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North Carolina Court of Appeals Declines to Enforce Arbitration Clause in Construction Contract

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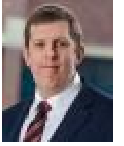
May 24, 2016



Introduction

An arbitration clause in a contract can affect the method parties will use to resolve disputes, what remedies are available to them, and, most importantly, where they will arbitrate and what state's laws will apply. A recent opinion from the North Carolina Court of Appeals, TMCS, Inc. d/b/a/ TM Construction, Inc. v. Marco Contractors, Inc., ("TM Construction"), calls into question the enforceability of arbitration clauses in certain situations.

What is Arbitration?

Arbitration is a form of dispute resolution that involves an agreement between the parties to submit their dispute to an arbitrator or arbitrators in lieu of litigating in the court system. Arbitration resulted from the perception that litigating in court with a judge and jury is overly expensive, complicated, and time consuming. The undergirding principle of arbitration is that the parties can fashion a flexible private procedure applicable to their dispute that is no more time consuming or costly than they desire.

Arbitration, although once highly favored as an alternative to court-based litigation, is now recognized by many as not substantially different in terms of cost and time from formal litigation in court. The basic principles of dispute resolution applicable to litigating in court and litigating through arbitration are substantially similar. However, arbitration differs from litigation in these significant respects:

- There are generally no appeals. Thus, the arbitrator's decision is typically final and unchallengeable.
- Most of the procedures used are guided by the parties' agreement rather than by the inflexible and rigid rules used in court-based litigation.

However, these benefits are balanced out by the fact that many of the major costs of court-based litigation – such as the cost of the judge, jury, court reporter, etc. – are borne by the government. In arbitration, the parties must bear all of the costs.

Background: The TM Construction Case

TM Construction arose from a construction project to renovate a Wal-Mart retail store in North Carolina (the "Project"). The general contractor (the "GC") was from Pennsylvania. The GC, as is typical in such construction projects, hired several local subcontractors. One local subcontractor (the "Subcontractor") was

retained to perform certain carpentry and painting work. The Subcontractor provided a quote to perform the work, and the GC accepted the quote. Since time was critical on the Project, the Subcontractor began furnishing materials to the Project even though there was no written contract between the parties.

After the Subcontractor commenced its work, the GC presented the Subcontractor a written contract using the GC's standard form agreement. But, because the proposed contract contained terms different than those the GC had orally agreed to, the Subcontractor balked at signing it. The parties then discussed changes to the terms to make the proposed written contract conform to their oral agreement. While one version of the proposed written contract was ultimately signed by both the GC and the Subcontractor, it was signed with the understanding that further revisions would be made to it before it was to be considered final.

The proposed written contract contained an arbitration provision which included:

- A forum selection clause (often referred to in arbitration situations as a "venue selection clause"), required that any litigation or dispute resolution to address issues arising between the parties be conducted in Pennsylvania at the option of the GC; and,
- A 30-day time limit for submitting a demand for arbitration.

The costs and expenses to the subcontractor (not to mention inconvenience) would obviously increase dramatically if the venue selection clause in the proposed written contract was enforceable.

As frequently occurs on construction projects of this type, the Subcontractor performed additional work above and beyond that contemplated by the parties when the quote was first accepted by the GC. This additional or "change order" work was performed at the request and direction of the GC. The Subcontractor completed all of its work on the Project, including the additional or change order work.

Not surprisingly and, again, as is common on construction projects of this type, a dispute arose between the GC and the Subcontractor over the amount of additional compensation the Subcontractor was due for the additional work performed. The parties disagreed over the pricing for this additional work with the GC arguing that the pricing for the additional work was governed by the terms of the written contract and the Subcontractor arguing that the written contract did not apply, particularly in regard to the extra or additional work.

The Subcontractor sued the GC in the North Carolina county where the Project was located. The GC filed an Answer and the parties engaged in court-ordered mediation which was unsuccessful. The parties then engaged in a "protracted battle over discovery issues." When the subcontractor pressed its advantage on the discovery issues, the GC responded by seeking to have the case transferred to arbitration to be held in Pennsylvania consistent with the written contract that the GC contended was the enforceable agreement between the parties.

The Subcontractor countered that the written contract was not the actual agreement between the parties, was not enforceable, and that, even if the written contract and its arbitration clause were enforceable, the GC had failed to request arbitration within the 30-day time limit as required by the arbitration clause.

The trial court agreed with the Subcontractor and denied the GC's motion to move the case from litigation in North Carolina to arbitration in Pennsylvania. The trial court ruled that the GC had not timely demanded arbitration – regardless of whether the written contract was enforceable. The GC appealed the trial court's ruling to the North Carolina Court of Appeals.

The Ruling on Appeal

The Court of Appeals affirmed the trial court's ruling that the GC had failed to timely demand arbitration within the 30-day period required by the written contract. Thus, regardless of whether the written contract was deemed to be the operable agreement between the parties, the GC was not entitled to send the case into arbitration because, under any reasonable measure, it had failed to comply with the requirements of the written contract. By so concluding, the Court of Appeals avoided the need to determine whether the written contract applied. The practical effect was that the case remained in court in North Carolina and was not transferred to arbitration in Pennsylvania.

Importance

Why did the GC pursue the arbitration clause so vigorously? Why did the subcontractor resist it just as vigorously? Why is the Court of Appeals ruling significant? The choice of arbitration over litigation in court was not of importance to the parties. What was important was that the arbitration clause contained a venue requirement that the parties arbitrate in Pennsylvania.

Many arbitration clauses contain a requirement that the arbitration be conducted out-of-state; often in a location that is distant and inconvenient for the party that did not draft the clause. If required to arbitrate or litigate in a distant location, the local party will incur increased costs and expenditures of their own time. They will also likely have to retain counsel in the distant location who may be unfamiliar with them and their business or internal policies and procedures, thereby frequently requiring additional legal fees. In addition, there may be specific procedural rules in the distant location that are unfavorable to the local party. By agreeing to another party's venue selection clause, a party typically gives the other party a serious home court advantage, which can be used as a hammer in pre-arbitration negotiations.

Applicable Laws

While the court in TM Construction did not find it necessary to address them, North Carolina has two statutes that apply to forum and venue selection (often referred to as "forum selection") clauses. One, N.C. Gen. Stat. § 22B-2, applies to all contracts entered into in North Carolina for the improvement of real property, and voids any provision that attempts to require the parties to arbitrate or litigate in another state. A second statute, N.C. Gen. Stat. § 22B-3, applies to all contracts entered into in North Carolina regardless of whether they are for the improvement of real property and similarly voids any provision that requires the parties to arbitrate or litigate in another state. Those statutes, if applied to the facts in TM Construction, would have prohibited the GC from doing what it was attempting to do: force the subcontractor to arbitrate in Pennsylvania where the GC would have home court advantage.

However, the application of the North Carolina statutes is limited by the Federal Arbitration Act, which is generally considered to preempt and render unenforceable venue selection or choice of law (governing which state's law will be used regardless of where the litigation or arbitration is conducted) clauses. By including a venue requirement in an arbitration clause, an out-of-state party can force arbitration regarding a North Carolina construction project to occur in another state. This is typically why parties have arbitration clauses; i.e., not so much because they prefer arbitration, but because it allows them to enforce an out-of-state venue requirement notwithstanding the North Carolina statutes prohibiting such clauses. This is particularly common in construction contracts.

The Court of Appeals in TM Construction, did not rely upon the North Carolina statutes to find that the matter need not be arbitrated in Pennsylvania, but instead held that the GC had not timely invoked arbitration and therefore the North Carolina-based subcontractor did not have to give up its home court advantage. In addition, the Court of Appeals implied, but did not explicitly hold, that the Federal Arbitration Act does not necessarily preempt state statutes that attempt to govern only the procedure for arbitration. Rather, the

Court of Appeals suggested that the two North Carolina statutes described above could result in preventing a case from being transferred to another state or from having it subjected to another state's law even if the Federal Arbitration Act required the dispute to be arbitrated and even if the choice of law and venue selection requirements were part of, or combined with, an arbitration clause. To the extent that the TM Construction decision may serve as a guide to how the Court of Appeals might rule on the issue when presented in the future, it suggests even more protection for local subcontractors that contract with out-of-state general contractors on construction protects located in North Carolina.

TM Construction provides protection to North Carolina parties that enter into contracts containing arbitration and venue selection clauses. It evidences that North Carolina courts will strain to insure that all requirements have been met before they will enforce such clauses. Any deviation from, or defect in, that procedure will likely cause the courts to decline to enforce an arbitration clause. Further, even if the arbitration clause is enforced, the courts may decline to enforce any venue selection or choice of law requirements tacked onto the clause. This would go far in protecting local subcontractors against overreaching by typically large, out-of-state general contractors.

Conclusion

Before entering into any contract, a party should carefully review the provisions and make sure each and every one is understood. An arbitration clause buried in a contract with more significant monetary and performance clauses can have serious implications beyond just the format of the dispute resolution method the parties will use. While the TM Construction case provides some protection to local parties litigating with out-of-state parties in the face of an arbitration clause that includes a venue selection requirement, careful reading and negotiation of such terms should be the first line of defense.

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