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The New Jersey Supreme Court Limits The Use Of Equitable Estoppel As A Basis To Compel Arbitration Of Claims Against A Person That Is Not A Signatory To An Arbitration Agreement

A. Introduction

The New Jersey Supreme Court has substantially restricted the use of equitable estoppel as a basis to compel arbitration of claims against a securities broker-dealer or its corporate affiliate that is not a signatory to an arbitration agreement, barring its application in the absence of proof that such entity relied to its detriment on the plaintiff's conduct. In *Hirsch v. Amper Financial Services, LLC,* 2013 N.J. LEXIS 823 (Aug. 7, 2013), the Court rejected the application of equitable estoppel to compel plaintiff investors to arbitrate claims against an accounting firm and financial services firm that were not parties to the plaintiffs' agreement to arbitrate disputes against the securities broker-dealer through whom plaintiffs had purchased the securities at issue where the claims and parties were "intertwined" but there was no evidence that the accounting firm and the financial services firm detrimentally relied upon the plaintiffs' conduct. *Hirsch*, 2013 N.J. LEXIS 823 at **31-33. The Supreme Court held that "intertwinement" cannot be used as "a theory for compelling arbitration when its application is untethered to any written arbitration clause between the parties, evidence of detrimental reliance, or at a minimum an oral agreement to submit to arbitration." *Id.* at *31. Writing for a unanimous Court, Justice LaVecchia reasoned that limiting the scope of equitable estoppel in such manner was appropriate in light of the rationale for applying the doctrine, which is to "prevent a party's disavowal of previous conduct if such repudiation would not be responsive to the demands of justice and good conscience." *Id.* at *33. The *Hirsch* decision thus stands in sharp contrast to the multiple federal court decisions, particularly by courts in the Second Circuit, which have held that a plaintiff can be compelled to arbitrate claims against a person that is not a party to the arbitration agreement (hereinafter referred to as a "non-signatory") pursuant to an intertwinement theory of equitable estoppel. *See, e.g., JLM Industries, Inc. v. Stolt-Nielsen, S.A.*, 387 F. 3d 167, 177 (2d Cir. 2004); *Astra Oil Co., Inc. v. Rover Navigation, Ltd.*, 344 F. 3d 276, 279 (2d Cir. 2003); *Sunkist Soft Drinks, Inc. v. Sunkist Growers, Inc.*, 10 F. 3d 753, 757 (11th Cir. 1993).

Hirsch makes it significantly more difficult for a non-signatory corporate affiliate of a securities broker-dealer (such as the broker-dealer's parent company) to enforce an arbitration agreement against a plaintiff customer who signed the agreement under New Jersey law, especially where there is no evidence of an agency relationship between the broker-dealer and the corporate affiliate. The non-signatory corporate affiliate cannot rely merely on the fact that the claims and parties are "intertwined." Instead, the non-signatory corporate affiliate must show some act or omission by the plaintiff which induced it to reasonably believe that the plaintiff would arbitrate claims against the non-signatory and that application of equitable estoppel is therefore necessary to "prevent injustice by not permitting [the plaintiff] to repudiate a course of action on which [the non-signatory] has relied to his detriment." *Hirsch,* 2013 N.J. LEXIS 823 at *10 (*quoting Knorr v. Smeal,* 178 N.J. 169, 178 (2003)).

The trial court granted SAI's moton, concluding that Plantiffs were "attempting to circumvent the policy favoring arbitration" by failing to name SAI as a defendant in the Law Division action.

B. The Motion To Compel Arbitration

Plaintiffs Michael Hirsch, Robyn Hirsch and Hirsch, LLP retained Defendants Amper Financial Services, LLC ("AFS"), a financial services firm, and Mark Scudillo, a financial advisor employed by AFS and its managing partner ("Scudillo"), to provide wealth planning services. Plaintiffs were referred to AFS and Scudillo by Defendant EisnerAmper, LLP ("EisnerAmper"), their accountants. EisnerAmper and Scudillo were the principals of AFS. *Hirsch* 2013 N.J. LEXIS 823 at **10-11. Scudillo was also a registered representative of Third Party Defendant Securities America, Inc. ("SAI"), a securities broker-dealer. Scudillo recommended that Plaintiffs purchase securitized notes issued by Medical Provider Financial Corporation ("Med Cap"). Plaintiffs signed two applications with SAI in connection with their purchases of the Med Cap notes. *Id.* at **11-12. Each of the SAI applications incorporated the following arbitration provision:

> All controversies that may arise between us (including, but not limited to controversies concerning any account, order or transaction, or the continuation, performance, interpretation or breach of this or any other agreement between us, whether entered into or arising before, on or after the date this account is opened) shall be determined by arbitration in accordance with the rules then prevailing of the New York Stock Exchange, Inc. or the [National Association of Securities Dealer (NASD)] as I may designate....

Hirsch, 2013 N.J. LEXIS 823 at **13-14.

Plaintiffs lost their entire investment in the Med Cap notes following Med Cap's default on one of the notes, investigations by the Securities and Exchange Commission ("SEC") and the Commonwealth of Massachusetts which determined that Med Cap had been operated as a Ponzi scheme, the filing of fraud charges by the SEC against Med Cap's senior officers and the placement of the corporation in receivership. *Hirsch,* 2013 N.J. LEXIS 823 at *16. Plaintiffs commenced an arbitration against SAI and Scudillo before FINRA Dispute Resolution to recover their losses on the Med Cap notes. Plaintiffs also filed a lawsuit against AFS and EisnerAmper in New Jersey Superior Court in connection with the Med Cap notes, asserting *inter alia* common law claims for breach of contract, negligent misrepresentation and breach of fiduciary duty. *Id.* at **16-17. AFS and EisnerAmper filed a third party complaint for indemnification and contribution against SAI. *Id.* at *17. SAI, in turn, filed a motion in the Superior Court action to compel Plaintiffs to arbitrate their claims against EisnerAmper and AFS. Among other things, SAI argued that AFS and EisnerAmper are subject to the arbitration agreement pursuant to the doctrine of equitable estoppel. AFS and EisnerAmper joined in the motion to compel arbitration. *Id.* at **17-18. The trial court granted SAI's motion, concluding that Plaintiffs were "attempting to circumvent the policy favoring arbitration" by failing to name SAI as a defendant in the Law Division action. *Id.* at *18. The Appellate Division affirmed the order compelling arbitration, albeit for a different reason. Specifically, the Appellate Division concluded that compelling arbitration was appropriate based on principles of equitable estoppel. Relying on *EPIX Holdings Corp. v. Marsh & McLennan Companies, Inc.*, 410 N.J. Super. 453, 463-68 (App. Div. 2009), the Appellate Division held that "[t]he complex and intertwined relationship between and among plaintiffs, Scudillo, EisnerAmper and AFS is an

'integral' one which provides 'sufficient basis to invoke estoppel.'" *Hirsch,* 2013 N.J. LEXIS 823 at **18-19 (internal citations omitted).

C. The Supreme Court's Decision In *Hirsch*

The Supreme Court rejected the Appellate Division's "intertwinement" theory of equitable estoppel and reversed the order compelling Plaintiffs to arbitrate their claims against EisnerAmper and AFS. Initially, the *Hirsch* Court acknowledged that in determining whether a party can be compelled to arbitrate, "courts can use principles of contract law even in the absence of an express arbitration clause." *Hirsch,* 2013 N.J. LEXIS 823 at **24-25. In this regard, the Court noted that under federal law, "in the context of arbitration, 'traditional principles' of state law allow a contract to be enforced by or against nonparties to the contract through 'assumption, piercing the corporate veil, alter ego, incorporation by reference, third party beneficiary theories, waiver and estoppel.'" *Id. (quoting Arthur Andersen LLP v. Carlisle,* 556 U.S. 624, 631, 129 S. Ct. 1896 (2009)) (emphasis in original).

Reviewing the doctrine of equitable estoppel under New Jersey law, Justice LaVecchia observed that "equitable estoppel has been defined as the effect of the voluntary conduct of a party whereby he is absolutely precluded, both at law and in equity, from asserting rights which might perhaps have otherwise existed ... as against another person, who has in good faith relied upon such conduct, and has been led thereby to change his position for the worse ...." *Hirsch,* 2013 N.J. LEXIS 823 at *25 (*quoting Heuer v. Heuer,* 152 N.J. 226, 237 (1998)). Put another way, equitable estoppel is "designed to prevent a party's disavowal of previous conduct if such repudiation would not be responsive to the demands of justice and good conscience." *Hirsch,* 2013 N.J. LEXIS 823 at *25 (*quoting Heuer,* 152 N.J. at 237). In order to establish equitable estoppel, the moving party must prove that the opposing party "engaged in conduct, either intentionally or under circumstances that induced reliance, and that [they] acted or changed their position to their detriment." *Hirsch,* 2013 N.J. LEXIS 823 at *26 (*quoting Knorr,* 178 N.J. at 178). In other words, "equitable estoppel ... requires detrimental reliance." *Id.*

With respect to the use of equitable estoppel as a basis to compel the arbitration of claims against a party that is not a signatory to the arbitration agreement, the Supreme Court acknowledged the general principle that under New Jersey law, "arbitration may be compelled by a non-signatory against a signatory to a contract on the basis of agency principles." *Hirsch,* 2013 N.J. LEXIS 823 at **30-31. The Court cautioned, however, that while "equitable estoppel may be used in certain circumstances as a basis to compel arbitration, its use has limited applicability." *Id.* at *31. The *Hirsch* Court found the notion of compelling arbitration of claims against a non-signatory based on the intertwinement theory of equitable estoppel to be problematic, opining that "when the rationale rests solely on the connection between the parties and claims, [such application of equitable estoppel] overlooks our case law emphasizing that parties are giving up their right to sue in court when they agree to use the alternative dispute resolution technique of arbitration." *Id.* The Supreme Court "reject[ed] intertwinement as a theory for compelling arbitration when its application is untethered to any written arbitration clause between the parties, evidence of detrimental reliance, or at a minimum an oral agreement to submit to arbitration." *Id.* In light of the fact that equitable estoppel "is invoked in the interests of justice, morality and common fairness," the Court concluded that "estoppel

... equitable estoppel is "designed to prevent a party's disavowal of previous conduct if such repudiation would not be responsive to the demands of justice and good conscience."

[T]he *Hirsch* Court rejected the panel's "reliance on a theory of intertwinement under the guise of equitable estoppel," holding that the Appellate Division was "mistaken in concluding that the intertwinement of claims and parties in the litigation -- in and of itself -- was sufficient to give a non-signatory corporation standing to compel arbitration."

cannot be applied solely because the parties and claims are intertwined and, to the extent that *EPIX Holdings* suggests otherwise in its rationale, it extends equitable estoppel beyond its proper scope." *Id.* (*quoting Knorr,* 178 N.J. at 178). While finding the Appellate Division's decision in *EPIX Holdings* to compel arbitration to be appropriate "given the agency relationship between the parent and subsidiary insurance corporations in the litigation," the *Hirsch* Court rejected the panel's "reliance on a theory of intertwinement under the guise of equitable estoppel," holding that the Appellate Division was "mistaken in concluding that the intertwinement of claims and parties in the litigation -- in and of itself -- was sufficient to give a non-signatory corporation standing to compel arbitration." *Hirsch,* 2013 N.J. LEXIS 823 at *32. Instead, the focus should have been on "the agency relationship between the parent and subsidiary corporations in relation to their intertwinement with the plaintiff's claims and the relevant contractual language." *Id.*

Focusing on the fact that equitable estoppel does not apply "absent proof that a party detrimentally rel[ied] on another party's conduct," the *Hirsch* Court explained that "reliance is critical when a party seeks to compel arbitration using that doctrine." *Hirsch,* 2013 N.J. LEXIS 823 at **32-33. That is, reliance "underlies the rationale for applying equitable estoppel in the first place," which is to "'prevent a party's disavowal of previous conduct if such repudiation would not be responsive to the demands of justice and good conscience.'" *Id.* (*quoting Heuer,* 152 N.J. at 237).

Turning to whether the Appellate Division erred in ordering Plaintiffs to arbitrate their claims against AFS and EisnerAmper, the Supreme Court observed that many of their claims "implicate the right to a jury trial." *Hirsch,* 2013 N.J. LEXIS 823 at **33-34. The Court found this fact to be material "given the importance of ensuring that a party has actually waived its right to initiate a claim in court in favor of submitting to binding arbitration." *Id.* The arbitration provision contained in the contract between Plaintiffs and SAI "ma[de] no mention of other parties aside from Scudillo, who served as SAI's representative when executing [that] agreement...." *Id.* at *35. The Court concluded that there was no express contractual obligation on the part of Plaintiffs to arbitrate their claims against AFS and EisnerAmper, holding that "[t]hough the language in the arbitration clause is sufficiently broad to cover any and all disputes related to the business transaction between plaintiffs and SAI, it does not embrace any express inclusion of claims involving other parties." *Id.* The *Hirsch* Court also rejected SAI's argument that AFS and EisnerAmper had standing to compel Plaintiffs' claims to arbitration under an agency theory, finding that Scudillo signed the agreement containing the arbitration provision "as an agent of SAI, not as an agent of AFS or EisnerAmper." *Id.* Nor did SAI share any "corporate ownership with AFS or EisnerAmper," both of whom conceded before the trial court that they are "separate and distinct corporate entities." *Id.* While Plaintiffs' claims against SAI, AFS and EisnerAmper all arose out of the same alleged Ponzi scheme involving the sale of the Med Cap notes, and each of the parties had some type of relationship with each other, the Supreme Court concluded that the "intertwinement of claims and parties, by itself, is insufficient to warrant application of equitable estoppel." *Hirsch,* 2013 N.J. LEXIS 823 at *36. The Court also concluded that proof of detrimental reliance was lacking, finding that there was "no evidence in the record that AFS or EisnerAmper expected to arbitrate their disputes in detrimental reliance on plaintiffs' conduct." *Id.*

In this regard, there was "nothing in the record to suggest that AFS or EisnerAmper knew about the arbitration clause in Plaintiffs' agreement with SAI, let alone expected to reap the benefits that accompany arbitration, prior to SAI raising it as an issue in the Law Division." *Id.* Indeed, AFS and EisnerAmper's responsive pleadings "made no request for arbitration, nor did they even mention the existence of an arbitration clause." *Id.* Because "the record ... [did] not support that AFS or EisnerAmper detrimentally relied on Plaintiffs' conduct...," the Supreme Court held that "application of equitable estoppel was unwarranted." *Hirsch,* 2013 N.J. LEXIS 823 at *37. Since Plaintiffs "never sought to arbitrate their disputes with AFS or EisnerAmper," the Court concluded that "compelling them to do so would result in an injustice contrary to the doctrine's intent." *Id.*

D. Conclusion

In deciding *Hirsch,* the New Jersey Supreme Court emphasized the "equitable" component of the doctrine of equitable estoppel in limiting its application to situations where the non-signatory has relied to its detriment on the plaintiff's conduct, taking a markedly different approach from the one taken by the federal courts in cases such as *JLM Industries* and *Astra.* While not rejecting equitable estoppel entirely as a basis for compelling arbitration of claims against a non-signatory, the *Hirsch* decision makes it substantially more difficult for the non-signatory to establish equitable estoppel, particularly in the absence of an agency relationship between the non-signatory and a corporate affiliate that is a party to the arbitration agreement. The non-signatory cannot rely solely on the close connection between the parties and the claims, as intertwinement is insufficient in and of itself to serve as a basis for compelling arbitration. Instead, the non-signatory must show that it relied on the plaintiff's conduct and that it would be unjust to allow the plaintiff to avoid arbitration of the claims against the non-signatory. For such a detrimental reliance argument to succeed, the non-signatory must show that the plaintiff's conduct gave rise to a reasonable expectation by the non-signatory that it would "arbitrate [its] disputes" with the plaintiff rather than litigating them in court and therefore "reap the benefits that accompany arbitration ...." *Hirsch,* 2013 N.J. LEXIS 823 at *36. In our view, it will be difficult to establish a claim of detrimental reliance by the non-signatory, as a plaintiff does not ordinarily engage in the type of conduct that induces the non-signatory to believe that the plaintiff will arbitrate his claims against the non-signatory. Consequently, it is unlikely that the non-signatory will be able to show that that application of equitable estoppel is necessary to "prevent injustice by not permitting [the plaintiff] to repudiate a course of action on which [the non-signatory] has relied to his detriment." *Id.* at *10. Thus, equitable estoppel is likely to be of relatively little utility to a non-signatory in seeking to compel arbitration of the plaintiff's claims under New Jersey law. ■

For more information about any of the topics covered in this issue of the Securities Law Alert, please contact:

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