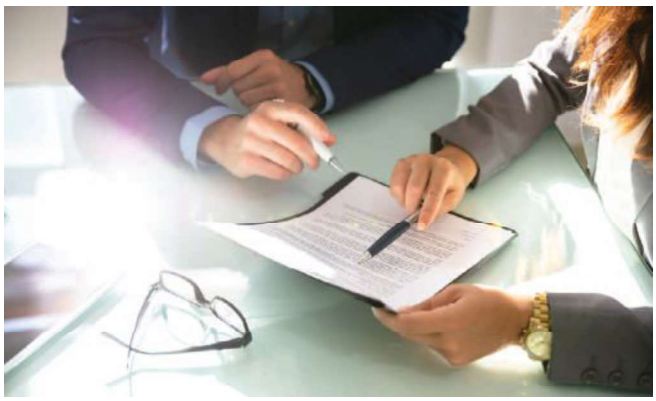

When Is a Waiver of the Right to Arbitrate a Waiver?

A look at caselaw.

WRITTEN BY **TED P. PEARCE**

Arbitration continues to be a growing preference for dispute resolution. Mandatory arbitration provisions are found in a variety of commercial contracts, especially in consumer agreements. In fact, it has been reported in a 2018 study that 81 of America's 100 largest companies use binding arbitration agreements as a standard provision in their consumer contracts.[1] While arbitration is not yet as prevalent in business-to-business agreements, the complexity of these types of agreements encourages using arbitration.[2]

In franchising, mandatory arbitration clauses have grown in popularity because, among other reasons, they can serve as a shield against class actions in the form of an arbitral class waiver.[3] As far back as 1997, one prominent franchise attorney concluded, "franchisors with an arbitration clause in their franchise agreements have an effective tool for managing these new class action risks"—in other words, a "class action shield."[4]

Even with the perceived advantages and the growing reliance on arbitration, it is not uncommon for a party mandating arbitration to waive that right by asserting or defending its claim in court, only to compel arbitration at a later time during the litigation. The question is; Can a party with an arbitration right initially waive that right and then later compel arbitration?

Historically, and seemingly unique to arbitration, a non-waiving party challenging a party's right to compel arbitration after first waiving it must show that it would be prejudiced if it is required to arbitrate a claim that is already in litigation. This element of proof, not found in waiver challenges outside of the arbitration context, appears to give arbitration a special preferred status. The Supreme Court recently muted that status and held that a showing of prejudice in proving waiver is no longer necessary when determining the arbitrability of a claim.

In *Morgan v. Sundance, Inc.*,[5] involving a franchisee and one of its employees, the court addressed the issue of whether a party challenging a party's right to compel arbitration must show prejudice in addition to proving that the party possessing the arbitration right acted inconsistently with that right. Robyn Morgan, the original plaintiff, was an hourly worker at a Taco Bell franchise owned by the franchisee, Sundance. At the time of her employment, the franchisee required Morgan to sign an agreement that mandated confidential binding arbitration, instead of going to court for any employment dispute. A dispute arose concerning her compensation. Morgan's specific complaints were that on numerous occasions, her employer violated the Fair Labor Standards Act by not paying her properly for the hours she worked. Ignoring the agreement's arbitration provision, Morgan sued the franchisee in court. Instead of seeking to stay the litigation to invoke its arbitration rights, the franchisee proceeded with litigation and filed an answer asserting 14 affirmative defenses, which did not include a demand for arbitration. The parties later unsuccessfully attempted mediation. After a total of more than eight months of procedural maneuvering and general inactivity, the franchisee suddenly switched gears and sought to stay the litigation and compel arbitration pursuant to the arbitration agreement and Sections 3 and 4 of the Federal Arbitration Act, or FAA.[6]

As expected, Morgan opposed the franchisee's motion, arguing that the franchisee waived its right to arbitration by engaging in litigation for almost eight months.[7] The franchisee countered Morgan's argument by asserting that the litigation had not yet proceeded to the merits stage, so there was no real harm to Morgan.

On the appellate level, the U.S. Court of Appeals for the 8th Circuit, relying on earlier precedent, found there could be waiver of arbitration only if the non-waiving party could show (1) knowledge of the arbitration right; (2) the party possessing the right to arbitration acted inconsistently with the right; and (3) the non-waiving party suffered prejudice by the waiving party's inconsistent actions.[8] The 8th Circuit previously adopted the prejudice requirement in the arbitration context in the case of *Erdman Co. v. Phoenix Land & Acquisition, LLC,* grounding its decision on the "federal policy favoring arbitration."[9] In this case, however, the 8th Circuit found that no prejudice existed and thus sent the case back to arbitration. The court based its decision on the fact that the parties had not yet contested any matters going to the merits of the case.[10] In a dissenting opinion, Judge Steven Colloton noted that "prejudice is not needed for waiver outside the arbitration context, and therefore should not be part of the waiver test."[11]

In granting certiorari, the Supreme Court noted there being a conflict between the federal circuits, with nine of the 11 courts having invoked the "strong federal policy favoring arbitration" and supporting an arbitration-specific waiver rule requiring a showing of prejudice. Only two circuits rejected

the rule.[12] In this case, the sole issue that the court considered is whether there is an arbitration-specific variant of the federal procedural rules requiring a showing of prejudice to establish waiver. While the FAA's policy is to favor arbitration, the question is whether that preference collides with a general proof of waiver outside the arbitration context, where there is no required showing of prejudice.

In situations outside of arbitration, a federal court in assessing waiver does not generally ask about prejudice. Waiver being the intentional relinquishment or abandonment of a known right, a court usually focuses on the actions or the person that held the right and not the effects of those actions on the opposing party. The court considers the requirement of showing prejudice to establish waiver in the arbitration context a bespoke rule.[13] The court noted further that the "FAA policy favoring arbitration does not authorize federal courts to invent special, arbitration-preferring procedural rules."[14] While the policy espoused in *Prima Paint Corp. v. Flood & Conklin Mfg.,* was to make arbitration agreements enforceable as other contracts, it was not to do more.[15] So while a court must hold a party to its arbitration contract, as it would any other contract, it cannot devise novel rules to favor arbitration over litigation.[16]

The court further noted that section 6 of the FAA provides that any application under statute—including an application to stay litigation or compel arbitration—"shall be made and heard in the manner provided by law for the making and hearing of motions." In other words, "apply the usual federal procedural rules, including any rules relating to a motion's timeliness, or conversely it is a bar to using custom made rules to tilt the playing field in favor of (or against) arbitration."[17]

The court returned the case to the 8th Circuit with instructions to limit its waiver inquiry to the franchisee's conduct; "[did] Sundance, as the rest of the Eighth Circuit's test asks, knowingly relinquish the right to arbitrate by acting inconsistently with that right?"[18] As noted by the appellate court, "A party acts inconsistently with its right to arbitrate if it substantially invokes the litigation machinery before asserting its arbitration right. When for example, it files a lawsuit on arbitrable claims, engages in extensive discovery, or fails to move to compel arbitration and stay in litigation in a timely manner."[19]

That being said, the majority found that the parties' engagement in mediation and the waiting for the district court's procedural findings did not invoke the litigation machinery. Conversely, in his dissent, Judge Colloton makes clear that in his view, *Sundance* did invoke the machinery of litigation by, among other things, answering Morgan's complaint on the merits and listing 14 affirmative defenses in its answer, which made no mention of arbitration or engaging in mediation. And the franchisee moved to compel arbitration only after more than seven months following the case's filing in court.[20] According to Judge Colloton, this conduct constituted waiver.

Arbitration offers parties a bundle of dispute resolution services, but as the recent Supreme Court decision holds, an arbitration agreement does not receive special preference over other contracts when it comes to the issue of waiver. As a practice pointer, practitioners litigating agreements with arbitration provisions should be well advised to compel arbitration at the earliest possible time, or risk waiving that right. **TBJ**

NOTES

1. Imre Stephen Szalai, *The Prevalence of Consumer Arbitration Agreement in America's Top Companies,* UC Davis Law Review, Vol. 52 online 233, 242 (2019), https://lawreview.law.ucdavis.edu/online/vol52/52-online-Szalai.pdf.
2. Douglas Shontz, Fred Kipperman, Vanessa Soma, *Business to Business Arbitration in the United States*, Rand Institute of Civil Justice, p. 19 (2011), https://www.rand.org/content/dam/rand/pubs/technical_reports/2011/RAND_TR781.pdf.
3. See pg 9 footnote 31.
4. Edward Wood Dunham, *The Arbitration Clause as Class Action Shield*, 16 Franchise L.J. 141 (1997).
5. *Morgan v. Sundance, Inc.,* 142 S.Ct., 1708 (2022).
6. Section 3 of the FAA provides a party the ability to seek to stay the proceedings if there is an agreement to arbitrate. Section 4 gives a judge the right to require arbitration if it is provided for in the subject agreement.
7. *Morgan v. Sundance, Inc.,* 142 S.Ct. at 171.1
8. *Erdman Co. V. Phoenix Land & Acquisition, LLC,* 650 F.3d 1115, 1117 (8th Cir. 2011)
9. *Id.* at 1120.
10. *Morgan v. Sundance, Inc.,* 992 F. 3d 711, 715 (8th Cir. 2021).
11. *Id.* at 716.
12. *Morgan v. Sundance, Inc.,* 142 S.Ct. at 1712.
13. *Id.* at 1713; Webster's Dictionary defines the term would be a rule tailored for a specific customer.
14. *Id.,* citing *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.,* 460 U.S 1 at 24, 103 S. Ct. 927.
15. See *Prima Paint Corp. v. Flood & Conklin Mfg.,* 388 U.S. 395, 404 n. 12, 87 S.Ct. 1801 L.Ed, 2d 1270 (1967).
16. *Morgan v. Sundance, Inc.,* 142 S.Ct. at 1713, citing *Dean Witter Reynolds, Inc. v. Byrd,* 470 U.S. 213, 218, 221 (1985).
17. *Id.* at 1714.
18. *Id.*
19. *Morgan v. Sundance, Inc.,* 992 F. 3d 711 at 714.
20. *Id.* at 715.

TED PEARCE
is a senior attorney with the law firm of Bradley Arant Boult Cummings in the Charlotte, North Carolina, office. Among its other offices, Bradley has offices in Houston and Dallas. Pearce concentrates his practice on franchise law, representing both franchisees and franchisors in mostly transactional and relationship issues. He also serves as a commercial arbitrator for the American Arbitration Association.