Enforceability of Arbitration Provisions Against Third Parties

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Construction agreements commonly include contractual provisions in which the parties agree in advance to resolve all disputes arising from the contract through arbitration rather than litigation. Absent an agreement to arbitrate, the default rule requires disputes to be resolved through litigation. Accordingly, because construction-related disputes often involve numerous parties under separate contracts, it is critical that the selected dispute resolution process is consistent among each relevant contract. For example, if a developer agrees to arbitration in its contract with the general contractor, the developer should make sure to include a similar arbitration provision in its architectural agreement. Otherwise, in the event the developer attempts to assert claims for both construction defects and design errors arising from the same project, it will be forced to pursue its claims in separate venues: arbitration with respect to its claims for construction defects and litigation for its design claims. The developer will face the possibility of receiving inconsistent results and will undoubtedly incur additional legal expenses than if it had the right to pursue both parties in a single venue. For the same reasons, a general contractor who agrees to arbitrate disputes with its owner client should similarly require arbitration in its down-stream subcontracts.

While the general rule is that courts will not force parties to arbitrate their disputes unless they have agreed – typically in writing – to do so, there are certain exceptions by which third-parties can be required to arbitrate even without an arbitration provision in the body of their written agreement. Indeed, the United States Supreme Court has recognized numerous ways by which agreements – including agreements to arbitrate – can be enforced by or against non-signatories. See Arthur Anderson LLP v. Carlisle, 556 US 624 (2009). In the construction industry, the most commonly used mechanism to require a party without a contractual arbitration provision to arbitrate is through incorporation by reference provisions.

Incorporation by Reference Provisions

Incorporation by reference provisions – if drafted properly – integrate the contents of a secondary document into the main document solely by mentioning the title of the secondary document. As a result, the contents of the secondary document are treated as if they were repeated verbatim in the main document. BLACK’S LAW DICTIONARY 1886 (10th ed. 2014). For example, in subcontracts, incorporation by reference provisions bind the subcontractor to the general contractor in the same manner and to the same extent as the contractor is bound to the owner. As such, if a general contractor agrees to an arbitration provision with the owner but not with its subcontractor, it can still require the subcontractor to arbitrate disputes so long as the subcontract properly incorporates the owner-contractor agreement by reference.

The Supreme Court of Nebraska recently decided a case based on a very similar factual scenario. See Frohberg Electric Co. v. Grossenburg Implement, Inc., 297 Neb. 356 (2017). In Frohberg, the owner contracted with a general contractor pursuant to an agreement that required arbitration of all disputes. The contractor subsequently contracted with the plaintiff subcontractor to provide electrical services and related materials at the project. In the subcontract, the subcontractor agreed “to be bound to … Contractor by the terms of the General Contract” and “to conform to and to
comply with the provisions of the General Contract.” *Id.* at 358. Following a payment dispute between the subcontractor and the contractor, the subcontractor recorded a mechanics lien against the project and later initiated litigation to foreclose upon its lien. The owner and contractor responded by moving to dismiss the lawsuit and compel arbitration of the subcontractor’s claims. The Supreme Court of Nebraska found in favor of the owner and contractor and held that the subcontract unambiguously incorporated the terms of the general contract, including the requirement to arbitrate disputes. *Id.* at 363.

**When Incorporation By Reference Is Insufficient**

While incorporation by reference provisions can help reconcile otherwise inconsistent contract provisions, as evidenced by the *Frohberg* decision, such provisions in and of themselves are not always enough to obligate a third-party to arbitrate disputes. Indeed, courts from across the country disagree as to whether an incorporation by reference provision in a surety bond will obligate the surety to arbitrate where the incorporated contract includes an arbitration provision but the bond does not. This issue was most recently considered by Maryland’s highest court in the case of *Schneider Electric Buildings Critical Systems, Inc.* v. *Western Surety Co.* 454 Md. 698 (2017).

The *Schneider* case involved a dispute between a contractor, Schneider Electric and its sub-subcontractor, National Control Services (“NCS”). Schneider entered into a master subcontract agreement with NCS to allow Schneider to engage NCS as a sub-subcontractor “from time to time” (the “Master Subcontract”). The Master Subcontract included a mandatory arbitration provision. *Id.* at 701. The parties later executed a subcontract for a specific project that incorporated the Master Subcontract and also required NCS to furnish a performance bond for the project. *Id.* at 702. NCS thereafter secured a performance bond from Western Surety Company which incorporated the NCS subcontract and the Master Subcontract by reference. The bond included the following provision:

> Any proceeding, legal or equitable, under this Bond may be instituted in any court of competent jurisdiction in the location in which the work or part of the work is located and shall be instituted within two years after a declaration of Contractor Default or within two years after the Contractor ceased working or within two years after the Surety refuses or fails to perform its obligations under this Bond, whichever occurs first. If the provisions of this Paragraph are void or prohibited by law, the minimum period of limitation available to sureties as a defense in the jurisdiction of the suit shall be applicable.

*Id.* at 710 (emphasis added).

During construction, NCS abandoned the project as a result of a payment dispute between NCS and Schneider. When NCS refused to perform, Schneider terminated the NCS subcontract, hired a replacement subcontractor, and filed a demand for arbitration against NCS and its surety for approximately $1.5 million in cost-to-complete damages. The circuit court granted Western Surety’s motion for summary judgment, holding that the surety could not be compelled to participate in arbitration proceedings between Schneider and NCS. *Id.* at 703-04. The court of special appeals affirmed, finding that Western Surety was “not compelled to arbitrate … simply
because th[e] bond incorporated by reference an agreement, to which it was not a party, containing a mandatory arbitration provision.” *Id.* at 704.

In appealing the appellate court’s ruling, Schneider likely expected Maryland’s highest court to enforce the arbitration provision against the third-party surety in much the same way as the *Frohberg* court enforced the arbitration provision in the owner-contractor agreement against the third-party subcontractor. Instead, the Court of Appeals of Maryland rejected Schneider’s incorporation by reference arguments and affirmed the lower courts’ rulings. In finding that Western Surety had no obligation to arbitrate, the court relied upon the following inconsistencies in the relevant subcontract documents:

1. The text of the bond evidenced Western Surety’s intent to guarantee performance of all of NCS’ construction obligations, not all of its contractual obligations. *Id.* at 706-08. Therefore, the Court found that the incorporation by reference provision in the bond only incorporated NCS’ duties to perform “the Work” as defined in the subcontract, not NCS’ obligation to arbitrate its disputes with Schneider.

2. The arbitration provision in the Master Subcontract only required arbitration of disputes between Schneider and NCS. *Id.* at 708-10. While the term “surety” was used elsewhere in the Master Subcontract, it was noticeably absent from the arbitration provision. Instead, the arbitration provision was labeled “disputes between Contractor and Subcontractor” and specifically required the “Contractor” (Schneider) and “Subcontractor” (NCS) to arbitrate disputes.

3. Requiring Western Surety to arbitrate would directly conflict with the bond provision requiring judicial resolution of any dispute involving the bond. *Id.* at 710-11. The court reasoned that “a clause within the Bond providing for legal remedy demonstrates the parties’ intent to litigate disputes arising under the Bond, not arbitrate them.” *Id.* at 710.

In this circumstance, an incorporation by reference provision was not sufficient to bind the third-party surety to the contracting parties’ agreement to arbitrate. As a result, despite clearly agreeing to arbitrate any disputes with its subcontractor, the court required Schneider to pursue its claims against NCS and its surety – which claims arose from the very same set of facts – in two separate proceedings, subjecting Schneider to excessive additional legal costs and the risk of inconsistent results as between the arbitration proceedings against NCS and the litigation against Western Surety. All of which could have been avoided had Schneider considered and then addressed the impact of its arbitration provision on the third-party surety when negotiating its agreement with NCS.

**Drafting Tips to Help Ensure Sureties Are Required to Arbitrate**

While some jurisdictions disagree with the *Schneider* ruling and rely on incorporation language in a bond to require a surety to arbitrate, best practice is to draft the relevant contract so as to avoid any potential for an interpretation that is inconsistent with the parties’ intent to arbitrate their disputes. *See, e.g., Hoffman v. Fidelity Deposit Co. of Maryland*, 734 F. Supp. 192 (D.N.J. 1990) (citing decisions from the First, Second, Fifth, Sixth, and Eleventh federal circuits to support its
finding that a bond’s incorporation by reference language was sufficient to require the surety to arbitrate). Some suggestions to avoid the scenario in *Schneider* are:

1. Require the contractor (or subcontractor) to provide a specific bond form that incorporates the dispute resolution procedures set forth in the underlying contract and makes clear that the surety is guaranteeing performance of all of the contractor’s (or subcontractor’s) underlying contractual obligations, not solely performance of the work. This can be accomplished by attaching a bond template form as an exhibit to the contract and including language mandating that the contractor (or subcontractor) “secure a bond in the form attached hereto as Exhibit __.”

2. Make specific reference in the arbitration provision to the surety and other third parties who are intended to be bound by the arbitration provision. In many cases involving a surety’s attempts to avoid arbitration, courts focus on the language of the arbitration provision to determine the parties’ intent. Therefore, it is critical that the relevant arbitration provision is not strictly limited to the contracting parties.

3. Require the contractor (or subcontractor) to indemnify the other contracting party for all costs incurred as a result of any challenges by the surety to the arbitration provision. Therefore, in the event the surety refuses to arbitrate, the claimant can seek the costs resulting from such refusal from its contractual counterpart.