Prima Paint v. Flood & Conklin--What Does It Mean?

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VOLUNTARY arbitration is employed by businessmen to achieve expedition, expertise and expense-saving in resolving their commercial disputes. When the arbitration is permitted to proceed in its own forum, free from undue technicalities and properly administered, these three great advantages over litigation can be gained. Alternatively, if a respondent is permitted to plead dilatory defenses to avoid his promise to arbitrate when, after the dispute erupts, delay better suits his purpose, all of these advantages are materially impaired and even destroyed.

To avoid this dilemma and to insure prompt compliance with the promise to arbitrate, modern arbitration laws provide a convenient and summary procedure to specifically enforce the arbitration agreement. One such law is the Federal Arbitration Act,1 enacted in 1925, which contains in section 3 procedures to stay court proceedings brought in lieu of the arbitration clause, and in section 4 remedial steps to compel compliance with the arbitration agreement. The Congressional intent behind the enactment of the


The opinions expressed are those of the author and do not necessarily represent the views of the American Arbitration Association.

Federal Arbitration Act was ruled upon in 1967 by the United States Supreme Court in *Prima Paint v. Flood & Conklin Mfg. Co.*, which is undoubtedly the most significant judicial opinion ever rendered concerning agreements to arbitrate commercial controversies. For the first time since the enactment of the Federal law, the businessman has been assured by the High Court that when he intends a prompt resolution of his disputes through the arbitral forum, he is legally entitled to pursue his rights in that forum without any “delay . . . [or] obstruction in the courts.”

*Prima Paint v. Flood & Conklin Mfg. Co.*, holds that as a matter of federal law, where the parties insert a broad arbitration clause, an arbitrator rather than a federal court decides if the principal contract has been fraudulently induced, and this rule, one of national substantive law, governs even in the face of a contrary state rule. The holding is important because it will seriously curtail attempts to circumvent the broad arbitration clause used in so many interstate commercial transactions today.

Of greater impact, however, are the many other issues necessarily ruled upon by the Court. In addition to resolving a conflict in the circuit courts of appeals concerning the appropriate approach to this question, the opinion dealt with such questions as the scope to be accorded the broad arbitration clause, the concept of the “separate” arbitration agreement, the test of “commerce” applicable to evidence a transaction under the Act, the uniform treatment that federal district courts will apply to motions to compel or stay arbitration whether under sections 3 or 4 of the Act, the meaning of federal jurisdiction save for the arbitration agreement, the characteri-

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2 388 U.S. 395 (1967).
3 Id. at 404.
4 Id. at 404-05.
zation of arbitration as "substantive" rather than procedural for *Erie* purposes thus disposing of constitutional limitations, the effect of seeking "rescissional" relief, the attempts to define the area of contracts to which the rule applies, and the difference in result from *Robert Lawrence v. Devonshire Fabrics, Inc.*—all of which are affected by this decision.

Indeed, the issues treated directly, as well as the implications on the enforcement of future agreements to arbitrate and the effect of contrary state rules easily presage *Prima Paint* as a "landmark" opinion. This article will discuss and analyze the decision both as to its immediate impact and its effect on the future development of voluntary arbitration law and practice in the commercial community.

**Freedom to Arbitrate Fraud — A Triumph of Voluntarism**

The key to the meaning of the brief but straightforward opinion of Mr. Justice Fortas rests in the "policy decision" that parties are free to agree that legal issues such as fraud may be arbitrated. Indeed, this may be the primary consideration behind a firm understanding of this decision which sets forth the national substantive law of voluntary agreements to arbitrate commercial controversies, *i.e.*, where parties intend that a third person, other than a publically constituted court, should decide whether fraud has been practiced, they may so provide.

Let us look briefly at the facts of this case for an example of how this policy applies. The business transaction involved here concerned two parties both of whom were in the business of manufacturing and selling paint. Sometime in September of 1964, Prima Paint purchased F&C's paint business. Later, in October of 1964, an agreement was entered into between them whereby F&C for a six year period was to furnish advice and consultation in

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*271 F.2d 402 (2d Cir. 1959).*
connection with the formulae, manufacturing operation, sales and services of Prima Paint’s trade sale accounts. Further, F&C promised to make no trade sales of paint in the existing sales territory or to any of its current customers. F&C also appended to the agreement lists of its customers whose patronage was taken over by Prima Paint. For its part, Prima agreed to pay certain percentages of all its receipts, such payments not to exceed a maximum amount of $225,000 over the life of the agreement. Approximately one year later, on October 1, 1965, the first payment under the consulting agreement was due from Prima to F&C. Rather than make payment, Prima first notified the attorneys for F&C that in various respects F&C had breached the consulting agreement and then made the first payment to an escrowee under protest. The principal allegation was that F&C had fraudulently represented that it was solvent, whereas, in fact, it was insolvent and had intended to file a voluntary petition in bankruptcy shortly after the execution of the consulting agreement. Prima’s contention was that had it known of this fact of insolvency, it would never have entered into this transaction at all. That is, were it not for this fraudulent misrepresentation, it would not have consummated “the business deal.”

At this juncture, let us assume for a moment that the consulting agreement did not contain any provision for arbitration. There is little doubt, that absent an arbitration clause, if the parties had desired, they could have submitted this pending dispute over fraudulent inducement to an arbitrator and his final and binding determination would have been as effective as any voluntary settlement between disputants.

Instead, there already was an arbitration clause in the consulting agreement which recited “any controversy or claim arising out of or relating to this agreement shall be settled by arbitration.” Ignoring the arbitration clause,

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7 One week after the consulting agreement was entered into, F&C filed a voluntary petition in the U.S. District Court for the District of New Jersey under the provisions of Chapter XI of the Bankruptcy Act.
Prima Paint brought an action to rescind the entire consulting agreement on the ground of fraud. F&C moved to stay Prima Paint's lawsuit for rescission pending arbitration of the fraud issue raised by Prima. The district court and the Second Circuit Court of Appeals granted the stay of the lawsuit holding as a matter of national substantive law that an arbitration clause contained in a contract evidencing a transaction in commerce is separate from the rest of the contract and, therefore, allegations which go to the validity of the principal contract as opposed to the arbitration clause itself are properly matters to be decided by the arbitrator rather than the court.

In affirming, Prima holds that parties are permitted to agree in advance of a dispute over misrepresentation that this issue may be submitted to arbitration. Nor is this permission lightly granted. What is required is contractual language which clearly shows an intent to arbitrate rather than litigate what is otherwise a "legal issue," namely fraud. Honoring this voluntary agreement to arbitrate future questions of fraud is no more than upholding the principle of freedom of contract.

Once it is conceded that parties may provide by contract to arbitrate fraud in the inducement disputes, the question of appropriate contractual intent arises. This requires an examination of the arbitration clause.

**The Arbitration Clause**

The contractual language by which the parties manifested their intent to have issues of fraud arbitrated read:

Any controversy or claim arising out of or relating to this agreement, or the breach thereof, shall be settled by arbitration in the City of New York in accordance with the rules then obtaining of the American Arbitration Association. . . .

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8 The complaint neither sought nor alleged any damages, but asked only for a judgment that the agreement be rescinded.


The Court characterized this arbitration agreement as one which was "easily broad enough" 12 to encompass disputes allegedly procured by fraud.

This wording is the "Standard Arbitration Clause" 13 recommended by the AAA for insertion in all commercial contracts and was specifically designed for use by parties desiring maximum assurance that any later-arising dispute be adjudicated in the arbitral forum.

Acknowledging the intent accorded this all-embracing arbitration clause was merely a reaffirmation of every prior court decision in this field of arbitration law. Indeed, several courts have even used this clause as establishing clear guidelines for attorneys to use in framing appropriate language which would avoid disputes over its meaning. For instance, in In re Kinoshita & Co., 14 it was noted in passing upon another arbitration agreement:

Had the parties used the standard clause recommended by the American Arbitration Association and widely used, the arbitration agreement would clearly have been sufficiently broad to cover a dispute over fraudulent inducement. ... 15

In addition to the Kinoshita case previously cited, another recent illustration was a clause found in a construction contract which limited arbitration to "any question of fact." 16 Once again, the court made special reference to the fact that the parties had not utilized the broad language suggested by the AAA, and therefore intended to limit the issues that the arbitrator could properly decide.

The Court's ruling concerning the interpretation accorded the "broad arbitration clause" will undoubtedly ease the task of counsel in drafting future commercial contracts. Utilization of the standard language will eliminate any doubt over what is to be arbitrated. All disagreements, of

12 Id. at 406.
13 See P. KELLOE, AMERICAN ARBITRATION 231 (1948).
14 287 F.2d 951 (2d Cir. 1961).
15 Id. at 953.
any nature whatsoever, whether based on tortious conduct or contractual breaches, shall be heard by the arbitrator.

Henceforth, parties desiring to exclude certain questions from arbitration will not use the broad clause. Where it is the intent of businessmen to exclude from the arbitral forum "legal issues" relating to the contract, they may so provide in their arbitration clause.

**Separability**

The essential point that makes this broad jurisdiction of the arbitrator possible is the ruling that the arbitration clause is separable.17

Prima was a Maryland corporation, F&C a New Jersey company, and the agreement provided for arbitration in New York. The state law of all three of these states18 enforced valid agreements to arbitrate future disputes so that it was immaterial whether Section 2 of the Federal Act or the appropriate state law applied. The result would have been the same.

The issue in Prima was therefore not directly concerned with enforceability, but rather with "whether the arbitration clause in a contract induced by fraud is 'separable'." 19

As a matter of national substantive law, it is now abundantly clear that an arbitration clause providing that "any controversy or claim arising out of or relating to this agreement, or the breach thereof . . ." is "separable" from the rest of the contract so that allegations toward the validity of the main contract as opposed to the arbitration agreement are to be decided by the arbitrator.

Once again, the "policy" ruling that the promise to arbitrate may be considered separately from the principal

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17 For a treatment of this subject, see Nussbaum, The "Separability Doctrine" in American and Foreign Arbitration, 17 N.Y.U.L.Q. Rev. 609 (1940).

18 See, e.g., N.Y. CIV. PRAC. § 7501; N.J. REV. STAT. § 2A: 24-1 (1951); Md. ANN. CODE art. 7, § 1 (1957).

19 Realistically, however, there is very little difference because one would not reach the question of separability unless the arbitration agreement was enforceable.
contract in which it is "embedded" becomes paramount. For if the Court had decided otherwise, an allegation that the entire transaction was fraudulently induced would have meant that the arbitration provision necessarily falls with the rest of the contract. A prime illustration exists in this case where Prima sought rescission of the whole transaction. If it merely would have commenced an action for damages based on the alleged fraud, this would have had the effect of affirming the principal contract, including the arbitration clause, if the latter was considered inseparable.

Conversely, where the arbitration clause is viewed as separable, the objection is avoided, since no taint attaches to the arbitrator's contractual power under the arbitration clause, unless that clause itself is alleged to be fraudulently induced.

Proof that the arbitration agreement is separable from the principal agreement is drawn from Section 4 of the Federal Arbitration Act.20 Under this section, so long as a matter is properly before the jurisdiction of the federal court, the federal court must order arbitration to proceed if it is "satisfied that the making of the agreement for arbitration is not in issue." This language provides a remedy obtainable in federal courts when a party is aggrieved by the alleged failure, neglect or refusal of another to arbitrate under a written agreement of arbitration. Further, the federal court is limited at the hearing to a determination of whether an agreement for arbitration has been made and has not been honored. Once satisfied on these two points, it has no choice but to order arbitration to proceed.

20 Section 4 reads in part:
The court shall hear the parties, and upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement . . . . If the making of the arbitration agreement, or the failure, neglect, or refusal to perform the same be in issue, the court shall proceed summarily to the trial thereof. . . . 9 U.S.C. § 4 (1964),
It is perhaps significant to note that neither New Jersey nor Maryland nor any other state with a modern arbitration law—with the possible exception of New York—has formulated a rule of "non-separability."

In the final analysis, for those states which have not enacted modern legislation enforcing future dispute arbitration clauses, the issue of the separate arbitration clause is not likely to arise; for if the promise to arbitrate is itself not specifically enforceable, it is difficult to imagine how the question of separability would even be reached under state law. In the twenty-three jurisdictions that have enacted such legislation the state courts can take comfort in the fact that there is no strong public policy against an arbitrator being permitted to decide issues of fraudulent inducement of the contract. No state anywhere in the United States has a statute codifying a rule of non-separability. (There is no state statute to the contrary). Indeed, the state courts now have the benefit of clear precedent by the highest judicial tribunal establishing a separability rule. This ruling will undoubtedly carry persuasive weight that may be followed when and if state judges are called upon to interpret their own local arbitration laws.

The present state of the law in New York is, admittedly, uncertain. The confusion stems from an "assumption" on the part of jurists that arbitration clauses in New York are not separable from the contracts in which they are contained. Nevertheless, the issue has not been squarely faced by the New York Court of Appeals. It is submitted that the Prima Paint decision paves the way for a "fresh look" at the New York law and a possible re-evaluation of its past policy which, conscious or otherwise,

21 There are 23 states with such statutes. They are: Arizona, California, Connecticut, Florida, Hawaii, Illinois, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, New Hampshire, New Jersey, New York, Ohio, Oregon, Pennsylvania, Rhode Island, Texas, Washington, Wisconsin, Wyoming.

avoided fashioning a separability rule. 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. For in *Exercycle*, the Court ordered arbitration although the complainant alleged the main contract was void for lack of mutuality. 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.

It would also be a strange result if New York followed a non-separability rule based on the language of its arbitration act, since it was in fact the same law which was later enacted by Congress and presently embodied in the United States Arbitration Act. Since the federal act follows the pattern of the New York law and incorporates the language of the same draftsmen, the meaning of the same terms now ruled upon by the Supreme Court should be of significance to the New York courts.

Even if it be assumed that the judicial interpretation of New York law is that arbitration clauses are not separable, this rule may be easily overturned even though technically not "pre-empted" where interstate commerce is evidenced.

**NATURE OF RELIEF SOUGHT — RESCISSION**

Another primary consequence of the separability view is that it once and for all disposes of the rescission or "red herring" argument which couches itself in the nature of the relief sought. Some commentators and jurists had

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26 Although New York amended its Arbitration Statute (CPLR 7501) so that it no longer contains the words "valid, enforceable and irrevocable," no difference in result was intended by the New York legislature. See 8 WEINSTEIN, KORN & MILLER, NEW YORK CIVIL PRACTICE 7501.03 (1967).
previously attempted to establish artificial guidelines as to when a court or an arbitrator could decide fraud. Court decisions in New York\textsuperscript{27} may be found which hold that fraudulent inducement is arbitrable where the plaintiff seeks damages but is a question for the court if rescissional relief is sought. Such a distinction is artificial and in any event denies any weight to the parties’ contractual intent. This view undoubtedly resulted from the unexplained determination that arbitration clauses were not separable from the principal contracts. As rescission was the relief requested by \textit{Prima}, the Court’s result proves that under the separable arbitration agreement view, the rescission argument amounts to nought.

\textbf{THE FEDERAL ARBITRATION ACT}

The first four sections of the Federal Arbitration Act were given careful scrutiny by the Court. In so doing, the opinion renders valuable insight into a clear understanding of the appropriate scope to be accorded the Federal Arbitration Act. First, it points out that section 1 is meant both to define the areas of “maritime” transactions and “commerce” and to limit the applicable contracts to which the act applies.\textsuperscript{28}

Perhaps it is too obvious to mention, but the primary requirement calls for the principal contract, not the arbitration agreement, to evidence a transaction involving interstate commerce. This test was clearly enunciated by the Court when it recited that “[o]ur first question . . . is whether the \textit{consulting agreement} between F&C and Prima Paint” evidences a transaction in interstate commerce.\textsuperscript{29} The main contract was then analyzed in reaching the conclusion on commerce. Once having determined that the principal contract in question was within the coverage of

\textsuperscript{27} An excellent survey will be found in 42 Wash. L. Rev. 621, 626-29 (1967).
\textsuperscript{28} 388 U.S. 395, 400 n.4 (1967).
\textsuperscript{29} Id. at 401 (emphasis added).
the Arbitration Act, the Court then analyzed the language of the arbitration agreement.

This is perhaps a unique situation in that the contract used to meet the "commerce requirement" test is the same agreement which the Court is not permitted to interpret. For, if the principal contract does reflect an interstate commerce element, then under the broad-type separate arbitration clause, the arbitrator rather than the federal court will determine the principal agreement's validity.

At this juncture, it might be wise to determine what contracts are governed by the Federal Arbitration Act of 1925, for it is only contracts within the scope of this law that the Court addresses itself to in Prima. Certain categories of contracts, namely those "in which one of the parties characteristically has little bargaining power"\(^3\) are expressly excluded, said the Court, from the reach of the Act. This latter point while mentioned only in passing in a footnote will probably become as famous as another Supreme Court footnote where it was held that arbitrability is for the courts.\(^3\) For here we have an inkling of the Court's feeling on arbitration. On the one hand, the holding in Prima Paint sets a general policy rule that federal courts will give effect to the intention of the parties to a contract that all their disputes shall be settled by arbitration. But, in so doing, the Court reflects the view that the contract involved should be one in which "arms length negotiations" have preceded the promise to arbitrate. In other words, where parties are of equal bargaining power, giving an arbitrator the power to rescind because of fraud is not objectionable. In this case Prima and F&C, both represented by counsel, freely and voluntarily negotiated the terms of the consulting agreement and the arbitration clause.

Whether or not the holding in Prima will be applied to form contracts or other agreements where there is usually

\(^3\) Id. at 402-03 n.9.

\(^3\) United Steelworkers of America v. Warrior & Gulf Navigation Co., 363 U.S. 574, 583 n.7 (1960).
a disparity in economic power is not clear. For instance, insurance policies, employment contracts, construction agreements and shipping forms have been recognized as routinely containing arbitration clauses without any choice available to one party. Under these transactions, it is difficult to say that the promise to arbitrate was the result of equality in negotiations. Future judicial interpretation will be needed before a definitive list of the types of contracts which the Federal Act excludes in section 1 can be compiled. Even so, it is doubtful in today's economic and social climate, coupled with the urban calendar congestion plaguing trial and appellate courts, whether significant value can be placed upon the "take-it-or-leave-it contract" theory. Indeed, it could be argued today that the "poor employees" or the unsuspecting policyholder of an insurance contract might prefer this faster mode of arbitration were he given his choice. "Overprotection" based on legal technicality may prove to his detriment.

Next, the Court interpreted the meaning of the "heart" of the modern Federal Arbitration Act—section 2 which provides that "[a] written provision in . . . a contract involving commerce to settle by arbitration a controversy thereafter arising out of such contract . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exists at law or in equity for this revocation of any contract." It is this section of the law which in fact overrules the common-law hostility toward arbitration so as to avail the benefits of arbitration to the business community. While arbitration agreements historically were "valid" in the sense that parties could agree to arbitrate, they were revocable

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32 Hearing on §4213 and §4214 before a Subcommittee of the Committee on the Judiciary of the United States Senate, 67th Cong., 4th Sess., at 9-11. Senator Walsh: "The trouble about the matter is that a great many of these contracts that are entered into are not voluntary things at all. Take an insurance policy. . . . You can take it or leave it. . . ." Mr. Piatt: "[B]ut it is not the intention of this bill to cover that kind of case." Id. at 9.

33 There are many different types of contracts for which arbitration is used. See M. Domke, Commercial Arbitration ch. 13 (1960).

at the will of either party prior to the award and completely unenforceable.

In other words, prior to the enactment of section 2, contracts to arbitrate were treated in a discriminatory fashion. Any other contractual promise was enforceable at law or in equity but not an arbitration contract. Section 2 merely carries out the Congressional intent to remove arbitration contracts from second class status and to place them in a "separate but equal" ground with all other contracts. As a matter of national substantive law, arbitration agreements were made, by section 2, as enforceable "as other contracts, but not more so." 35

To insure that arbitration clauses are placed upon the same footing as other contracts, Congress specifically placed the "saving clause" 36 in section 2 so that if the contract to arbitrate is itself invalid or revocable then the federal courts have the authority to invalidate it just as they could any other contract in which there were grounds "at law or in equity" to be revoked.

Prima makes clear that if fraud is alleged toward the arbitration clause, then the federal court shall preliminarily proceed to a trial on this issue. There is no doubt that section 2 assumes the existence of a valid contract to arbitrate. Together with sections 3 and 4 Congress has furnished safeguards so that a person fraudulently induced to sign an arbitration clause is guaranteed the right to submit this legal issue to the federal court for determination.

Nor is it difficult to envision what kinds of issues raised by allegations of fraudulent inducement of an arbitration clause a court will decide under the Prima holding. All the complaint need allege is fraud relating to the arbitration provision rather than to the principal agreement. An example of such an allegation was given in the prior Supreme Court decision of Moseley v. Electronic & Missile Facilities. 37 Here, it was alleged that the aggrieved party

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36 Id.
to the arbitration agreement was deliberately defrauded into arbitrating in another state so that the wrongdoer could make unreasonable demands in the hope that the extra expense and inconvenience of having to travel from Georgia to New York would induce yielding to such demands. The Court held that such an allegation charged fraud as to the arbitration clause itself and remanded to the district court for a determination of that issue before arbitration could be compelled under section 3.

The Court in *Prima* then proceeded to give its explanation of sections 3 and 4 of the Federal Act:

Section 3 requires a federal court in which suit has been brought "upon any issue referable to arbitration under an agreement in writing for such arbitration" to stay the court action pending arbitration once it is satisfied that the issue is arbitrable under the agreement. Section 4 provides a federal remedy for a party "aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement of arbitration," and directs the federal court to order arbitration once it is satisfied that an agreement for arbitration has been made and has not been honored.\(^\text{38}\)

Under the facts of this case, F&C brought on the arbitration not by a section 4 petition to compel arbitration, but rather by merely serving a Demand for Arbitration\(^\text{39}\) under the Commercial Arbitration Rules of the AAA. Thereafter, Prima instituted an action in the federal district court seeking a judgment that the consulting agreement be rescinded. Contemporaneously with the institution of the action, Prima sought to enjoin F&C from proceeding with the arbitration filed with AAA.

The manner in which the parties proceeded is interesting if for no other reason than that neither of them availed himself of the applicable section 4 remedies offered by the statute. (There is no procedure under the Act by which

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\(^{38}\) 388 U.S. 395, 400 (1967).

\(^{39}\) According to §7(a) of the Commercial Arbitration Rules of the American Arbitration Association, arbitration under an arbitration provision in a contract may be initiated in the following manner: “The initiating party may give notice to the other party of his intention to arbitrate (Demand), which notice shall contain a statement setting forth the nature of the dispute, the amount involved, if any, [and] the remedy sought...”
to enjoin arbitration—the remedy pursued by Prima; it was not until Prima moved to enjoin arbitration that F&C cross-moved for an order to stay the federal rescission action instituted by Prima—presumably under section 3.)

This order of proceedings is of further significance because it helps one to understand the Court's explanation of how federal district courts are to deal with future applications to compel arbitration, stay arbitration or stay a court proceeding pending arbitration. Most obvious is the fact that the federal law recognizes two methods of commencing arbitration, either by filing a notice of intention to arbitrate or by a section 4 motion to compel arbitration.

It follows that since a party to an interstate contract may initiate arbitration without a court order, a procedure should be available to stay that arbitration where valid grounds exist. This procedure although not specifically stated in either sections 3 or 4 of the Act was exactly the course pursued by Prima when it sought to enjoin arbitration.

Likewise, the Court recognizes that a party may commence a litigation in violation of the promise to arbitrate, and realizes that section 3 permits the district court to stay the trial of that action until arbitration has been had in accordance with the terms of the arbitration agreement.

Where a party commences arbitration under section 4, (which did not occur here) the court, "upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, must make an order directing the parties to arbitrate." Section 4 allows no choice to the federal district judge. He has now been instructed to order arbitration to proceed. This mandatory direction to the federal courts is found only in section 4. The question then arises as to whether the district court is so compelled to order arbitration under a section 3 request

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40 The Federal Arbitration Act has no specific section containing a motion to stay arbitration. The New York Arbitration Statute has CPLR § 7503(b) entitled "Application to stay arbitration."

to stay a pending lawsuit. In the clearest possible language Prima states:

Section 4 does not expressly relate to situations like the present in which a stay is sought of a federal action in order that arbitration may proceed. But it is inconceivable that Congress intended the rule to differ depending upon which party to the arbitration agreement first invokes the assistance of a federal court. We hold, therefore, that in passing upon a § 3 application for a stay while the parties arbitrate, a federal court may consider only issues relating to the making and performance of the agreement to arbitrate.42

The Prima decision would thus appear to be dispositive of any questions as to the Arbitration Act's application to interstate transactions, just as Bernhardt v. Polygraphic Co. of America43 disposed of intrastate dealings. Not only do section 3 applications fall within the kind of contracts specified by sections 1 and 2 of the Act, but also section 4 applications are similarly treated.

Although not discussed in the case, there is little doubt that federal law will also have to be fashioned upon other sections of the Act. For instance, section 5 provides a procedure for the district court to appoint arbitrators where the parties are unable to agree. In at least one state with a modern arbitration law, namely Illinois,44 the rule is to the contrary. In this state, if the parties fail to agree on arbitrators, "the entire arbitration agreement shall terminate." Only future judicial clarification will tell whether section 5 is of sufficient substance to prevail over a "contrary state rule." The choice once again will be to enforce

42 388 U.S. 395, 404 (1967).
   If the arbitration agreement provides a method of appointment of arbitrators, this method shall be followed. In the absence thereof, any method of appointment of arbitrators agreed upon by the parties to the contract shall be followed. An arbitrator so appointed has all the powers of one specifically named in the agreement. When an arbitrator appointed fails or is unable to act, his successor shall be appointed in the same manner as the original appointment. If the method of appointment of arbitrators is not specified in the agreement and cannot be agreed upon by the parties, the entire arbitration agreement shall terminate.
arbitration by relying on federal law or to deny arbitration because of the conflicting state law.

Likewise, there are other important sections of the Federal Act which seem “procedural” at first glance, but will upon reflection require fashioning of federal policy. Sections 9, 10 and 11, for example, provide specified grounds for confirming, vacating or modifying awards. While most state laws are similar, there are some differences and several states have additional or other grounds. Here again, the appropriate law to be applied may conceivably affect the result.

CONSTITUTIONAL PROBLEMS

The first realization of constitutional problems caused by the Federal Arbitration Act came to light in Bernhardt v. Polygraphic Co. of America where the Supreme Court avoided the need of resolving any constitutional problems by holding the Act inapplicable to a diversity of citizenship case involving only an intrastate contract. In this case, however, the Court decided that enforcement of arbitration agreements is “outcome determinative” for Erie purposes and, therefore, the federal courts would be bound to follow state law. The stage was thus set for the drama that unfolded when F&C entered into its consulting agreement with Prima. For as already noted, unless the arbitration agreement was viewed as separable, Prima would have had a trial on the issue of fraud in the inducement. Briefly, the issue was whether the Federal Arbitration Act promulgated 13 years prior to Erie v. Tompkins could be constitutionally applied in a diversity case even though

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45 Pennsylvania, for example, provides, in addition to the standard grounds for modification of awards that “[i]n either of the following cases the court shall make an order modifying or correcting the award upon the application of any party to the arbitration . . . (d) where the award is against the law, and is such that had it been a verdict of the jury the court would have entered different or other judgment notwithstanding the verdict.” Pa. Stat. Ann. tit. 5, § 171 (1963).

46 350 U.S. 198, 202, 208 (1956). “Erie v. Tompkins indicated that Congress does not have the constitutional authority to make the law that is applicable to controversies in diversity of citizenship cases.” Id. at 202.
such an interpretation might mean that the federal court result would be different from that of a state court "across the street." By characterizing the United States Arbitration Act as being "based upon and confined to the incontestable federal foundation of control over interstate commerce and over admiralty" the Supreme Court has avoided the "constitutional problem" left open by the Bernhardt decision. The confusion oft-discussed by commentators and court decisions has finally been resolved. There should no longer be any doubt that Congress prescribed federal substantive law governing an arbitration agreement where this separate provision to arbitrate is embedded in a contract which itself evidences a transaction in commerce. This rule comes about not because Congress was trying to promulgate substantive rules for diversity situations, but rather because Congress was prescribing "how federal courts are to conduct themselves with respect to subject matter over which Congress plainly has power to legislate." Thus in one brief passage the constitutional dilemma has been dispelled.

**Differences Between Lawrence and Prima**

It should not come as a surprise that the Act itself was founded upon Congress' constitutional power to enact legislation creating substantive law for interstate commerce and maritime transactions. The second circuit in Lawrence v. Devonshire Fabrics, had similarly resolved the constitutional argument propounded by Erie and Bernhardt some five years before F&C and Prima ever thought of signing their deal. What may be of import, however, is the acknowledged statement by Justice Fortas that the result

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50 271 F.2d 402 (2d Cir. 1959).
in *Prima* although the same as in *Lawrence* was concluded "for somewhat different reasons." Let us compare the results and the "reasons," and attempt to analyze what possible differences there are and what effect, if any, they will have on future arbitration law.

To begin with, both decisions disposed of the constitutional issue by finding the Federal Act based on Congress' power to enact substantive law governing interstate commerce. Judge Medina reinforced this finding for three basic reasons: 1) "Because the exclusion of diversity cases would emasculate the federal arbitration act," 2) he found a "reasonably clear legislative intent to create a new body of federal substantive law . . ." and 3) doubts as to the construction of the Act ought to be reached in line with its liberal policy of promoting arbitration. Thus, the rationalization in *Lawrence* was primarily based on "policy" type reasoning rather than specific language. Not so with Justice Fortas' opinion. Instead, *Prima* employs definite statements in finding the congressional purpose and constitutional base—"[t]here 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." Policy decisions cannot be gleaned from this language. It is directly relegating to a back seat that rule of *Erie* in favor of the commerce clause.

Secondly, in *Lawrence* the second circuit buttressed the separable arbitration clause argument on section 2 of the Act, the section which makes arbitration agreements "valid, irrevocable and enforceable." It stated that "§ 2 does not purport to affect the contract as a whole" and relied in addition upon "other pertinent considerations [such as the fact that] historically arbitration clauses

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51 The court actually said "We agree [with the Robert Lawrence opinion] albeit for somewhat different reasons . . ." 388 U.S. 395, 400 (1967).
52 271 F.2d at 404 (emphasis added).
53 *Id.* at 406 (emphasis added).
54 *Id.* at 410.
55 388 U.S. at 405.
56 271 F.2d at 409-10.
were treated as separable parts of the contract." In *Prima*, the Supreme Court found that Congress provided an "explicit answer" on separability from section 4 of the Act. However, on this point it needed the assistance of implied language and the reminder of the congressional purpose behind voluntary arbitration.

Third, Judge Medina gave sweeping effect to the scope of the Act by talking more in terms of its overall scheme. He constantly referred to the Act as creating national substantive law. Not so with Justice Fortas. It seems apparent that the latter's words were chosen with extreme care. For instance, it is not by chance that he talks of a "rule" of separability being a matter of national substantive law which "governs even in the face of a contrary state rule" and that this "rule" is constitutionally permissible and that federal courts are bound to follow "rules" enacted by Congress. It is almost as if the Supreme Court was "straining" to arrive at the *Lawrence* result in a manner calculated to "out do" and "tighten up" the judicial legislative reasoning employed by the second circuit.

In any event, so far as permitting an arbitrator to decide fraud by finding that Congress made arbitration agreements separable, there is no significant difference in the result. The fact that the reasoning is "somewhat different" certainly is of no importance to either F&C or Prima or the legal practitioners who have to worry about drafting future arbitration agreements.

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57 Id. at 410.
58 388 U.S. at 403.
59 Id.
60 Id. at 404.
61 271 F.2d at 404.
62 Justice Fortas' opinion is unique in that he relies heavily on the statutory provisions of the Federal Arbitration Act as establishing control over the arbitration procedure in the federal courts in order to justify the separability doctrine. In *Lawrence*, Judge Medina begins by establishing that the Arbitration Act was designated as a substantive national law governing even in the face of a contrary state rule.
MUST STATE COURTS FOLLOW THE FEDERAL RULE?

Why then did the Court attempt to distinguish its reasons from those advanced by Judge Medina? Was the concurring opinion by Mr. Justice Harlan merely designed to express a feeling that the policy reasons advanced by Judge Medina were sufficient to arrive at the result that the Act created national substantive law? Of course this is a possibility. It is conceivable, however, that the Prima opinion took a narrower tack for another "reason." It is unlikely that the Supreme Court would trouble itself with new language for vain reasons. Its purpose probably was to more clearly enunciate the national substantive law. Lawrence stated that the body of federal law fashioned by federal courts under the Arbitration Act "is equally applicable in state or federal courts." 63 But Prima does not hold that the national substantive law of separability is required to be applied by state courts where the requisite federal court jurisdiction is lacking.

While it is true that this issue was not essential for the Court to decide the case before it, 64 and, therefore, may still be an open question, the language employed by Prima, permits one to conjecture that the Supreme Court intentionally remained silent on this issue of "preemption" over state courts.

Thus, the Prima opinion goes to great pains to emphasize that national law on separability is mandatory for federal courts to follow. The decision is replete with such references: "the case presents a question of whether a federal court resolves claims of fraud"; "§ 3 motions require federal courts to stay court actions"; "§ 4 directs a federal court to order arbitration"; "with respect to cases in federal courts Congress has provided explicit answers"; "matters in federal courts save for the existence of the arbitration clause"; "the federal court is instructed as to what to do"; "statutory language does not permit federal courts

63 271 F.2d at 407.
to consider claims of fraud as to the contract generally”; “the case is in federal court solely by reason of diversity”; “Congress may prescribe how federal courts are to conduct themselves with respect to subject matter”; “federal courts are bound to apply rules enacted by Congress.” This constant reiteration of “federal courts” must have been used to acknowledge the fact that “over and over again” the drafters of the Federal Act referred to the establishment of a procedure in the federal courts. By this language, it is possible that the Court is saying that the intent of Congress was to only have federal courts enforce separable arbitration agreements whenever the main contract involves interstate commerce. This would explain the constant reference to “federal courts” in the opinion while most appropriately following the actual legislative intent of Congress in 1925.

However, the Court’s failure to hold that state courts must apply a rule of separability where the principal contract evidences a transaction in commerce does not necessarily mean that state courts will fashion a contrary rule. To begin with, it is likely that most state courts will be inclined to follow the federal rule voluntarily because to do otherwise might give rise to “forum shopping”—a practice that state courts have no desire to encourage. If this latter conflict arises, surely a state court is capable of weighing the interests of its citizens against the countervailing considerations of uniformity of results in interstate commerce. For a discussion of policy considerations as to why the preemption doctrine need not apply, see, for example, Note, Commercial Arbitration in the Federal Courts, 20 Vand. L. Rev. 607 (1967); Note, Scope of the United States Arbitration Act in Commercial Arbitration: Problems in Federalism, 58 Nw. U.L. Rev. 468 (1963).
CONCLUSION

Concluding that the Federal Arbitration Act created national substantive law upholds the Congressional purpose of enforcing arbitration agreements so commonplace among commercial transactions in interstate commerce and admiralty. The concept of a "separate" arbitration clause enables businessmen to have all their controversies determined by commercial experts where a clear intent is so expressed.

Congress recognized years ago that parties are entitled to agree, should they so desire, that an arbitrator may decide whether one of the parties was induced by fraud to enter into the overall business deal. The Supreme Court has merely affirmed that the judicial hostility toward arbitration eliminated by Congress is truly an anachronism of the past and shall remain relegated to history. Although it is not certain whether state courts will apply similar rules to arbitration agreements where no federal court jurisdiction is possible, the Prima case makes it uniquely difficult for a state court to construe it any other way.

As untold numbers of transactions involve interstate commerce, business firms will be able to provide for arbitration without fear of dilatory tactics to frustrate reaching the arbitrator promptly.66 This decision is undoubtedly going to further the independent forum of arbitration of commercial disputes much the same way that labor disputes have been freed from litigation. Although it has been a long time in coming and despite several attempts to thwart this result, arbitration promises, by federal law, are placed on an equal footing with all other contractual promises. The voluntary choice of providing for this method of dispute settlement now rests with the business community.