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Not So Fast...California Court of Appeal Holds That Non-Signatory Plaintiff To Arbitration Contract Cannot Be Compelled To Arbitrate Where The Plaintiff Was Not An Intended Beneficiary To The Contract

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In a decision which will provide some additional guidance as to the reach of arbitration clauses in general, the California Court of Appeal, Second District, ruled in Epitech, Inc., et al. v. Garry Michael Kann, et al. (2012) Westlaw 1255297 ("Epitech Case"), that a plaintiff non-signatory to an arbitration contract could not be compelled to arbitrate under that contract where the plaintiff was only an incidental, as opposed to intended, beneficiary to the contract. The Epitech Case is significant in that the Court acknowledged that the plaintiff would have benefited based upon performance of the subject contract, but found that the plaintiff would only have been an incidental beneficiary.

The facts of the Epitech Case are reasonably straightforward. In the Epitech Case, a startup company, AutoLife Acquisition Corporation ("AutoLife") had two groups of shareholders known as the "Majority Shareholders" and the "Minority Shareholders." The Majority Shareholders had originally provided startup funding for AutoLife and owned 75 percent of its stock. The Minority Shareholders ultimately bought out the Majority Shareholders for an immediate payment of cash and a note from AutoLife for \$1.6 million secured by a lien on all AutoLife assets and stock pledge agreements. An investor, Mitchell Family Investments, LP (herein referred to the "AutoLife Investor") invested \$3.5 million in AutoLife in exchange for warrants and a note for \$3.5 million secured by AutoLife's assets. In addition, Epitech, Inc. ("Epitech"), a supplier of AutoLife, was acquired by AutoLife for cash and a note in the approximate of \$375,000.00, which note was secured by an interest in certain AutoLife assets. The Majority Shareholders, the AutoLife Investor and Epitech are sometimes herein collectively referred to as the "Secured Creditors" or "Secured Creditor Plaintiffs".

The transactions involving the Minority Shareholders' purchase of the Majority Shareholders' stock, the AutoLife Investor's investment and the Epitech investment all closed on or about December 30, 2005. The notes securing those transactions had due dates in or about March of 2006.

In February 2006, AutoLife retained Kann Capital, Ltd., through its principal, Garry Michael Kann (collectively "Kann"), to assist AutoLife in raising growth capital and to act on AutoLife's behalf as financial advisor with respect to financing. Financing did not materialize by March 2006, but the Secured Creditors did not then foreclose on their security interests. However, in April 2007, the Majority Shareholders foreclosed on their stock pledge agreements, thereby regaining control of AutoLife. It was then learned that Kann had resigned earlier in January 2007, due to disputes with AutoLife. After discovering Kann's resignation and learning of the dire financial condition of AutoLife, the Majority Shareholders placed AutoLife into bankruptcy in June 2007.

Lawsuits were later filed against Kann and others by the Majority Shareholders, the AutoLife Investor and Epitech (i.e., the Secured Creditors). After discovery had been taken in the actions (which were consolidated), Kann filed a Petition to Compel Arbitration pursuant to an arbitration clause in Kann's February 2006 engagement letter with AutoLife. Kann argued that the Secured Creditors were third party beneficiaries of the Kann engagement agreement. The Trial Court disagreed and the Petition to Compel was denied. Kann then filed a timely notice of appeal.

On appeal, the Court of Appeal noted that there were two issues before the Court, the first being whether there had been an implied waiver of the arbitration clause due to discovery which had occurred and secondly whether the Secured Creditor Plaintiffs could be considered to be third party beneficiaries under the Kann engagement agreement.

In its ruling, the Court of Appeal did not reach the waiver issue, as it concluded, as a matter of law, that the Secured Creditors were not third party beneficiaries of Kann's engagement agreement with AutoLife.

In its holding, the Court of Appeal noted that Code of Civil Procedure § 1281.2 requires arbitration where an agreement to arbitrate exists, and further noted the strong public policy in favor of arbitration, citing Crowley Maritime Corp. v. Boston Old Colony Insurance Co. (2008) 158 Cal.App.4th 1061. Nevertheless, the Court of Appeal acknowledged that the public policy favoring arbitration does not apply to disputes that the parties have not agreed to arbitrate but also noted that there are exceptions to the rule that a non-signatory cannot be compelled to arbitrate. In that regard, the Court of Appeal acknowledged that a non-signatory to an arbitration contract may be compelled to arbitrate where it is a third party beneficiary but noted that a third party can only be considered a third party beneficiary where it is either a creditor

beneficiary or donee beneficiary, citing Lake Almanor Associates, LP v. Huffman-Broadway Group, Inc. (2009) 178 Cal.App.4th 1194, 1199.

Noting that there was no issue as to whether the Secured Creditor Plaintiffs were donee beneficiaries, the Court then addressed whether the Secured Creditor Plaintiffs could be considered creditor beneficiaries. As to that question, the Court of Appeal ruled that while the Secured Creditors potentially stood to benefit in the event Kann obtained financing for AutoLife, the Court of Appeal commented that Kann's performance under its contract would not necessarily have discharged any obligation which AutoLife owed to the Secured Creditor Plaintiffs. In that regard, the Court noted that Kann did not "contract to pay the secured creditors *any money at all*" (emphasis supplied).

The Court of Appeal also noted that the Secured Creditor Plaintiffs were not suing Kann for breaching any contractual duties owed to them as third party beneficiaries, but were instead pursuing claims against Kann for fraud, negligent misrepresentation and concealment.

The Epitech Case is important in that an earlier Court of Appeal ruling, from the same district, in JSM Tuscany, LLC v. Superior Court (2001) 193 Cal.App.4th 1222 (a case involving various breaches regarding the acquisition of real property) ("JSM Tuscany Case") held that a non-signatory plaintiff could be compelled to arbitrate a claim against a non-signatory defendant when the claim was itself based on, or inextricably intertwined with, the contract containing the arbitration clause.

The Epitech Case will certainly have some impact. In cases where a non-signatory to an arbitration contract contests the application of the contract to the subject lawsuit, the non-signatory party can argue that it was not an intended beneficiary of the contract containing the arbitration clause. Of course, the party attempting to compel arbitration can still argue, as in the JSM Tuscany Case, that the dispute is inextricably intertwined with the contract containing the arbitration clause, and this should lead to some interesting rulings.

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