NEW YORK LAW JOURNAL

Arbitrating Contract Formation Challenges: Putting the Cart Before the Horse?

By Avi Israeli and Karen Sebaski | December 10, 2021

This article examines how New York courts approach the question of arbitrability generally and explores the murky depths of New York case law where that question coincides with a challenge to contract formation.

Because arbitration is "a creature of contract," the threshold question to be decided on a motion to compel arbitration is whether the parties have agreed to arbitrate. New York law is clear that this question—arbitrability—is typically an issue for judicial determination. It is also clear that when presented with a valid arbitration clause in a fully formed contract, New York courts, relying on New York law and substantive federal precedent, will cede control to the arbitrator to interpret the contract, including when the parties' dispute goes to the *validity* of the contract.

What is considerably more opaque, however, is whether the court or the arbitrator decides a challenge to the *existence* of the contract itself, i.e., a question of contract *formation* rather than *validity*. Supreme Court precedent holds that disputes about contract formation are generally for courts to decide. But New York courts are not always uniform about what constitutes a contract formation issue. Unsurprisingly, agreement that "contract formation" is for the court to decide, without consensus about what is covered by the term, results in a muddled body of case law. Adding to the confusion, challenges to contract formation are often, in effect, premised on arguments that a contract is void. In these instances, it is not always clear when New York courts should follow the general rule (that questions about whether a contract is void go to the arbitrator), or the exception (that questions about contract formation should be decided by the court). This article attempts to shed some light on these issues by examining how New York courts approach the question of arbitrability generally and exploring the murky depths of New York case law where that question coincides with a challenge to contract formation.

Arbitrability in New York: An Overview

Article 75 of the CPLR sets forth the rules governing arbitration in New York. Section 7501 provides that agreements to arbitrate are enforceable and "confers jurisdiction on the courts of the state to enforce [such agreements] and to enter judgment on an award." CPLR 7501. Under CPLR 7503, a New York state court has jurisdiction in the following circumstances: (1) where a party refuses to arbitrate a dispute, the court on motion can compel the party to do so (CPLR 7503(a)); (2) where one party initiates a court action on a dispute that another party claims to be subject to arbitration, the court on motion can compel arbitration and stay the judicial action (CPLR 7503(a)); and (3) where one party initiates an arbitration proceeding about a dispute that the other party contends is not subject to a valid agreement to arbitrate, the court can stay the arbitration (CPLR 7503(b)). In each instance, it is for the court to determine arbitrability—the issue of whether there is an agreement to arbitrate that requires arbitration. *JetBlue Airways v. Stephenson*, 88 A.D.3d 567, 571 (1st Dept. 2011).

Relevant federal case law binds New York state courts, as the Federal Arbitration Act "create[d] a body of federal substantive law" that is "applicable in [both] state and federal court[s]." *Southland Corp. v. Keating*, 465 U.S. 1, 12 (1984) (internal quotations omitted). Thus, federal opinions are a key component of the arbitration law landscape—in New York state and federal courts alike.

Agreements To Agree … To Arbitrate: A Grey Area?

Courts widely distinguish between challenges to an arbitration clause itself, and challenges to a contract generally that includes an arbitration clause. In *Buckeye Check Cashing v. Cardegna*, the U.S. Supreme Court explained that, because arbitration clauses are "severable" from the agreements that contain them, "unless [a] challenge is to the arbitration clause itself, the issue of the contract's validity is considered by the arbitrator in the first instance." 546 U.S. 440, 445-46 (2006). But there is an important carve-out: "the issue of the contract's validity is different from the issue [of] whether any agreement between the alleged [parties] was ever concluded." Id. at 444 n.1. Thus, "where the dispute at issue concerns contract formation, the dispute is generally for courts to decide." *Granite Rock Co. v. Int'l Broth. of Teamsters*, 561 U.S. 287, 296 (2010). This exception makes practical sense: allowing

arbitrators to decide whether the contract granting their authority ever came into existence in the first place would be putting the cart before the horse. So, although "mindful of [their] limited role," New York courts will decide whether a contract that includes an arbitration clause was validly executed, including allegations of forgery, that the signor lacked mental capacity to assent, and that the signor "lacked authority" to commit the alleged principal. E.g., *City of Rensselaer v. Relentless Awareness*, 142 N.Y.S.3d 892, 896 (N.Y. Sup. Ct. 2021); *Buckeye*, 546 U.S. at 444 n.1.

But how far do issues of contract formation extend? Under New York law, agreements that leave material terms to be negotiated later, lack mutual assent or are not supported by consideration do not form enforceable contracts. *Misopoulos v. LoveBug Nutrition*, 143 N.Y.S.3d 527, 528 (1st Dept. 2021); *Reddy v. Mihos*, 76 N.Y.S.3d 13, 18 (1st Dept. 2018). Therefore, one might expect that if a party challenges such an agreement that contains an arbitration clause, New York courts, rather than an arbitrator, will decide, as a threshold matter, such issues. The case law, however, does not always bear this out.

Take, for example, two recent cases where parties argued that an arbitration clause was included in a non-binding "agreement to agree." Taking opposite approaches, the court in *Siegel v. Milstein*, No. 21-CV-4032 (JS)(SIL), 2021 WL 5052748, at *4 (E.D.N.Y. Nov. 1, 2021), considered the formation issue and refused to compel arbitration because there was no manifestation of mutual assent, while in *Krakowitz v. Krakowitz*, No. 650868/2021, 2021 WL 854334, at *1 (N.Y. Sup. Ct. March 5, 2021), relying on the U.S. Supreme Court's severability rule, the court refused to entertain such formation challenges and directed these grievances to be brought before the arbitrator. Despite being expressed in different ways, arguments for judicial determination of contract formation—whether based on an "agreement to agree", "lack of mutual assent" or "no meeting of the minds"—essentially take the position that the contract at issue never came into existence. The different ways that parties characterize these arguments are confounded by the divergent and contradictory approaches that courts take to analyze the related issues. Compare *Zachman v. Hudson Valley Federal Credit Union*, No. 20 CV 1579 (VB), 2021 WL 1092508, at *4-5 (S.D.N.Y. March 22, 2021) (denying motion to compel arbitration where there was no "meeting of the minds" and "manifestation of mutual assent") with *Convergen Energy v. Brooks*, No. 20-CV-3746 (LJL), 2020 WL 4500184, at *6 (S.D.N.Y. Aug. 5, 2020) ("[W]hether a contract is void for lack of mutual assent" is for the arbitrator to decide) (citations omitted). New York courts are similarly divided on the question of who gets to hear disputes about a lack of consideration. Compare *Coleman v. Sys. Dialing*, No. 15CV3868 (DLC), 2016 WL 3387748, at *3 (S.D.N.Y. June 17, 2016) (holding that adequacy of consideration goes to "formation of the contract" under *Granite Rock* and, thus, the issue must be decided by the court before compelling arbitration) with *Abeona Therapeutics v. EB Rsch. P'ship*, No. 18CV10889(DLC), 2019 WL 623864, at *3 (S.D.N.Y. Feb. 14, 2019) (relying on the same Supreme Court decision to hold that "whether a contract as a whole lacks consideration is irrelevant to a court's inquiry on a motion to compel" and reserving that question for the arbitrator).

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Parties asking a court to stay arbitration proceedings have a limited number of tools in their toolkit, particularly when a litigant is seeking to avoid an apparent prior agreement to arbitrate. The distinction between issues of contract validity (for the arbitrator) and contract formation (for the court) may appear straightforward in theory, but courts reach different conclusions about which types of disputes fall into which camp, leaving the precedent far from clear. When an arbitration clause is contained in an agreement subject to a formation challenge, practitioners would be well served to focus on whether the contract in question is fully formed and explain to the judge specifically why it is or is not. As we have seen, even if judges generally agree that courts decide formation issues and arbitrators decide validity issues, judges may still have different interpretations of what issues of contract validity, contract formation and contract existence encompass. Judge Learned Hand observed that "[w]ords are chameleons, which reflect the color of their environment." Avoiding reliance on conclusory terms and instead focusing on the specific facts surrounding your agreement better assures that you and the judge are not only using the same words, but also are reaching the same conclusion.


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