HORSESHOES AND HAND GRENADES—WHEN CLOSE ENOUGH MAY BE GOOD ENOUGH TO COMPEL ARBITRATION

By: Brandon Bains

A common fact pattern for the claims professional is a payment bond dispute where a subcontractor wants to enforce an agreement to arbitrate found in its subcontract with the principal. The subcontractor likewise wants to compel the surety to arbitrate. The surety can at times avoid arbitration because (1) it does not have an express agreement to arbitrate; and (2) the arbitration provision in the subcontract is not incorporated into the payment bond. Avoiding arbitration can be advantageous for the surety because it foregoes litigation expenses associated with the principal and subcontractor fighting over the merits of the claim. This fact pattern reflects the dominant theory of the Courts – you will not be compelled to arbitrate unless you specifically agreed to do so.

The dominant theory, however, is beginning to shift. Late last year, the Fifth Circuit was asked whether a non-signatory could still be compelled to arbitrate if that party had a "close relationship with one of the signatories and the claims are intimately founded in and intertwined with the underlying contract obligations."[1] Because the Texas Supreme Court has not specifically ruled on this issue, the Fifth Circuit was required to make an *Erie* guess. Although the Fifth Circuit recognized that there was a split among Texas appellate courts, it decided that the Texas Supreme Court would approve of this "close enough" concept. As a result, the non-signatory was compelled to arbitrate. Since that time, at least one federal district court in Texas has followed suit and has compelled arbitration for a surety in a payment bond context even though the surety did not have an express agreement to arbitrate.[2]

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[1] *Hays v. HCA Holdings, Inc.*, 838 F.3d 605, 610 (5th Cir. 2016)

[2] *Dallas Digital Signs & Graphics v. Bunting Graphics, Inc.*, N.D. Tex., Fort Worth Div., case no. 4:16-cv-00923-A, ECF No. 26 (order dated Nov. 17, 2016) (unpublished)

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- Benjamin Franklin

For the claims professional, there are three main takeaways:

1. An early and active investigation has heightened importance. If there is the possibility of the matter getting shifted to arbitration, this could result in truncated discovery and a fast track towards judgment.

2. With most claims, the goal of the surety is to obtain a reasonable resolution as soon as possible provided that the claimant has a valid claim and the right documentation. Anecdotal experience for some involved in arbitration is that the result is a mixed bag. Thus, there could be a premium on considering an early resolution, recognizing that a complete victory in arbitration is the exception and not the rule.

3. The "right answer" is not always the result in arbitration. Valid legal defenses of the surety often are ignored by the arbitrator, who is concerned with the equities involved. Involving counsel at the beginning may help mitigate against this risk if the other side can be educated early on before an arbitration is fully underway and the parties are entrenched.

It is still too early to tell how far the courts will let the pendulum swing. In theory, this exception should be just that – something that is not the default answer any time someone wants to compel a non-signatory to arbitration. Currently, the courts have not endeavored to define what is "close enough" or the factors that should be considered. Certainly, in the payment bond example, a surety might have a good argument to preclude arbitration if the defenses are solely surety based (notice, perfection, penal limit, etc.) as opposed to a situation where it is adopting the defenses of its principal for various offsets. So, if nothing else, stay tuned for updates . . .

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