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Lessons On Arbitration Carveouts From Diddy-Diageo Suit

Combs Wines and Spirits LLC, a company owned by Sean “Diddy” Combs, has a long-standing business relationship with Diageo North America Inc. by which Diageo distributes Ciroc Vodka and DeLeon Tequila.

In May, Combs filed a complaint against Diageo in New York Supreme Court alleging that Diageo had failed to comply with its contractual obligation to treat the DeLeon brand equally to its other tequila brands due to racial animus.[1]

The complaint seeks an injunction requiring Diageo to comply with the agreement’s equal treatment provision requiring that Diageo treat the Diageo-Combs DeLeon tequila joint venture brand equal to the way Diageo treats its competing tequila brands.

In response to the complaint, Diageo filed a motion to compel arbitration. On Sept. 7, the court denied Diageo’s motion[2] and on Oct. 4, the court denied Diageo’s motion for leave to reargue.[3]

The specific arbitration provision at issue is as follows:

Section 13.06. Dispute Resolution.

(a) To the fullest extent permitted by the Delaware Act and other applicable law, except for claims for equitable relief in accordance with Section 13.06(c), any controversy, claim or dispute arising out of or relating to this Agreement or any breach hereof, whether at law or in equity, in contract or in tort, will be resolved exclusively by arbitration. The arbitration will be conducted in accordance with the Rules of Arbitration of the ICC in effect at the time of the arbitration, except as they may be modified by unanimous agreement of the parties to such arbitration … Nothing in this Section 13.06(a) will be construed as preventing the Company or any Member from seeking conservatory, injunctive or similar relief (but in any event, not damages) in any court of competent jurisdiction in order to enforce Article IX and/or Section 13.14. ...

(c) Notwithstanding anything in this Agreement to the contrary, the Members agree that irreparable damage would occur if any provision of this Agreement were not performed in accordance with the terms hereof and that the Members will be entitled to equitable relief, including injunctive relief or

specific performance of the terms hereof, in addition to any other remedy to which they are entitled at law or in equity.

In denying Diageo's motion to compel arbitration, New York Supreme Court Justice Joel M. Cohen determined that the arbitration provision provided that equitable claims, such as the one brought by Combs for injunctive relief, were carved out of the parties' agreement to arbitrate and he denied the motion to compel arbitration.

Diageo has appealed the decision, arguing that because of the broad agreement to arbitrate — i.e., "any controversy, claim or dispute arising out of or relating to this Agreement or any Rosanne Felicello breach hereof, whether at law or in equity, in contract or in tort, will be resolved exclusively by arbitration" — the carveout should be read narrowly and that because Combs seeks to recover damages in a related arbitration, its claim does not fit within the carveout. Diageo also requested an injunction pausing the litigation while the appeal is pending, and that request was denied by the First Department on Oct. 11.

It's true that in the usual case, when an agreement contains an arbitration clause, any disputes related to that agreement must be resolved through arbitration. And the arbitrator, not a court, is the one to determine the arbitrability of the dispute. But, as is true with most legal maxims, there are exceptions.

In the Combs-Diageo dispute, the agreement to arbitrate contains an ambiguity that suggests that the parties chose to litigate some claims, such as those for damages, and arbitrate others, such as those seeking injunctive relief.

This situation has led to the possibility — unless the appellate court overrules Judge Cohen — that the parties will be required by their own agreement to carry on two separate litigations in two separate forums and the very real possibility of two disparate resolutions of closely related matters.[4]

While the Combs-Diageo matter is currently before the New York Supreme Court Appellate Division, First Department for resolution, even before it is decided, it offers a warning about careful drafting. Most arbitration agreements include a carveout for injunctive relief, which can only be obtained in court.

In the Combs case, this carveout is very broad — claiming that "irreparable damage would occur if any provision of this Agreement were not performed in accordance with the terms hereof."

Read literally, any breach of the agreement could be stated as an invitation to assert a claim for injunctive relief in court, rather than, or in addition to, damages in arbitration. This is likely not the result that most clients are

looking for when they decide to include an arbitration provision in their agreements.

The Combs-Diageo dispute is a good reminder to counsel that it is important to understand your client's goals with each business arrangement and to carefully draft each agreement to meet those goals, i.e. no cookie-cutter drafting.

Instead of including catchall provisions providing for injunctive relief for any breach of the agreement, any carveout for injunctive relief provided in an agreement containing an arbitration provision should be narrowly tailored to only apply in specific scenarios. For instance, the client may want to be able to obtain an injunction if the opposing party violates a confidentiality provision because damages in that case will not be sufficient to remedy the harm.

But for most contract breaches, such as failing to make payment or failing to perform the services contracted for, damages will usually be sufficient to make the client whole. Any injunctive relief obtained in those scenarios is not likely to provide the client with what it really wants — i.e., damages.

At the same time, it opens the client up to the risk of fighting two battles in two separate battlegrounds, with the potential of disparate results — i.e., an injunction preventing the continued breach but no damages or vice-versa.

To avoid the scary scenario of being forced to proceed both in court and in arbitration for related disputes, be sure to narrowly tailor any carveouts for injunctive relief contained in your client's arbitration provisions.

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[4] Another exception to the arbitrator deciding who is required to arbitrate occurs when there are non-parties to the agreement who are parties to the dispute. When a person who did not sign the agreement is a party to the dispute, a court can compel the non-signing person (called a nonsignatory) to participate in arbitration even if that party objects. There are five traditional theories that courts use to compel nonsignatories to participate in arbitration:

1. Incorporation by reference;
2. Assumption;
3. Agency;
4. Veil piercing/”alter ego”; and
5. Estoppel.

Nonsignatories who fit within any one of these five theories are routinely compelled by courts to participate in arbitration of disputes even where they did not directly agree to arbitrate. The question of whether the dispute itself is arbitrable is left for the arbitrator to decide. It is important that parties to an arbitration agreement—and those nonsignatories who assume the rights under an arbitration agreement, are agents of parties to an arbitration agreement, are deemed to be an “alter ego” of a party to an arbitration provision, or benefit from an agreement containing an arbitration clause—are mindful of the language of the arbitration agreement to avoid the scary scenario of being forced to proceed both in court and in arbitration for related disputes.