2nd Circ. Ruling Is A Cautionary Tale On Arbitration Motions

By **Raphael Janove** (January 17, 2023)

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In May 2022, the U.S. Supreme Court in Morgan v. Sundance Inc.[1] made clear that there is no freestanding federal policy favoring arbitration, saying:

> The federal policy is about treating arbitration contracts like all others, not about fostering arbitration.[2]

The U.S. Court of Appeals for the Second Circuit may have missed the message. In the Sept. 14, 2022, Zachman v. Hudson Valley Federal Credit Union decision,[3] the appeals court reversed the U.S. District Court for the Southern District of New York's denial of a motion to compel arbitration and effectively created a new pro-arbitration rule.

In essence, Zachman now requires district courts — if they are inclined to deny a motion to compel arbitration — to give defendants a second chance. They can provide new evidence to avoid a potential denial of the motion.

No court has yet interpreted or applied Zachman's new rule. To limit the fallout of this pro-arbitration decision — and to avoid giving out further Zachman-style second chances — I recommend that, before defendants file their initial motion to compel arbitration, litigants get confirmation that defendants are supporting their motion with all evidence they might possess or control that could support arbitration.

That way, courts can decide the motion on a full record and determine arbitrability as a matter of law, or whether a trial on the issue is warranted.

It is better to find out what defendants have the first time around, instead of finding out after several months — if not years — of delays and appeals, that defendants had other evidence that could shore up a deficient motion to compel arbitration. If defendants want to compel arbitration, they should put their best motion forward, instead of waiting for second chances.

Background on Zachman

In Zachman, the district court denied defendant HVCU's motion to compel arbitration. HVCU failed to carry its burden of demonstrating "that plaintiff was on inquiry notice of the mandatory arbitration and class action waiver provisions."[4]

In its moving papers, HVCU did not provide a copy of the website layout that was presented to plaintiff when registering for defendant's services. It merely asserted that the arbitration clause was presented "in a clear and conspicuous way"[5] within the contract itself.

But HVCU needed to procure evidence more than the conspicuous terms within the contract: it needed to demonstrate plaintiff had inquiry notice that it was agreeing to the contract in the first place.

But, having failed to submit a copy of the relevant web page, HVCU could not demonstrate "that the design and content of the registration interface provided plaintiff reasonable notice

of the mandatory arbitration provision."[6]

Because the defendant did not submit this evidence, "the Court [was] unable to assess whether the relevant language and hyperlink are clear and conspicuous or obscured by advertisements, colors, links, or other information."[7]

On appeal, the Second Circuit "agree[d] with the district court that granting HVCU's motion to compel arbitration was not warranted in light of this evidentiary gap in the record."[8]

HVCU "did not submit evidence of how the [agreement containing the arbitration clause] was presented to users."[9]

That should have ended the inquiry — the defendant moved to compel arbitration but failed to support that motion with evidence. Nonetheless, the Second Circuit contended that the district court's denial of HVCU's motion was premature because the "record in this case [was] insufficiently developed." Therefore, the Second Circuit remanded for further proceedings, concluding that "the district court should have required further evidence or proceeded to trial on that issue."[10]

The New Second-Chance Motions to Compel Arbitration Rule

It is hard to fault the district court here: It assessed the evidence defendant submitted, and found it wanting. Since HVCU carried the burden on its motion to compel arbitration, it was the party at fault for "insufficiently develop[ing] the record."

The Second Circuit, however, decided that defendants should routinely get a second chance. Now, before denying a motion to compel arbitration, courts need to double check with defendants and ask, "Are you sure there isn't any other evidence that might support your motion?"

Tellingly, the Second Circuit did not have much support for its new give-defendants-a-second-chance rule. The court asserted that "we have remanded cases for trial on the issue of contract formation where the record was insufficiently developed."[11]

However, all it could muster in support were two decades-old cases from 1981 and 1974. Moreover, Zachman's characterizations of these dated precedents are questionable.

In both the 1981 Interbras Cayman Co. v. Orient Victory Shipping Co. S.A. decision[12] and the 1972 Interocean Shipping Co. v. National Shipping & Trading Corp. decision[13] the Second Circuit reversed the grant of a motion to dismiss because the party opposing arbitration showed a genuine dispute of material fact.

In those two cases — and much like normal summary judgment practice, from which come the standards by which courts decide motions to compel arbitration — the party seeking to compel arbitration produced its evidence.

The party opposing the motion produced its counter evidence. And then the Second Circuit decided there was a genuine issue of material fact as to whether the litigants were parties to the arbitration agreements. As a result, Interbras and Interocean held that the district courts erred in compelling arbitration.[14]

In sum, these old precedents stand for the uncontroversial proposition that if a party opposing a motion to compel arbitration creates a genuine dispute of material fact, further

proceedings on arbitration might be warranted.

These old cases did not say that the defendants should get a second chance to supplement the record when, in the first instance, they fail to support their motion with key evidence. Yet, the Second Circuit in Zachman derived a new rule that requires just that.

How to Avoid Zachman

I posit that Zachman is on shaky legal grounding. Its second-chance rule for defendants seeking to compel arbitration does not gel well with the Supreme Court's recent clarification in Morgan v. Sundance that there is no federal policy that puts its thumb on the scale in favor of arbitration.

If defendants have evidence that supports their motions to compel arbitration, they should put it forward first instead of years later, getting a do-over on their motion.

All the same, the Second Circuit seems inclined to give defendants special treatment when they move to compel arbitration. Accordingly, going forward, courts and practitioners should ensure that when a party moves to compel arbitration, it has fully produced any or all evidence it might have used to support that motion.

Courts can make this directive crystal clear in any scheduling or discovery order. When a defendant moves to compel arbitration, it should put forth any evidence it has to support arbitration. If the defendant identifies a category of yet-to-be produced evidence that might help its motion, it should have to explain why it is moving now without the benefit of such evidence.

To avoid such a delay and eliminate the risk of reversal by the Second Circuit, plaintiffs counsel, in opposing to motions to compel arbitration the first time around, need to make certain first that defendants do not have any other evidence they might want to use to force the case into arbitration. Attorneys can insist that a defendant, in writing, confirm that it has no other evidence before moving to compel arbitration. That way, a court can rule on a complete record without risking reversal.

Doing so allows plaintiffs attorneys to head off a defendant's attempts to find another reason to delay litigation simply by attempting to compel arbitration.

To illustrate, in Zachman, on July 1, 2020, HVCU moved to compel arbitration. On March 22, 2021, the district court denied the motion. After the Second Circuit reversed on Sept. 14, 2022, the district court scheduled additional discovery and a summary bench trial on March 6, 2023 — nearly three years after HVCU initially tried to kick the lawsuit to arbitration.

In sum, until the Second Circuit heeds Morgan v. Sundance's admonition that there is no federal policy that favors arbitration, plaintiffs will just have to take prophylactic measures to avoid the outcome in Zachman.

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[1] Morgan v. Sundance, Inc., 142 S. Ct. 1708, 1713 (2022).

[2] Id. at 1713.

[3] Zachman v. Hudson Valley Federal Credit Union, 49 F.4th 95 (2d Cir. 2022).

[4] Zachman v. Hudson Valley Fed. Credit Union, 2021 WL 1092508, at *6 (S.D.N.Y. Mar. 22, 2021),vacated and remanded,49 F.4th 95 (2d Cir. 2022).

[5] Id. at *7.

[6] Id.

[7] Id.

[8] 49 F.4th at 103.

[9] Id.

[10] Id. at 104–05.

[11] Id. at 103.

[12] Interbras Cayman Co. v. Orient Victory Shipping Co., S.A., 663 F.2d 4 (2d Cir. 1981).

[13] Interocean Shipping Co. v. Nat'l Shipping & Trading Corp., 462 F.2d 673 (2d Cir. 1972).

[14] See Interbras, 663 F.2d at 7 (reversing grant of motion to compel arbitration because opposing party submitted evidence "sufficient to raise a 'genuine' issue of fact" as to whether it was a party to the contract); Interocean, 462 F.2d at 678 (reversing grant of motion to compel arbitration because opposing party "have shown enough to entitle them to a trial o[n whether it was a party to the arbitration agreement").