CPLR 7501: Separability of the Arbitration Provision--Time to Reconcile New York and Federal Approaches

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[t]he deprivation of any tools and equipment tends in obvious ways to limit the party's ability to earn a living; imposes tremendous hardship on the defendant; and gives the plaintiff unwarranted leverage. The chattels seized by the plaintiff from the defendant herein were special property.\textsuperscript{104}

Subsequent to this decision but prior to its affirmance,\textsuperscript{105} the United States Supreme Court decided \textit{Fuentes v. Shevin}.\textsuperscript{106} Invalidating the prejudgment replevin statutes of Florida and Pennsylvania, the Court struck down the troublesome property classifications: "The Fourteenth Amendment speaks of 'property' generally. . . . It is not the business of a court adjudicating due process rights to . . . protect only the ones that, by its own lights, are 'necessary.'"\textsuperscript{107} The Court recognized that "extraordinary situations" might justify outright seizure, but cautioned that these "must be truly unusual."\textsuperscript{108} This warning was strictly adhered to in the \textit{Cedar Rapids} affirmance, in which the Appellate Division, Third Department, held that the case did not fall within the \textit{Fuentes} exception.

Justice Stewart stated for the majority in \textit{Fuentes} that the \textit{Snidach} holding should not be read as placing a limitation on procedural due process, but rather as emphasizing the special importance of the property involved therein, \textit{i.e.}, wages.\textsuperscript{109} It is now clear that the type of property sought to be replevied is irrelevant, and that due process will afford the litigant an opportunity to present a defense before the seizure, in the absence of extraordinary circumstances.

\textbf{Article 75 — Arbitration}

\textit{CPLR 7501}: Separability of the arbitration provision — time to reconcile New York and federal approaches.

When a party alleges fraudulent inducement of a contract containing an arbitration provision, the issue arises as to whether a court of law or the arbitrator is to pass upon the question of fraud. If the arbitration provision is viewed as separable from the underlying contract, there is no logical difficulty in permitting the arbitrator to determine whether the contract has been fraudulently induced, since the

\begin{footnotesize}
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\item \textsuperscript{104} 68 Misc. 2d at 210, 326 N.Y.S.2d at 657-58.
\item \textsuperscript{105} 39 App. Div. 2d 275, 323 N.Y.S.2d 953 (3d Dep't 1972).
\item \textsuperscript{106} 407 U.S. 67 (1972) (4-3).
\item \textsuperscript{107} \textit{Id.} at 90. The Court noted that summary seizure of property has been allowed to collect federal taxes, to further a national war effort, to counteract the effects of a bank failure, and to protect the public from misbranded drugs and contaminated food. \textit{Id.} at 91-92.
\item \textsuperscript{108} \textit{Id.} at 90.
\item \textsuperscript{109} \textit{Id.} at 89.
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arbitrator's authority can be viewed as arising from the separate agreement to arbitrate. Where the arbitration clause is considered non-separable, however, to allow the arbitrator to evaluate the allegations of fraud would be to permit him to determine the very basis of his own authority, for if the contract is voided, the arbitration provision must similarly fall.

The United States Supreme Court has viewed the arbitration clause as separable from the principal contract, and has held that the issue of the validity of the underlying contract may properly be submitted to the arbitrator, unless the fraudulent inducement pertains specifically to the arbitration clause itself. The rationale is that the parties' mutual promises to arbitrate support the arbitration agreement. Importantly, the United States Arbitration Act apparently distinguishes between the arbitration clause and the underlying contract.

In Housekeeper v. Lourie, the Appellate Division, First Department, recently held that the issue of fraudulent inducement of an arbitration contract must be decided as a threshold question by a court before the parties can proceed to arbitration. While the separability approach is well settled under federal substantive law, the New York courts, as Housekeeper indicates, have generally held that the arbitration clause is a subordinate element of the entire contract, the validity of which is a matter for judicial determination. The law

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110 "Generally, the mutual promise of both parties to arbitrate will be a good and sufficient consideration each for the other because rights and obligations are in this very contract divided between the parties." M. DOMKE, THE LAW AND PRACTICE OF COMMERCIAL ARBITRATION 32 (1968) [hereinafter DOMKE].


112 See Moseley v. Electronic & Missile Facilities, Inc., 374 U.S. 167 (1963). The Supreme Court held that, where a plaintiff alleges that an arbitration clause in a contract involving interstate commerce is an integral part of a fraudulent scheme whereby the contract was induced, the issue of fraud is to be decided by a court.


in New York on this point remains uncertain, however, and the increasingly significant role of arbitration in commercial transactions impels New York to adopt the federal approach.

New York enacted the first modern arbitration statute,117 which was the model for the federal statute.118 Previously, arbitration agreements were unenforceable as against public policy.119 The constitutionality of the New York statute was soon confirmed;120 indeed, the Legislature and the judiciary now encourage arbitration.121

While it was early argued that the New York statute supports separability,122 New York has not formally adopted that approach, but has treated the question in accordance with traditional contract theory.123 In viewing the contract and the arbitration clause as non-separable, the courts have held that fraudulent inducement renders a contract voidable rather than void.124 In an action for rescission, the relief sought is not merely termination of the contract, but a declaration that it is void ab initio.125 The arbitration clause, as part of the

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117 L. 1920, ch. 275. The New York arbitration statute was incorporated under article 84 of the CPA, §§ 1448-69. The present statute is found in article 75 of the CPLR, §§ 7501-14. For the historical background of the New York act, see 8 WK&M ¶ 7501.01.
121 For a general discussion of the value of arbitration in resolving disputes quickly and economically and relieving over crowded courts, see Dworkin, Arbitration: An Obvious Solution to a Crowded Docket, 31 OHIO BAR 1124 (1958); Smith, Commercial Arbitration at the American Arbitration Association, 11 ARB. J. (n.s.) 3 (1956).
125 The court in Lummus Co. v. Commonwealth Oil Ref. Co., 280 F.2d 915 (1st Cir.), cert. denied, 364 U.S. 911 (1960), observed:

The purpose of an action for rescission, as distinguished from one for damages, is to permit the defrauded party to obtain restitution of the benefits conferred by him. The contract is not merely terminated (as with a 'rescission' based on total breach), but is abrogated and undone from the beginning.

280 F.2d at 927, citing BLACK, RESCission OF CONTRACTS AND CANCELLATION OF WRITTEN INSTRUMENTS § 1 (2d ed. 1929); 2 RESTATEMENT OF CONTRACTS § 349, comment a at 596 (1932).
entire contract, would then also be voided, and there would be no valid source from which the arbitrator could derive his power.126

By instituting a fraudulent inducement action for damages127 sustained in the performance of a contract, however, the defrauded party is deemed to affirm the contract.128 Thus, the arbitration clause remains

126 Professor Corbin elucidated the traditional view:
Suppose, however, that the agreement to arbitrate disputes is a component part of the very bargaining transaction that is now asserted to be void for want of mutual assent, consideration, or capacity, or to be voidable for fraud, duress, lack of capacity or mistake .... It would seem that if the alleged defect exists, it affects the provision for arbitration just as much as it affects the other provisions. Even if, for some purposes, the provision for arbitration is declared to be independent and collateral, the factor that makes the rest of the transaction void or voidable would affect that transaction as a whole ....

6A A. CORBIN, CONTRACTS 449 (1962). Those favoring the separability approach counter that [t]he argument that the arbitrator would, in effect, be deciding the existence of the contract from which his jurisdiction stems would not apply because his authority is embodied in the "separate" arbitration agreement.

DOMKE, supra note 110, at 57.

In Cheney Bros. v. Joroco Dresses, Inc., 218 App. Div. 652, 658, 219 N.Y.S. 96 (1st Dep't 1929) (per curiam), rev'd on other grounds, 245 N.Y. 375, 197 N.E. 272 (1927), the court held that fraud in the inducement places in issue the existence of the contract and that "if the contract was voided by fraud the arbitration provision therein falls." In reversing, the Court of Appeals found that arbitration clauses are directed to the remedy, rather than to the validity of the principal contract, and that proceedings to enforce arbitration "presuppose the existence of a valid and enforceable contract at the time the remedy is sought." See also Finsilver, Still & Moss, Inc. v. Goldberg, Maas & Co., 253 N.Y. 382, 171 N.E. 579 (1930); Manufacturers Chem. Co. v. Caswell, Strauss & Co., 259 App. Div. 321, 19 N.Y.S.2d 171 (1st Dep't 1940); Royal Hair Pin Corp. v. Rieser Co., 218 N.Y.S.2d 773 (Sup. Ct. Kings County), modified and aff'd, 15 App. Div. 2d 559, 222 N.Y.S.2d 719 (2d Dep't 1961); Application of Grossman, 203 N.Y.S.2d 393 (Sup. Ct. Kings County 1961); Reo Garment, Inc. v. Jason Corp., 253 Misc. 318, 28 N.Y.S.2d 412 (Sup. Ct. N.Y. County 1958); Metro-Goldwyn-Mayer Distrib. Corp. v. Dewitt Dev. Corp., 150 Misc. 408, 269 N.Y.S. 104 (Sup. Ct. Erie County 1931). The issue of usury, which also challenges the validity of the principal contract, has been held to be for judicial determination. Metro Plan, Inc. v. Misconline, 257 App. Div. 652, 15 N.Y.S.2d 35 (1st Dep't 1939). Thus, "[u]nder New York law ... it is essential that the party seeking to avoid arbitration ... have a proper claim for rescission of the contract." DOMKE 63.

127 An action for rescission of the basic contract does not preclude the recovery of special damages by the defrauded party to return him to the position he occupied before making the disputed agreement. Generally, however, a party cannot both affirm the contract and receive damages based on breach, while at the same time rescind the contract and recover restitutionary damages. See Lummus Co. v. Commonwealth Oil Ref. Co., 280 F.2d 915, 927 n.15 (1st Cir.), cert. denied, 364 U.S. 911 (1960), citing N.Y. LAW REVISION COMM'N REP. 291-344 (1941).

128 In Amerotron Corp. v. Maxwell Shapiro Woolen Co., 3 App. Div. 2d 899, 162 N.Y.S.2d 214 (1st Dep't 1957) (mem.), aff'd mem., 4 N.Y.2d 722, 148 N.E.2d 319, 171 N.Y.S.2d 111 (1958), the court directed arbitration upon a finding that the contract was being affirmed and that the arbitration agreement was sufficiently broad to encompass the issue of fraudulent inducement. See also M.W. Kellogg Co. v. Monsanto Chem. Co., 9 App. Div. 2d 744, 192 N.Y.S.2d 869 (1st Dep't 1959) (per curiam). Domke observed that [a]s a result of the Amerotron and Monsanto cases, it is probably safe to generalize that where a contract contains a broad arbitration agreement .... the issue of
valid and disputes within its purview must be submitted to the arbitrator.129

The principal Court of Appeals decision in this area is *Wrap-Verteri Corp. v. Plotnick.*130 The Court, faced with an action for damages rather than for rescission, held that the issue of fraudulent inducement was for judicial determination, since the arbitration clause in question was not broad enough to encompass the relief sought.131 The Court, however, in dictum, strongly emphasized that had rescis-

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129 Under the separability concept, the rescission-performance distinction becomes irrelevant, since the arbitration clause is viewed as distinct from the principal contract regardless of the mode of relief requested. A leading advocate of the separability approach has argued that the distinction followed by the New York courts is "artificial and in any event denies any weight to the parties' contractual intent." Aksen, Prima Paint v. Flood & Conklin — *What Does it Mean?*, 43 St. John's L. Rev. 1, 11 (1968) [hereinafter Aksen].

130 3 N.Y.2d 17, 143 N.E.2d 366, 163 N.Y.S.2d 639 (1957) (4-3).

131 The arbitration clause in *Wrap* made arbitrable any question "as to the validity, interpretation or performance of [the] agreement." *Id.* at 18, 143 N.E.2d at 366, 163 N.Y.S.2d at 640. It is always a threshold matter for judicial determination whether a particular controversy is encompassed within the arbitration clause in question, unless the clause itself or a subsequent stipulation expressly confers such authority upon the arbitrator. See Lafayette Iron Works, Inc. v. Wilaka Constr. Co., 23 App. Div. 2d 487, 255 N.Y.S.2d 693 (1st Dep't 1968) (per curiam); Uddo v. Taormina, 21 App. Div. 2d 402, 250 N.Y.S.2d 645 (1st Dep't 1964). In *Wrap* the petitioner sought "[d]amages for breach of contract arising from fraud and misrepresentation inducing claimant to enter into the contract" (3 N.Y.2d at 18, 143 N.E.2d at 366, 163 N.Y.S.2d at 640), which the majority held was not a question relating to the "validity, interpretation or performance" of the principal contract. The dissent argued vigorously that

[the] claims asserted here are related to the contract and to the prior course of dealings engaged in by the parties in connection with the contract. They are so interrelated that whether the conduct challenged occurred prior or subsequent to the execution of the contract, the appraisal of the conduct is within the defined jurisdiction of the arbitrator.

*Id.* at 21, 143 N.E.2d at 368, 163 N.Y.S.2d at 642.
sion of the contract been sought, "such an issue would have had to have been decided in court before it could be known that an agreement existed supplying a foundation for the jurisdiction of the arbitrator." 132

In *Exercycle Corp. v. Maratta*, 133 the petitioner sought a stay of arbitration on the ground that the underlying contract was void for want of mutuality. The Court of Appeals, per Judge Fuld, noted four exceptions to the general policy of directing arbitration in accordance with the scope of the arbitration clause: (1) where fraud or duress results in a voidable agreement; (2) where there is no genuine dispute between the parties; (3) where the performance sought to be compelled in the arbitral forum is prohibited by statute; and (4) where the parties have not complied with a condition precedent to arbitration. 134 While the Court specifically upheld *Wrap* as to enjoining arbitration of the fraudulent inducement issue, the majority undercut the non-separability rationale of earlier decisions by ordering arbitration although the existence of a valid underlying contract had not yet been established. The majority concluded:

Once it be ascertained that the parties broadly agreed to arbitrate a dispute "arising out of or in connection with" the agreement, it is for the arbitrators to decide what the agreement means and to enforce it according to the rules of law which they deem appropriate in the circumstances. 135

The dissent in *Exercycle* favored the traditional view, 136 while the concurring opinion noted that the majority had apparently adopted the separability theory, 137 a contention which most commentators on *Exercycle* support. 138

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132 3 N.Y.2d at 20, 143 N.E.2d at 367, 163 N.Y.S.2d at 641.
134 Id. at 334-35, 174 N.E.2d 465, 214 N.Y.S.2d at 356. The second exception would seem no longer applicable, since CPLR 7501, enacted subsequent to *Exercycle*, provides that "the court shall not consider whether the claim with respect to which arbitration is sought is tenable, or otherwise pass upon the merits of the dispute."
136 Id. at 340, 174 N.E.2d at 469, 214 N.Y.S.2d at 361.
137 Id. at 340, 174 N.E.2d at 468, 214 N.Y.S.2d at 360. The concurring opinion maintained that as a matter of law the contract in question was not void for want of mutuality, and strongly criticized the majority's rationale.

138 Gerald Aksen of the American Arbitration Association, an advocate of the separability approach, argued:

Indeed, *Exercycle v. Maratta*, the very case which contained dictum to the effect that arbitration would not lie where the plaintiff seeks rescission for fraud, can itself be cited for the proposition that arbitration clauses are separable in New York... It is difficult in logic to explain how an arbitrator can void such an agreement unless, in fact, his authority stems from a "separate" contract.

Aksen, supra note 129, at 10. See also 75 Harv. L. Rev. 835-56 (1962) and the commen-
Although *Exercycle* supported *Wrap*, its rationale indicates that the separability question is unsettled in New York. If the court can direct arbitration notwithstanding the need to determine the validity of the underlying contract when lack of mutuality is alleged, there would seem to be no logical basis for staying arbitration when the validity of the principal contract is challenged by a claim of fraud or duress.\(^\text{139}\)

Prior to *Exercycle*,\(^\text{140}\) several decisions apparently departed from the traditional view that the issue of fraudulent inducement is for the court to determine when rescission of the principal contract is sought. In *Lugay Frocks, Inc. v. Joint Board Dressmakers' Union*,\(^\text{141}\) the Sutaries on *Exercycle* cited in note 133 *supra*. Not all commentators, however, viewed *Exercycle* as an adoption of the separability approach:

> To press *Exercycle* into the separability mould, as some have done, is to disregard Judge Fuld's opinion, which leaves no doubt that it views the parties' undertaking to arbitrate only in terms of its being a constituent part of their overall "agreement."


No arbitrator has power to invent rules of law that will validate the contract by which his power as an arbitrator is created; its validity depends upon the rules of law antecedently known to and enforced by the courts. . . . If the court's statement were correct, there would be no reason for the four exceptions that the court enumerate[d]. The issue was not one of "interpretation"; it was as to the legal operation of uncontroverted facts. . . . If the agreement was void for "lack of mutuality," the arbitration clause fell with the rest.\(^\text{140}\)

\(^\text{139}\) See 8 WK&M § 7501.25. Professor Corbin, criticized the *Exercycle* decision:

> No arbitrator has power to invent rules of law that will validate the contract by which his power as an arbitrator is created; its validity depends upon the rules of law antecedently known to and enforced by the courts. . . . If the court stated correctly, there was no reason for the four exceptions that the court enumerated[d]. The issue was not one of "interpretation"; it was as to the legal operation of uncontroverted facts. . . . If the agreement was void for "lack of mutability," the arbitration clause fell with the rest.

\(^\text{140}\) Several early cases, while not dealing with fraudulent inducement, indicated a judicial sympathy toward the separability concept. In Marchant v. Mead-Morrison Mfg. Co., 252 N.Y. 284, 169 N.E. 386 (1929), the Court of Appeals apparently adopted the separability approach for conflicts purposes in construing an arbitration provision in accordance with the New York statute, even though the underlying contract contemplated performance in Massachusetts. Professor Nussbaum, in *The "Separability Doctrine" in American and Foreign Arbitration*, 17 N.Y.U.L.Q. Rev. 609, 615 n.28 (1940), noted the case, *In re Albert*, 95 N.Y.L.J. 59, March 12, 1936, at 1276, col. 7 (N.Y. City Ct. N.Y. County), an arbitration confirmation proceeding in which the court expressly adopted the separability theory. Nussbaum also cited Exeter Mfg. Co. v. Marrus, 254 App. Div. 495, 5 N.Y.S.2d 438 (1st Dep't 1938), in which the court directed arbitration notwithstanding an apparent noncompliance with the Statute of Frauds. For Nussbaum this represented "the separability doctrine applied to the question of formalities." Nussbaum, *supra*, at 614.

\(^\text{141}\) See 8 WK&M § 7503.02.

\(^\text{141}\) 140 N.Y.L.J. 1, July 1, 1958, at 3, col. 1 (Sup. Ct. N.Y. County), aff'd mem., 6 App. Div. 2d 1000, 177 N.Y.S.2d 1008 (1st Dep't 1958).
preme Court, New York County, held that fraudulent concealment of a contract provision, by which the contract was induced, gives the defrauded party the right to rescind the contract, but that "such concealment cannot be the basis for staying arbitration. As long as there is a signed contract in existence providing for arbitration, the respondents have the right to demand arbitration. . . ."142 In Aaron Krumbeim & Sons, Inc., v. Winola Silk Mills, Inc.,143 the same court, faced with a rescission action based on fraudulent inducement, stated simply that the "parties may provide for the arbitration of such questions as would give one of them the right to rescind."144 In Fabrex Corp. v. Winard Sales Co.,145 the court stated in dictum:

Where an arbitration clause is broad and all inclusive, a request for rescission, either in a pending action or in a demand for arbitration, based upon fraud in the inducement, will be left for determination of the arbitrators.146

While these cases did not refer to separability, that theory appears to be the only basis on which the courts could have argued, the validity of the principal contracts having been challenged.

Two decisions after Exercycle, both of which directed arbitration in rescission actions based on fraudulent inducement, failed to consider Exercycle. In Amphenol Corp. v. Microlab,147 the Supreme Court, New York County, relying solely on Fabrex, asserted that "[t]he issue of fraudulent inducement of a contract may unquestionably be arbitrated in New York."148 In Coler v. GCA Corp.,149 the First Department, relying on Fabrex and Amphenol, directed arbitration and stated that regardless of the possibility that the ultimate result of the arbitration might be vitiation of the very contract under which the arbi-

142 Id.
143 133 N.Y.L.J. 65, April 4, 1955, at 6, col. 7 (Sup. Ct. N.Y. County 1955).
144 Id.
146 Id. at 27, 200 N.Y.S.2d at 280. Although the court clearly indicated that arbitration would be directed even if rescission of the principal contract were sought, the basis of the court's decision is in line with the traditional view "that issues raised by claims relating to performance of contracts . . . are for determination by the arbitrators." Id. The court distinguished Wrap on the ground that the arbitration clause there was too narrow to encompass the relief sought.
148 Id. at 47, 266 N.Y.S.2d at 769. The court further noted that such questions were contingent upon the scope of the particular arbitration clause, but did not explore the traditional rescission-performance distinction.
tration will have taken place... the contract will have remained viable a sufficient period of time to sustain the arbitration.\footnote{Id., 831 N.Y.S.2d at 938-39. The court, as in Amphenol, cited Fabrex for the proposition that Wrap was not controlling because of the limited arbitration provision there, without commenting on the fact that both Wrap and Fabrex were held to be concerned with performance, rather than rescission, questions. The Coler dissent vigorously espoused the traditional approach.}

The Coler majority, while not alluding to the separability concept, thus appeared to view the arbitration clause as a separate entity whose validity would be unaffected by a determination that the underlying contract is void.

While Wrap has not been specifically overruled, Exercycle and decisions such as Fabrex, Amphenol, and Coler reveal a certain confusion and uncertainty as to the exact state of the law in New York on the separability issue. While New York courts have moved slowly and with conflicting results toward acceptance of that approach, the federal courts have acted decisively in this area, although some questions as to the applicability of federal substantive law in the state courts remain unanswered.

In Robert Lawrence Co. v. Devonshire Fabrics, Inc.,\footnote{Id., 831 N.Y.S.2d at 938-39. The court, as in Amphenol, cited Fabrex for the proposition that Wrap was not controlling because of the limited arbitration provision there, without commenting on the fact that both Wrap and Fabrex were held to be concerned with performance, rather than rescission, questions. The Coler dissent vigorously espoused the traditional approach.} the Second Circuit Court of Appeals held that section 2 of the Federal Arbitration Act,\footnote{152 9 U.S.C. § 2 (1970).} which makes an arbitration provision in a contract involving maritime transactions or interstate commerce "valid, irrevocable, and enforceable," pertained solely to the arbitration clause itself, and that, therefore, an arbitration provision was separable from the principal contract. Thus, the court reasoned:

Once it is settled that arbitration agreements are "valid, irrevocable, and enforceable" we know of no principle of law that stands as an
obstacle to a determination by the parties to the effect that arbitration should not be denied or postponed upon the mere cry of fraud in the inducement, as this would permit the frustration of the very purposes sought to be achieved by the agreement to arbitrate, i.e., a speedy and relatively inexpensive trial before commercial specialists.\textsuperscript{153}

The United States Supreme Court, in *Prima Paint Corp. v. Flood \& Conklin Manufacturing Co.*,\textsuperscript{154} endorsed the Second Circuit's adoption of the separability theory as a matter of federal substantive law. The Court, however, relied on section 4 of the Federal Arbitration Act,\textsuperscript{155} which provides that arbitration must be directed when the court is satisfied that a valid arbitration agreement has been made. It reasoned:

Under § 4, with respect to a matter within the jurisdiction of the federal courts save for the existence of an arbitration clause, the federal court is instructed to order arbitration to proceed once it is satisfied that "the making of the agreement for arbitration or the failure to comply [with the arbitration agreement] is not in issue." Accordingly, if the claim is fraud in the inducement of the arbitration clause itself — an issue which goes to the "making" of the agreement to arbitrate — the federal court may proceed to adjudicate it. But the statutory language does not permit the federal court to consider claims of fraud in the inducement of the contract generally.\textsuperscript{156}

While *Prima Paint* binds the federal courts,\textsuperscript{157} the Supreme Court

\textsuperscript{153}271 F.2d at 410. The Second Circuit subsequently placed certain limitations on the separability concept, however. In *El Hoss Eng'r \& Transp. Co. v. American Independent Oil Co.*, 289 F.2d 946 (2d Cir.), *cert. denied*, 368 U.S. 837 (1961), the court held that an arbitration clause was not separable upon an allegation of failure to comply with an express condition precedent. The court, in *In re Kinoshita \& Co.*, 287 F.2d 951 (2d Cir. 1961), held that the arbitration provision must still be broad enough to encompass an allegation of fraudulent inducement; thus, the separability approach does not preclude judicial determination of whether a specific controversy is within the scope of the arbitration agreement in question. Domke has observed:

Under the separability rule, the only test of what may be arbitrated is the measure of the scope of the arbitration clause. . . . Whether a clause is sufficiently broad must be decided on a case-by-case basis by the court.

Domke 59. The *Kinoshita* court held that the standard arbitration clause of the American Arbitration Association is broad enough to encompass the question of fraudulent inducement of the underlying contract. The Association's arbitration agreement provides:

Any controversy or claim arising out of or relating to this contract, or the breach thereof, shall be settled by arbitration, in accordance with the Rules, then obtaining, of the American Arbitration Association, and judgment upon the award rendered may be entered in any court having jurisdiction thereof.

\textsuperscript{154}388 U.S. 395 (1967).
\textsuperscript{156}388 U.S. at 403-04.
did not mandate that state courts adopt a similar approach when dealing with maritime transactions and interstate commerce. In the landmark case of *Erie Railroad v. Tompkins*,\(^{158}\) the Supreme Court ruled that when diversity of citizenship was the only ground for federal jurisdiction, the federal courts must apply state substantive law.\(^{159}\) In *Bernhardt v. Polygraphic Co. of America*,\(^{160}\) the Court held that in diversity cases involving intrastate transactions, the federal courts must follow state law in determining whether to stay or compel arbitration.\(^{161}\) After *Bernhardt*, there was a split of authority as to whether the federal statute or state law was applicable in diversity cases involving interstate commerce and maritime transactions.\(^{162}\) *Lawrence* held that section 2 of the Act, by making arbitration agreements “valid, irrevocable, and enforceable” irrespective of state policy, represented “a declaration of national law equally applicable in state or federal courts.”\(^{163}\)

\(^{158}\) 304 U.S. 64 (1938).


\(^{160}\) 350 U.S. 198 (1956).

\(^{161}\) The rationale of *Bernhardt* was that the federal courts must apply the relevant state law because it is outcome-determinative; thus, it was held to be immaterial whether state courts considered questions under state arbitration statutes as substantive or procedural. The outcome-determinative test was enunciated in *Guaranty Trust Co. v. York*, 926 U.S. 99, 109 (1945), in which the Supreme Court argued:

> In essence, the intent of [Erie] was to insure that, in all cases where a federal court is exercising jurisdiction solely because of the diversity of citizenship of the parties, the outcome of the litigation in the federal court should be substantially the same, so far as legal rules determine the outcome of a litigation, as it would be if tried in a State court. The nub of the policy that underlies Erie R. Co. v. Tompkins is that for the same transaction the accident of a suit by a nonresident litigant in a federal court instead of in a State court a block away, should not lead to a substantially different result.

\(^{162}\) The First and Ninth Circuits held that state law was applicable. See Lummus Co. v. Commonwealth Oil Ref. Co., 280 F.2d 915 (1st Cir.), cert. denied, 364 U.S. 911 (1960); Ross v. Twentieth Century-Fox Film Corp., 256 F.2d 632 (9th Cir. 1956). The Second Circuit, in *Lawrence*, held that the United States Arbitration Act, as federal substantive law, was applicable in the federal courts. This position was followed in *Amicizia Societa Navegazione v. Chilean Nitrate & Iodine Sales Corp.*, 274 F.2d 805 (2d Cir.), cert. denied, 363 U.S. 848 (1960).

\(^{163}\) 271 F.2d at 497. The *Lawrence* court distinguished *Bernhardt* on the ground that the arbitrable controversy therein was not an interstate commercial or maritime transaction; it further maintained that had the drafters of the federal Arbitration Act anticipated *Erie* they would have intended the act to represent federal substantive law. Thus, it concluded that the statute was concerned

> not with state-created rights but with rights arising out of the exercise by the Congress of its constitutional power to regulate commerce and hence there is involved no difficult question of constitutional law under *Erie*.\(^{164}\)”
The majority in *Prima Paint* did not comment on the *Lawrence* court's assertion that the federal statute was binding on the state courts. The dissent, however, stressed that "[t]he Court here does not hold today . . . that the body of federal substantive law created by federal judges under the Arbitration Act is required to be applied by state courts."

Although *Prima Paint* does not mandate that the states adopt its interpretation of the federal arbitration statute, it seems likely that state courts will follow *Prima Paint* in order to discourage forum shopping and insure uniformity in interstate commercial transactions. In *A/S J. Ludwig Mowinckels Rederi v. Dow Chemical Co.*, the New York Court of Appeals, in construing an arbitration clause in a maritime

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*Id.* at 464-05. The court's holding that federal law was controlling on the issue of arbitrability within the purview of the act was expressly followed in *Metro Indus. Painting Corp. v. Terminal Constr. Co.*, 287 F.2d 382 (2d Cir.), *cert. denied*, 368 U.S. 817 (1961).

Although the *Lawrence* court saw no *Erie* difficulties in its decision, it is apparent that *Lawrence* reduces the impact of *Erie* on the federal arbitration statute. The significance of its holding is that

the [act] is brought into play also in diversity actions in the federal courts when commerce or a maritime transaction is involved. Recognition of section 2 as substantive federal law means that whenever its provisions apply it will necessarily override state law on the subject, and render *Erie R.R. v. Tompkins* inapplicable. Where neither commerce nor maritime transactions are involved, however, federal courts in diversity cases will continue to apply state law with regard to arbitration clauses.

45 CORNELL L.Q. 795, 797 (1960). The *Lawrence* court's assertion that the federal arbitration statute is binding on the state courts would mean that arbitration clauses in interstate commercial and maritime transactions would fall within the purview of § 2 regardless of diversity of citizenship or jurisdictional amount. This aspect of *Lawrence* has been subjected to criticism in that, "politically and historically considered, it is in conflict with fundamental concepts of federalism." 8 WK&M ¶ 7501.12.

The Supreme Court in *Prima Paint* did hold that the United States Arbitration Act was federal substantive law binding on the federal courts:

The question in this case, however, is not whether Congress may fashion federal substantive rules to govern questions arising in simple diversity cases . . . Rather, the question is whether Congress may prescribe how federal courts are to conduct themselves with respect to subject matter over which Congress plainly has power to legislate. The answer to that can only be in the affirmative. And it is clear beyond dispute that the federal arbitration statute is based upon and confined to the incontestable federal foundations of "control over interstate commerce and over admiralty."


388 U.S. at 405. The same modifications of *Erie* which were noted with respect to *Lawrence* would seem equally applicable to *Prima Paint*. A controversy must be in federal court, however, because of diversity of citizenship, since the federal Arbitration Act does not itself provide a separate basis on which the federal courts may assume jurisdiction. See 9 U.S.C. § 4 (1970); DOMKE 27.
agreement, held that in commercial transactions to which the Federal Arbitration Act, by its terms, is applicable, "Prima Paint leaves no plausible alternative but application of the Federal statute in state courts as well as in Federal courts." The Appellate Division, First Department, in *Aerojet-General Corp. v. Non-Ferrous Metal Refining, Ltd.*, where the parties agreed that the federal act governed, clearly adopted the federal separability approach with respect to an interstate commercial contract allegedly induced by fraud.

Although the First Department viewed the arbitration provision and the principal contract as separable in *Aerojet*, the same court leaned toward the more traditional New York view in *Housekeeper v. Lourie*. The petitioners, partners with the respondent, an attorney, sought a stay of arbitration on the ground that they had been fraudulently induced to enter into an agreement for the termination of the partnership. They alleged that the respondent had misrepresented the contract as the only means to terminate the partnership, thereby breaching his fiduciary duty as their attorney.

The court, in reviewing decisions such as *Fabrex*, *Amphenol*, and *Coler*, offered as a summary of existing law a statement closely approximating the separability position:

> If issues with regard to alleged fraud or misrepresentation are within the scope of an arbitration clause and the clause itself is not rendered invalid or voidable by reason of the alleged fraud or misrepresentation, the issues are to be submitted to and determined by the arbitrators.

The court limited this statement by adding that it is fraud in the performance of a contract which is arbitrable, thus expressing the traditional New York view. The cases the court cited, however, maintain that the arbitrator may consider the question of fraudulent inducement

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168 Id. at 579-80, 255 N.E.2d at 775-76, 307 N.Y.S.2d at 662. The Court further argued: It is particularly important to apply Federal law in the present case, for, to hold otherwise would (1) permit, indeed encourage, forum shopping; (2) prevent and undermine the need for nationwide uniformity in the interpretation and application of arbitration clauses in foreign and interstate transactions; and (3) permit individuals to circumvent the national law relating to arbitration agreements as called for by the [federal Arbitration Act].

169 37 App. Div. 2d 531, 322 N.Y.S.2d 83 (1st Dep't 1971) (mem.). Echoing the Supreme Court's language in *Prima Paint*, the court held that applying the Federal Act and under the broad arbitration clause here involved, the issue of fraudulent inducement is for the arbitrators. Only if the claim is fraud in the inducement of the arbitration clause itself—an issue which goes to the "making" of the agreement to arbitrate—may the court resolve it.


171 Id. at 282, 333 N.Y.S.2d at 935.
when rescission is sought.\textsuperscript{172} Thus, the court's statement is susceptible to inconsistent interpretations.

The court's precise holding was that

[w]here, as here, there is a prima facie showing of an issue as to whether there exists a valid and binding agreement for arbitration and such issue is timely and properly raised, it is to be determined by the court.\textsuperscript{173}

While its holding that arbitration must be stayed where fraud touches the arbitration provision itself is consistent with the state and federal positions,\textsuperscript{174} the court considered primarily the question of fraud in the principal contract and not whether fraudulent inducement pertained specifically to the arbitration provision. Noting that the petitioners' allegations "show[ed] fraud permeating the entire agreement," the court refused to hold as a matter of law that the agreement to terminate the partnership "resulted from 'arm's length negotiations' rendering applicable an assumption that, notwithstanding the alleged fraud, the dominant intention of the parties was to settle their disputes by arbitration."\textsuperscript{175} It further noted that if the broad allegations of fraud were true, the entire contract, including the arbitration clause, "should be avoided as constituting a fraudulent breach of the fiduciary relationship between an attorney and his clients."\textsuperscript{176}

\footnote{172}{The court also cited M.W. Kellogg Co. v. Monsanto Chemical Co., 9 App. Div. 2d 744, 192 N.Y.S.2d 869 (1st Dep't 1959) (per curiam), which does refer to performance questions (see note 128 supra), and Hamilton Life Ins. Co. v. Republic Nat'l Life Ins. Co., 408 F.2d 606 (2d Cir. 1969), in which the court expressly followed \textit{Prima Paint}. The \textit{Housekeeper} court, while not rejecting the separability concept, referred with approval to two opinions which adopted the non-separability approach. It noted the concurring opinion in \textit{Exercycle}, which strongly criticized the majority's apparent adoption of the separability theory, and it also cited Justice Black's concurring opinion in Moseley v. Electronic & Missile Facilities, Inc., 374 U.S. 167, 172 (1963), in which he argued that fraudulent inducement of an arbitration contract, "like fraud in the procurement of any contract, makes it void and unenforceable and that this question of fraud is a judicial one. . . ." Justice Black's opposition to the separability theory became even more apparent in his dissenting opinion in \textit{Prima Paint}: The Court holds, what is to me fantastic, that the legal issue of a contract's voidness because of fraud is to be decided by persons designated to arbitrate factual controversies arising out of a valid contract between the parties. . . . I am by no means sure that thus forcing a person to forgo his opportunity to try his legal issues in the courts where, unlike the situation in arbitration, he may have a jury trial and right to appeal, is not a denial of due process of law. 388 U.S. 395, 407 (1967).}


\footnote{174}{\textit{Id. Housekeeper} raises a difficult question as to whether arbitration may be stayed where a contract is fraudulently induced through breach of a fiduciary duty. Public policy may require judicial resolution of such controversies. In the absence of}

\footnote{175}{\textit{Id. App. Div. 2d at 285, 333 N.Y.S.2d at 938.}}
The court's reasoning is clearly a rejection of the separability concept, since the court was unwilling to consider simply the arbitration provision itself, but rather looked to the entire agreement, and concluded that if the total contract were fraudulently induced, the arbitration clause, as an element thereof, must also have been touched by the alleged fraud. The federal approach is to differentiate between fraudulent inducement of the underlying contract and fraud which specifically induces the arbitration agreement. Both the federal and New York courts will stay arbitration in the latter instance, but the New York courts, notwithstanding *Exercycle*, will apparently also stay arbitration upon a general showing of fraud in the principal contract.

*Housekeeper v. Lourie* is the most recent illustration of the uncertainty of New York law as to the separability issue. The United States legislative authority for staying arbitration on public policy grounds, some courts have done so.

The *Exercycle* Court stated that arbitration should be stayed where the performance sought to be compelled in the arbitral forum is prohibited by statute. 9 N.Y.2d 329, 334-35, 174 N.E.2d 463, 465, 214 N.Y.S.2d 533, 536 (1961). In Aimcee Wholesale Corps. v. Tomar Prods., Inc., 21 N.Y.2d 621, 237 N.E.2d 223, 289 N.Y.S.2d 968 (1968), the Court held that the state's interest in enforcing its antitrust policy must preclude a resolution of such issues by commercial arbitrators. In Agur v. Agur, 32 App. Div. 2d 16, 298 N.Y.S.2d 772 (2d Dep't 1969), the court denied arbitration in a custody action pursuant to a Mexican divorce decree, even though the court found the dispute to be within the terms of the arbitration provision. In Durst v. Abrash, 22 App. Div. 2d 59, 253 N.Y.S.2d 351 (1st Dep't 1964), aff'd mem., 17 N.Y.2d 445, 213 N.E.2d 887, 266 N.Y.S.2d 806 (1965), the court stated that common-law grounds for staying arbitration should be distinguished from public policy grounds. Dean McLaughlin summarized the *Durst* argument:

Questions as to the validity of the contract under the common law, e.g., questions of mutuality, consideration, rescission, etc., should be left to the arbitrators. Questions of invalidity which trench heavily upon public policy, e.g., fraud, duress and usury, should be retained in the courts lest the overreaching party, by the simple expedient of inserting an arbitration clause and selecting friendly arbitrators, insulate his misconduct from judicial review.

7B McKINNEY'S CPLR 7503, supp. commentary at 174 (1965). The *Durst* rationale has been criticized in that faced with any allegation, a court has jurisdiction only to consider whether there is an agreement to arbitrate and whether the dispute is within the terms of the agreement. . . . Moreover, the statute does not indicate that the courts were intended to retain jurisdiction over questions of "public policy" even when reviewing arbitrators' decisions.

42 WASH. L. REV. 621, 627 n.24 (1967).

177 The Supreme Court, in *Prima Paint*, observed:

Whether a party seeking rescission of a contract on the ground of fraudulent inducement may in New York obtain judicial resolution of his claim is not entirely clear. . . . In light of our disposition of this case, we need not decide the status of the issue under New York law.

388 U.S. 395, 400 n.3 (1967). The Second Circuit viewed the adoption of the CPLR as bringing New York law into conformity with the federal separability approach:

Subsequent cases under the new statute indicate that the restrictive view taken in *Exercycle* is no longer the law in New York, and that the distinction recognized in the Federal Arbitration Act . . . between fraud in the inducement of the arbitration clause itself and fraud with respect to the contract generally has been adopted in New York.

Arbitration Act was modelled specifically on the New York arbitration statute. The corresponding provisions should be interpreted similarly.178 Furthermore, the New York courts, in Rederi and Aerojet, voluntarily followed the Prima Paint holding in maritime and interstate commercial transactions and considered an arbitration clause as distinct from the underlying contract. It is anomalous, therefore, to reject the separability approach when confronted with wholly intrastate activities, there being no compelling public interest requiring a different standard for intrastate commercial dealings.

New York, historically the leader in encouraging arbitration and developing a sophisticated arbitration jurisprudence, should clarify the present confusion as to its treatment of the question of fraudulent inducement and adopt the progressive separability approach of the federal courts. It should no longer remain the only state with a modern arbitration statute to follow a non-separability rule.179

CPLR 7501: Broad arbitration clause compels submission of question of recovery of consequential damages to arbitrator notwithstanding damage limitation clause.

In Allen Knitting Mills v. Dorado Dress Corp.180 the appellant, a textiles seller, applied to stay arbitration on the ground that the respondent, who sought consequential damages, was barred from such recovery by clauses in their contracts limiting the appellant's liability to the difference in value between goods ordered and goods actually received. Each of the arbitration clauses encompassed "[a]ny controversy or claim arising out of or relating to this contract, any interpretation thereof or breach thereof. . . ." The Appellate Division, First Department, affirmed the lower court's denial of a stay, noting that the arbitrator derives his authority from the scope of the arbitration clause.181

178 See Aksen at 10. The adoption of CPLR 7501, deleting the terminology declaring arbitration agreements to be "valid, enforceable and irrevocable," which was found in CPA 1448 and is currently found in § 2 of the federal statute, should not be viewed as a modification of New York's traditional approach favoring arbitration. It is the better view that this expression has been deleted as unnecessary. See 7B McKinney's CPLR 7501, commentary at 433 (1963); 8 WK&M § 7501.03.


181 The Court of Appeals, in Exercycle Corp. v. Maratta, 9 N.Y.2d 329, 336, 174 N.E.2d 463, 466, 214 N.Y.S.2d 353, 357 (1961), noted: "Where there is a broad provision for arbitration, . . . arbitration may be had as to all issues arising under the contract."