for relief under Section 3 of the FAA in order to enforce it.

In a dissenting opinion joined by Chief Justice Roberts and Justice Stevens, Justice Souter argued that Section 3 should be understood to "offer[] a stay only to signatories of an arbitration agreement," and Congress should not be assumed to have intended "to grant the right to appeal a Section 3 denial to anyone as peripheral as a non-signatory."

Big Picture

Depending on applicable state law, *Arthur Andersen LLP v. Carlisle* grants third parties the right to seek a stay of litigation pending arbitration. Such a right may provide strategic benefits to a co-defendant for a number of reasons. Further, this decision is one of several recent opinions in which the Court has upheld the strong federal policy in support of arbitration during this past year, including *Hall Street Associates LLC v. Mattel Inc.*, 128 S. Ct. 1396 (2008) (holding that the FAA prevailed over state law on the issue of reversal of arbitration awards), *Preston v. Ferrer*, 128 S. Ct. 978 (2008) (holding that the FAA supersedes state laws granting state agencies with exclusive jurisdiction over claims), and *Vaden v. Discover Bank*, 129 S. Ct. 1262 (2009) (holding that federal courts may "look through" a petition to compel arbitration to analyze whether the underlying matter is subject to federal subject matter jurisdiction).

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