

Third Circuit Limits Construction Arbitration Rights

By Henry J. Donner, Esq.

In an Opinion written by Chief Judge Aldisert, the Court of Appeals for the Third Circuit recently rendered a noteworthy decision that may in certain situations limit the right of subcontractors to demand arbitration of their disputes with general contractors under their subcontracts. In that case - *John F. Harkins Company Inc. v. The Waldinger Corporation*, 796 F.2d 657 (3d. Cir. 1986), - the court relied on federal common law to affirm the decision of the United States District Court for the District of New Jersey that an "incorporation-by-reference" provision in the subcontract incorporated the narrow arbitration provision in the principal contract between the general contractor and Project Manager, and that the incorporated "narrow provision" limited and superceded the broad arbitration clause in the subcontract.

As the prime mechanical contractor for construction of the Atlantic City Hilton Casino/Hotel, John F. Harkins Company, Inc. was responsible for the installation of heating, ventilation and air conditioning systems. Harkins entered into a subcontract with Waldinger Corporation to perform the sheet metal duct work portion of its contract.

The Harkins/Waldinger subcontract contained a broad mandatory arbitration provision that covered "all disputes, claims or questions." However, the Harkins/Waldinger subcontract also contained an incorporation clause which provided that the subcontractor "shall be bound by all ... applicable provisions of the principal contract to which the contractor is bound, and to the same extent." In contrast with the subcontract, the principal contract between Harkins and the construction manager Tishman contained a narrow arbitration provision that covered only disputes concerning the amount to be paid on written change orders.

After Waldinger and Harkins became embroiled in a dispute on the job, Waldinger invoked the mandatory arbitration clause in the subcontract and commenced an arbitration proceeding before the American Arbitration Association. Waldinger claimed that Harkins had "changed the conditions, sequence and schedule under which (Waldinger's) work was to be performed" resulting in excess cost to Waldinger and requested an award of \$6 Million. In response, Harkins instituted suit in a New Jersey state court seeking to enjoin the arbitration alleging that under the narrow arbitration clause in the principal contract, the dispute was not subject to arbitration. Waldinger removed the state court action to federal court and sought a stay of the district court proceedings pending arbitration.

The district court held that the more narrow arbitration provision of the prime contract controlled and that the dispute was not subject to arbitration. For that reason, it denied Waldinger's motion for a stay of the district court proceedings and granted Harkins' motion to stay the arbitration. Waldinger appealed.

In the opinion of the Third Circuit, there was sufficient evidence before the District Court to establish that Waldinger and Harkins intended to be bound by the arbitration clause of the principal contract between Harkins and Tishman. The majority reached this conclusion despite the express language of the subcontract arbitration clause and the federal policy favoring arbitration articulated by the Supreme Court in *Moses H. Cone v. Mercury Construction Co.*, 460 U.S.1 (1983). Accordingly, the Third Circuit affirmed the decision of the district court. Judge Garth vigorously dissented.

The majority based its decision on three pieces of evidence: (1) the phrase, "and to the same extent" in the incorporation clause of the subcontract; (2) a seemingly innocuous amendment to the incorporation clause prepared by Waldinger; and (3) an un rebutted affidavit offered into evidence by the president of Harkins that went to the intent of the parties. According to the majority, because the incorporation clause stated that the subcontractor was bound by all applicable provisions of the principal contract to which the contractor was bound, *and to the same extent*, the clause could have been intended to limit Waldinger's arbitration rights, and the district court did not err in so finding. Applying the logic of the majority, Waldinger was limited in its remedies against Harkins to the same extent as Harkins was limited in disputes with Tishman. Accordingly Waldinger's arbitration rights in the subcontract were no greater than those of Harkins in the principal contract.

Given the widespread use of form contracts in the construction industry, this decision could pose a trap for the unwary subcontractor because the "to the same extent" language often appears in the incorporation clause of subcontract forms. The language in these clauses often varies. In some cases, the clause may be expressly limited to apply only to the scope, nature and character of the work. However - as in *John F. Harkins* - this is not always the case. Accordingly, if the "to the same extent" language appears in the incorporation clause and there is no such limitation there is a danger that *John F. Harkins* could apply. In that event, to the extent the arbitration clause of the subcontract confers rights not conferred in the principal contract, it may be unenforceable, and a subcontractor who relies on the arbitration rights set forth in the arbitration clause of its subcontract could be frustrated when it attempts to exercise those rights in order to expedite resolution of a dispute and to receive payment.

The right to arbitrate is often of key importance to a subcontractor in disputes with the prime contractor where payment to the subcontractor is withheld. When that occurs, it may be crucial to the subcontractor to resolve the dispute as quickly as possible in order to compel payment. Arbitration of

the dispute is often the fastest way to reach such a resolution. Moreover, arbitration may provide other advantages such as streamlined discovery and informal procedure at the hearing. In contrast, litigation could prove to be substantially more costly and time consuming. Accordingly, subcontractors should be aware of the potential ramifications of the Third Circuit's decision in *John F. Harkins*. Where the incorporation clause of the subcontract provides that the subcontractor "shall be bound by all ... applicable provisions of the principal contract to which the contractor is bound, and to the same extent ...," it may be interpreted to limit the rights of the subcontractor including the right to demand arbitration.