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Who Decides If a Dispute Is Arbitratable?

By Michael J. Lane and Nicole Mastrocinque

The answer to this question should be simple. Many times it is. And with proper draftsmanship it will be clear. But when two (or more) documents are involved in a dispute, it can be a much more difficult answer.

This issue arises with some frequency in commercial litigation and can be difficult for courts to decide in the first instance, whether the matter is subject to arbitration, and even whether it is up to the court or an arbitrator to make that "gateway" decision.

As Judge Edgardo Ramos in the Southern District of New York observed a few years ago: "Whether the parties agreed to arbitrate is generally a question decided by the court unless the parties 'clearly and unmistakably provide otherwise.'"

Determinations of arbitrability may be delegated to an arbitrator "'if there is clear and unmistakable evidence from the arbitration agreement, as construed by the relevant state law, that the parties intended the question of arbitrability shall be decided by the arbitrator.'"

Arbitration exists only if the parties expressly agree to it. Courts generally have favored arbitration, no doubt in part because it lessens

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courts' overflowing dockets. In our experience, it seems that courts often prioritize finding arbitration, sometimes without fully considering the underlying transactions or the parties' rights.

That was the situation in the case we discuss in this article. The Federal Arbitration Act ("FAA") and Article 75 of the CPLR govern parties who are subject to arbitration in New York.

But what if a court is faced with one party seeking arbitration and the other wanting to litigate the dispute in the courts? Who makes the call on which forum should hear the dispute? As stated above and under established New York law,

generally the court in the first instance should make that call.

Because a party has an absolute right to litigate its disputes in the courts, that critical question should not be sent to an arbitrator or arbitration panel absent an express agreement between the parties that the arbitrator should make that fundamental first determination.

We recently were brought into a commercial litigation to act as counsel at the appellate stage where this issue was central to the dispute. Our client sought to enforce a personal guaranty under CPLR 3213, but the lower court instead sent the client to AAA arbitration.

The court below, after a very contentious hearing decided (wrongly, we believed), that the matter should be sent to arbitration for the arbitrator to decide in the first instance whether the matter was arbitrable. The court did so where, as we describe below, there were two competing agreements—an early personal guaranty and a years-later assignment agreement between different parties all relating to the same real estate transaction.

These competing agreements were inconsistent on what forum should hear the parties' dispute. The Guaranty provided for disputes to be heard in the New York courts and had no mention of arbitration, while the subsequent agreement had an AAA arbitration provision.

The Facts

Our client had invested in one of the defendant's real estate construction projects years ago. Subsequently, the defendant asked our client to transfer his investment into a different real estate development project (the Project) that the defendant was sponsoring. As part of inducing that transfer, our client was able to obtain a personal guaranty (the Guaranty) from the defendant ensuring repayment of his investment with interest.

Obviously, the Guaranty was very important to our client. The terms of the Guaranty were straightforward. The Guaranty provided that New York law applied to its construction, and made clear that any dispute arising out of the Guaranty was to be litigated in the New York courts. There was no mention of arbitration in the Guaranty.

The term of the investment came to an end. Our client sought full repayment of his investment (with interest) from the defendant's corporate entity. When that failed (after months of back-and-forth communications) our client advised the defendant they would seek to enforce the Guaranty. The defendant stalled for several more months, stringing our client along with repeated promises, made and broken.

Finally, as the client planned to commence an action seeking to enforce the Guaranty, the defendant offered a new proposal by which he promised to fully repay our client in 45 days. If our client agreed to permit the defendant to assign the parties' agreement to a corporate entity the defendant had newly funded and created, that new entity would repay our client in full within 45 days.

Anxious to obtain his money promptly, our client agreed. To his and his then counsel's credit, this new assignment agreement (the Assignment) was to give our client a second, separate source for the full repayment of his investment. Our client believed the defendant's promise of prompt full repayment. And whereas the Guaranty was between our client and the defendant, personally, the Assignment was between our client and the defendant's newly formed corporate entity.

The parties engaged in what turned out to be more difficult negotiations over the language of the Assignment that would transfer our client's investment to the defendant's newly created corporate entity. The defendant sought to combine the agreements and even proposed language that would extinguish the Guaranty. Our client rejected those attempts, wanting to keep his hard-fought-for Guaranty.

Ultimately, consistent with the parties' intent that this was a different source to repay our client, the Assignment was drafted as a free-standing agreement, separate and apart from the Guaranty. There was no merger clause in the Assignment. Indeed, the Assignment did not even mention the Guaranty.

There also was a significant record of negotiations between the parties that, in retrospect, would provide fertile parol evidence in the dispute that was to come. In total, there was a 15-month record of WhatsApp exchanges between our client and the defendant reflecting the defendant's repeated misstatements, mistruths, and half-truths relating to the parties' negotiations for fully repaying the money long overdue to our client.

As the fates would have it, the defendant's newly created entity also defaulted on repaying our client's investment in the Project. Our client therefore was left with two avenues to pursue: (1) seek to enforce the separate Guaranty against the defendant, personally, or (2) sue the defendant's newly created corporate entity in arbitration seeking full repayment from that entity.

The Litigation

Our client moved on the separate Guaranty under CPLR 3213, seeking summary judgment in lieu of complaint on an instrument for the payment of money only. In response, the defendant cross moved to (1) compel arbitration of the parties' dispute based on the arbitration provision contained in the Assignment and (2) stay the 3213 motion on the basis that the entire matter was arbitrable under the broad arbitration provision in the Assignment and that the 3213 motion should be stayed while the matter was sent to arbitration.

Our client's position was straightforward. He had obtained the Guaranty many years before from the defendant, personally, in connection with moving his investment from a different transaction the defendant was sponsoring to the Project. The Guaranty was a separate and independent agreement from the Assignment that clearly was to be litigated before the New York courts. There was no mention of arbitration.

The defendant's cross-motion sought to drag our client and the independent Guaranty into an AAA arbitration, based on the broad language in the arbitration provision that applied to disputes arising from the Project.

The arbitration provision was very broad in that it applied to any dispute arising from the Project. But there was no mention of the Guaranty nor was there a merger clause merging the Guaranty into the Assignment.

And although the Assignment instructed the arbitrator(s) to apply the AAA's Commercial Arbitration Rules, there was no express language in the Assignment that the parties agreed the AAA should determine whether the matter was arbitrable. In fact, there was no mention at all in the Assignment about what forum would determine if a dispute was arbitrable.

After full briefing and a hearing, the court decided that the matter should be sent to AAA arbitration. The court stayed our client's 3213 motion and sent the parties to AAA arbitration, directing the arbitrator to decide if the matter was arbitrable.

On appeal, our client has argued that (1) it was the court, not the arbitrator, which in the first instance should decide the forum for the dispute, (2) the Guaranty was a separate agreement with no mention of arbitration, (3) the Assignment lacked a merger clause and (4) the Guaranty and the Assignment were not "so inextricably interwoven" to subject the Guaranty to arbitration. Our client's appeal is pending.

The Takeaway

There is much to learn from this case. First, absent "clear and unmistakable evidence in

the arbitration agreement," the court decides whether the matter is in fact arbitrable. There was no such clear evidence assigning this "gateway" issue to an arbitrator.

Second, clear drafting is critical to every document a lawyer creates. In situations like our client's, where significant money was due and the client was in a hurry to collect it, you need to be careful in negotiating a subsequent agreement and the effect, no matter how small, of an overbroad provision that could be used "down the road" against your client.

In negotiating any document, we all make calculations of what the risks are to our client with the inclusion or exclusion of certain language.

And although we believe the lower court was wrong in sending the case to the AAA for determination whether the matter was arbitrable, in retrospect it was clear that the overbroad arbitration provision should not have been agreed to by our client, as it caused a clever litigation strategy to, at least for now, have lost our client's right to use the expedited CPLR 3213 to collect his full investment, now three-plus years overdue.

Third, you should fully understand the arbitral forum's rules that you are seeking to apply to the arbitration or otherwise incorporate into the agreement. For instance, another issue in our litigation was the adoption of the AAA's Commercial Arbitration Rules. In such cases, the courts have found the inclusion of such rules sufficient to conclude that the parties agreed to arbitrate arbitrability (depending on the forum's rules).

In our case, because the Guaranty was a separate and independent agreement with its own dispute resolution provision, that rule is inapplicable. But practitioners need to be wary of adopting arbitral forum rules.

The logic behind this is that once the arbitral forum's rules are referenced, the courts will defer to those rules to determine whether they specify that the arbitrator should decide arbitrability.

For instance, the AAA Commercial Rules provide: (1) "[t]he parties shall be deemed to have made these rules part of their arbitration agreement whenever they have provided for arbitration by the American Arbitration Association…," and (2) "[t]he arbitrator shall have the power to rule on his or her own jurisdiction, including any objections with respect to the existence, scope, or validity of the arbitration agreement or to the arbitrability of any claim or counterclaim, without any need to refer such matters first to a court."

This seems counterintuitive to the concept of "clear and unmistakable" intent to arbitrate arbitrability. By incorporating the arbitral forum's rules, you may agree that the arbitrator will decide arbitrability without having the express language in the agreement. You are essentially at the mercy of the AAA's or other arbitral forums' rules.

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