Contracts Tea no. 5 (July 2011)

South Carolina

Here again we speak of arbitration. Employers beware about protecting arbitration provisions contained in employment application.

It seems that arbitration issues are a hot topic recently. Just some months after the U.S. Supreme Court decision *AT&T Mobility v. Concepcion*[1], that had closely followed another U.S. Supreme Court decision on arbitration, *Rent-A-Center, West, Inc. v. Jackson*,[2] the S.C. Court of Appeals decides an arbitration issue in *Davis v. KB Home of South Carolina*, Inc.,[3] a wrongful termination case.

These are the facts: Mr. Lonnie J. Davis ("Davis") applied for employment with KB Home South Carolina, Inc. ("*KB Home*") on January 12, 2006. Davis's employment application contained an arbitration clause, stating, in the relevant part, as follows:

> I understand and agree that if employed, I will be required to arbitrate any disputes arising out of or related to my employment with or termination from the Company, including any claims for discrimination, harassment, retaliation and/or wrongful termination. I understand that only an arbitrator, not a judge or a jury, will hear such disputes.

On March 13, 2006, Davis was offered a position as the Vice President of Finance with KB Home. The employment agreement contained a merger clause.[4]

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[1] 563 U.S. __ (2011) issued April 27, 2011. We commented it on Contracts Tea no. 3. July 13, 2011.

[2] 561 U. S. _____ (2010).

[3] *Davis v. KB Homes of S.C., Inc.,* No. 4851, issued on July 13, 2011, available at http://www.sccourts.org/opinions/displayOpinion.cfm?caseNo=4851

[4] The merger clause provided:

KB Home terminated Davis on July 20, 2007 and Davis brought a lawsuit against KB Home on March 3, 2008, on -- among others -- breach of contract. After the parties had engaged in extensive discovery and filed several motions, in September 2009 (eighteen months after the action had been brought), KB Home filed a motion to compel arbitration and to stay the proceeding.

The trial court denied the motion holding that the merger clause of the employment agreement had the effect to supersede the arbitration clause contained in the application letter.

The Court of Appeals affirmed.

The Court of Appeals dealt with three important issues: (i) whether it was proper for a court to decide on the validity of the arbitration clause; (ii) whether the arbitration clause was superseded by the merger clause (iii) whether KB Home waived their right to enforce the arbitration clause by engaging in litigation for an eighteen-month period prior to filing a motion to compel arbitration.

(i) On the issue of whether it was proper for the circuit court, as opposed to an arbitrator, to address the threshold validity of the arbitration clause contained in the employment application, the Court of Appeals reminds that (1) "[a]rbitration is a matter of contract, and a party cannot be required to submit to arbitration any dispute which he has not agreed to submit" (*Zabinski v. Bright Acres Assocs.,* 553 S.E.2d 110, 118 (2001)) and that (2) "[a]rbitration clauses are severable from the contracts in which they are embedded" (S.C. Pub. Serv. Auth. v. Great W. Coal, 437 S.E.2d 22, 24 (1993). The court refused –

> Entire Agreement: This letter together with the documents referenced herein contain all of the agreements and understandings regarding your employment and the obligations of KB Home in connection with employment. … This letter supersedes any and all prior agreements and understandings between you and KB Home and alone expresses the agreement of the parties. This letter containing all of the agreements and understandings regarding your employment can only be amended in writing by the Senior Vice President, Human Resources of KB Home.

because wrong in fact - KB Home's argument that the case should be decided applying the holding of *Buckeye Check Cashing v. Cardegna,* 546 U.S. 440, 445-46 (2006)[5] based on the fact that Davis's challenge was to the entire agreement and not just the arbitration provision. According to the court, Davis challenged -- not the entire agreement but -- the arbitration clause contained in his employment application as superseded by the merger clause contained in the employment agreement. In addition, the arbitration clause here did not say that arbitrator had competence on any issues relating to the validity, existence, and scope of the arbitration agreement.

For these reasons, the court held that "the determination regarding whether a valid arbitration agreement existed was a "gateway matter" that the circuit court properly considers without delegating to the arbitrator.

(ii) On the issue of whether the arbitration clause was superseded by the merger clause, the Court of Appeals found that the trial court did not err in concluding that it was. The Court of Appeals reminded some South Carolina's precedents on merger clauses, among which *Wilson v. Landstrom*, 315 S.E.2d 130 (Ct. App. 1984) (holding that "the terms of a completely integrated agreement cannot be varied or contradicted by parol evidence of prior or contemporaneous agreements not included in the writing", id. at 134) and *U.S. Leasing Corp* v. *Janicare,* Inc., 364 S.E.2d 202 (Ct. App. 1988) (holding that "when the writing on its face appears to express the whole agreement, parol evidence cannot be admitted to add another term to the agreement, even when the writing is silent as to the particular term sought to be established", id. at 205). The Court of Appeals concluded that here:

> [T]he merger clause was clear and unambiguous on its face. In addition, the employment application at issue was executed two months prior to the employment agreement. Therefore, the arbitration clause in the application is not

[5] Holding that when a party challenges the contract as a whole as opposed to specifically challenging the arbitration provision, the contract's validity is considered by the arbitrator in the first instance.

admissible to modify or add to the terms of the subsequent employment agreement containing a merger clause.[6] . . . Accordingly, there was no arbitration clause to enforce, and the circuit court properly denied the motion to compel arbitration."

(iii) On the issue of KB Home's waiver of their right to enforce the arbitration clause, while noticing that "the right to enforce an arbitration clause may be waived" (*Liberty Builders, Inc. v. Horton*, 521 S.E.2d 749, 753 (Ct. App. 1999), the Court of Appeals reminds that in South Carolina three factors must be considered to that purpose "(1) whether a substantial length of time transpired between the commencement of the action and the commencement of the motion to compel arbitration; (2) whether the party requesting arbitration engaged in extensive discovery before moving to compel arbitration; and (3) whether the non-moving party was prejudiced by the delay in seeking arbitration" (*Rhodes v. Benson Chrysler-Plymouth, Inc.,* 647 S.E.2d 249, 251 (Ct. App. 2007). Here, according to the court, "a substantial length of time has passed, the parties have engaged in extensive discovery, and the parties have availed themselves of the circuit court's assistance on several occasions".

For these reasons, the Court of Appeals affirmed also the lower court's finding that KB Home's waiver of right to compel arbitration is an alternative basis to deny the motion to compel.

Two lessons can be drawn from this case. First, if you want to insist on an arbitration provision, do it promptly. Second, employers can avoid the loss of an arbitration provision by either including it in the employment agreement or by incorporating in the employment agreement the terms of the application for employment.

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[6] The Court of Appeals refused to follow a California case (Ramirez-Baker v. Beazer Homes, Inc., 636 F.Supp.2d 1008 (E.D. Cal. 2008)) cited by KB Home for the proposition that employment applications and subsequent employment agreements would be an exception to the parol evidence rule because t is not the law in South Carolina.

International

Chinese Supreme Court important decision on the transfer of investment in China.

Our assistant editor for China has just reported that on December 31, 2010, the Supreme People's Court of People's Republic of China (Zuìgāo Rénmín Fǎyuàn) (i.e. the Chinese Supreme Court) has publicized a decision issued on December 30, 2009. The issue at stake was the consequence of an assignment of a contract of Sino-foreign cooperative ("Zhong Wai He Zuo Jing Ying Qi Ye") that has not been authorized by the relevant authority. The Court held that, notwithstanding the lack of authorization, the assignment was valid nevertheless. The decision is also important for the focus that it takes on the principle of good faith. This principle is embedded in the Chinese Contract law 1999 that, in Article 6 provides: "The parties shall abide by the principle of good faith in exercising their rights and performing their obligations."

But first of all, let's clarify what we are talking about. If a foreign company wants to make business within the territory of China associating with a Chinese partner, it has two choices: (i) Sino-Foreign Cooperative and (ii) Sino-Foreign Equity Joint Venture. In both types of companies, while usually the Chinese partner provides labor, land use rights and factory buildings, the foreign company brings in the necessary technology and key equipment, as well as the investment capital. While the two types of arrangements have in common the purpose, they differ in some respects. While a Sino-Foreign Equity Joint Venture is always a legal person (i.e. a limited liability company), a Sino-Foreign Cooperative can be a legal as well as a non-legal person. Besides, the Sino-Foreign Equity Joint Venture has more restrictions than the Sino-Foreign Cooperative, e.g. on the foreign investment capital percentage – that must be no less than 25% -- and on the form of sharing profits, risks and losses – that must be based on the shareholders' contributions to the registered capital. The Sino-Foreign Cooperative has less restrictions: the parties regulate (actually *must* regulate) in their joint venture contract such matters

as investment or conditions for cooperation, distribution of profits, apportionment of risks and losses, governance, ownership of assets on termination of the contractual joint venture.[7] If their joint venture meets the conditions for being considered an entity under Chinese law, it acquires the status of a Chinese legal person. The name "Sino-Foreign Cooperative" derives from the fact that in this company a party, besides contributing registered capital, may provide for cooperative conditions such as market access rights.

The decision on which we are commenting involved a Sino-Foreign Cooperative and not a Sino-Foreign Equity Joint Venture. In the case at hand, a party -- after the establishment of the joint venture -- had transferred its contractual rights and obligations deriving from the Sino-foreign cooperative enterprise contract but had not applied for the transfer authorization to the relevant public authority. According to the law, without the authorization, while the assignment was not void, it was not effective.

In this decision of December 30, 2009, the Chinese Supreme Court held that even if the transfer of the contract was unauthorized, the parties were bound by the assignment contract and the latter was valid and effective. If it had not been so, a party could maliciously prevent the enforcement of the contract by not applying or by not

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[7] Article 2, first paragraph of Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures, adopted at the First Session of the Seventh National People's Congress and promulgated by Order No.4 of the President of the People's Republic of China on April 13, 1988 and modified by Ninth Session of the Eighteenth Standing Committee of the National People's Congress promulgated by Order No.40 of the President of the People's Republic of China on November 31, 2000:

> In establishing a contractual joint venture, the Chinese and foreign parties shall, in accordance with the provisions of this Law, prescribe in their contractual joint venture contract such matters as the investment or conditions for cooperation, the distribution of earnings or products, the sharing of risks and losses, the manners of operation and management and the ownership of the property at the time of the termination of the contractual joint venture.

assisting in the application for the public authorization. This consequence would be contrary to the principle of good faith.

Applying Article 8 of the Interpretation On the Application of Contract Law II (issued by the Supreme People's Court itself), the Court held that a court has the power to decide that the transferring party should have applied for authorization. Should this party omit to apply, it shall pay the cost incurred by the non-breaching party, and the non-breaching party's loss and damages. A court has also the power to impose the breaching party to request the authorization.

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