New Jersey Law Journal

VOL. CLXXXIX– NO.5 – INDEX 363 JULY 30, 2007 ESTABLISHED 1878

CORPORATE LAW

Courts Press Expansive View of Arbitration Clauses

Courts choose arbitration over competing state interests and legislative policies

By John D. Cromie and Noel D. Humphreys

New Jersey courts strongly favor arbitration of commercial disputes. Where arbitration is even moderately appropriate, courts choose arbitration over potentially applicable competing state interests and legislative policies. Clever drafters have embraced this strong public policy and use it to their advantage.

For example, in the recent *Alfano v. BDO Seidman* decision, the court forced a plaintiff into arbitration when the defendant was not even a party to the contract that contained the arbitration clause. 2007 WL 1712614 (N.J. Super. App. Div. 2007). John Alfano sold his business and wished to shelter the proceeds from taxation by means of a scheme promoted by his accountants. Under their advice, Alfano bought and sold Deutsche Bank stock through an account with Deutsche Bank Securities, Inc. (DBSI), a broker/dealer subsidiary of Deutsche Bank. To open the brokerage account, Alfano executed a "Customer Account Agreement" with DBSI. Following NASD rules, that Agreement specified, in part, that "all controversies which may arise … concerning any transaction … shall be determined by arbitration … pursuant to the rules then in effect of the National Association of Securities Dealers, Inc. [(NASD)]."

The IRS declared the tax shelter "abusive" and disallowed Alfano's claimed losses. Alfano sued Deutsche Bank among others. Alfano's lawyer did not name DBSI as a defendant. Avoidance of arbitration probably motivated this omission.

Deutsche Bank moved to stay Alfano's suit and compel arbitration of his claims pursuant to the customer account agreement. The trial court denied the motion because Deutsche Bank was not a party to that agreement. The trial court found that the Bank's parent-company status was insufficient to create an agency relationship between the bank and its broker/dealer subsidiary.

Deutsche Bank appealed. The Appellate Division ruling allowed Deutsche Bank to enforce the arbitration provision. Writing for the Appellate Division panel, Judge Marie Lihotz disagreed with the lower court's factual determination that no agency relationship existed. The opinion relied upon traditional agency principles and found that a corporate agent acting for a disclosed principal can bind the principal. The decision did not cite any case where the parent company of a subsidiary successfully enforced a subsidiary's contract by means of an agency relationship. Without citing any specific documentary evidence, the court found sufficient evidence that the agency relationship between Deutsche Bank and DBSI was disclosed to Alfano when he opened his account. The court referred to cases involving similar tax shelter schemes in which a broker/dealer subsidiary was named as a defendant in the complaint. In those cases, courts extended the subsidiary's arbitration clause to include the parent.

Judge Lihotz found that DBSI was essential to the tax shelter plan, because Deutsche Bank itself could not arrange the purchases and sales. The court noted that, "[h]ad Alfano not purchased the stock, Alfano could not have employed the [tax shelter] strategy and no cause of action against defendant would arise." Since DBSI's activities were "integral" to Alfano's causes of action, the Appellate Division declared that "Alfano must rely on the [subsidary's] transaction to assert his claims".

Cromie chairs the corporate law and transactions practice group at Connell Foley of Roseland, of which Humphreys is a member. Kelly Targett, a student at Rutgers University School of Law in Newark, assisted with the article. The firm represented Freightliner Corp. in Central Jersey Freightliner, Inc. v. Freightliner Corp. *discussed in the article.*

This article is reprinted with permission from the JULY 30, 2007 issue of the *New Jersey Law Journal*. ©2007 ALM Properties, Inc. Further duplication without permission is prohibited. All rights reserved.

Alfano's surprising treatment of the parent-subsidiary relationship demonstrates the strength of public policy favoring arbitration. In other settings, it is highly unusual for a holding company parent to be voluntarily drawn into litigation against a subsidiary. More often, subsidiaries are created to insulate holding companies from litigation. In *Alfano*, however, the Appellate Division allowed a parent to wield its subsidiary's contract as a sword against the plaintiff.

Several other recent New Jersey cases exemplify the power of the preference for arbitration. The Federal Arbitration Act, 9 U.S.C. §§ 1-16 (FAA), has played a key role in such cases. The FAA provides that a commercial contract provision "to settle by arbitration a controversy thereafter arising out of such contract…shall be valid, irrevocable and enforceable." In New Jersey, the preference for arbitration has been particularly notable in franchise cases, in which the FAA has been applied pre-emptively over state law and precedent. Even franchise contracts that call for arbitration in distant locations appear to be routinely enforced by New Jersey courts.

Late last year, the Appellate Division upheld a clause that mandated arbitration in Washington State. *Allen v. World Inspection Network International, Inc.*, 911 A.2d 484 (N.J. Super. Ct. App. Div. 2006). The Allens, who held a home inspection franchise, sought rescission in New Jersey courts of two separate franchise agreements with World Inspection Network International, Inc. Both agreements mandated application of the FAA and selected Washington State as the arbitral venue. New Jersey law applied to the claims. However, the parties could not agree on the venue in which the claims should be resolved.

The trial court declared the Washington State arbitration clause unconscionable. On review, the Appellate Division found this determination to have been made in error. Writing for the panel, Judge Susan Reisner declared that an agreement to arbitrate in a distant state was not patently unfair. Rather, a reasonable person might consent to arbitration in Washington State if that person concluded that the advantages of a franchise outweighed the possible risks and expense of arbitration.

Judge Reisner's opinion recognized that New Jersey's Franchise Practices Act, N.J. Stat. Ann. § 56:10-1 to 29 (NJFPA) created a presumptive invalidity for forum selection clauses that mandate out-of-state litigation. However, the Appellate Division found that an arbitration clause is often so integral to the underlying agreement that it cannot be severed unless it is "contrary to general principles of state contract law." Indicating that the agreement appeared to be enforceable, the Appellate Division remanded the case for further analysis of any potential conflict with state contract law.

A few months before the *Allen* decision, the Chancery Division considered a similar claim and reached nearly the same conclusion. In *B&S Limited, Inc. v. Elephant & Castle International, Inc.*, a New Jersey franchisee (B&S) allegedly failed to comply with the payment schedule and record-keeping provisions of a franchise agreement. The franchisor sought arbitration in Minneapolis pursuant to the agreement. 906 A.2d 511 (N.J. Super. Ct. Ch. Div. 2006). B&S sought to compel arbitration in New Jersey. Among its arguments, B&S submitted that the forum selection clause designating an out-of-state venue was presumptively invalid and the parties should have to arbitrate in New Jersey.

The Chancery Division looked to the NJFPA and the FAA for guidance. The court found that the NJFPA impermissibly burdened the public policy favoring arbitration. Judge Thomas Lyons concluded that the presumptive invalidity doctrine could not apply to the franchise agreement because federal law in favor of enforcement of arbitration agreements pre-empted the NJFPA. However, Judge Lyons noted that state law was not without a contribution to the analysis. The contract should be evaluated under state law governing the negotiation and validity of contracts. Judge Lyons concluded that there was insufficient evidence to support B&S's contention that the contract was unconscionable. Since the contract was otherwise valid under state contract law, the arbitration clause was also upheld. Arbitration in Minnesota was permitted to proceed.

Both *World Inspection Network* and *Elephant & Castle* relied upon *Central Jersey Freightliner, Inc. v. Freightliner Corp.*, 987 F. Supp. 289 (D.N.J. 1997). In that case, Judge Lifland held that the FAA rendered arbitration clauses enforceable regardless of NJFPA. The district court relied on the supremacy clause in the United States Constitution for this determination.

What makes these franchise cases dramatic is the New Jersey Supreme Court's holding in *Kubis & Perszyk Associates, Inc. v. Sun Microsystems, Inc.*, 146 N.J. 176 (1996). That case evaluated the NJFPA provision mandating that a franchisor cannot require a franchisee to submit disputes to a particular tribunal in a particular state outside of New Jersey. New Jersey's highest court said that the legislature enacted a "comprehensive legislative design" to enforce franchisee rights against franchisors. *Kubis* declared forum selection clauses in the context of litigation to be "presumptively invalid because they fundamentally conflict with the basic legislative objectives of protecting franchisees from the superior power of franchisors and providing swift and effective judicial relief against franchisors that violated the [New Jersey Franchise Practices] Act." Distinguishing franchise contracts from "arms-length commercial contracts," the court wrote, "…we are convinced that forum-selection clauses in the vast majority of franchise agreements are not the subject of arms-length negotiation between parties of comparable bargaining power."

The relevant sections of the NJFPA were drafted specifically to address motor-vehicle franchises. The *Kubis* Court gave these sections an expansive reading by applying them to a computer system vendor franchise. To justify this extension, the court emphasized that "[t]he strongest single factor weighing against enforcement of forum-selection clauses in franchise

agreements is the Legislature's avowed purpose, plainly expressed in the Franchise Act, to level the playing field for New Jersey franchisees and prevent their exploitation by franchisors with superior economic resources."

The *Kubis* approach favors in-state settlement of disputes arising under franchise contracts by presumptively invalidating clauses that mandate dispute resolution in foreign venues. The holding demonstrates New Jersey's avowed public policy that local franchisees should have access to local venues for dispute resolution. At the same time New Jersey has also shared in the strong federal policy favoring the resolution of commercial disputes by arbitration. As *Allen* and *B&S Investors* demonstrate, the FAA pre-empts New Jersey state law and prevails in defense of arbitration.

Alfano exemplifies the strong policy favoring arbitration in commercial contracts. New Jersey courts readily enforce arbitration provisions in foreign venues. New Jersey attorneys, franchisees and others involved in commercial transactions with out-of-state entities should expect that courts will expansively enforce arbitration clauses regardless of competing state legislative policies. ■