

# Scope of Arbitration Clauses in Commercial Contracts

St. John's Law Review

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## Recommended Citation

St. John's Law Review (1960) "Scope of Arbitration Clauses in Commercial Contracts," *St. John's Law Review*: Vol. 34 : No. 2 , Article 3.  
Available at: <https://scholarship.law.stjohns.edu/lawreview/vol34/iss2/3>

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*Conclusion*

The attempts to avoid conflict between federal and state judiciaries have been responsible for a disproportionate amount of litigation. It may well be one of the prices that must be paid for our rather unique form of government; on the other hand, it may be nothing more than the price that must be paid when a desirable end is sought to be attained through diverse and incongruous means. Congressional abnegation is undoubtedly responsible in at least a small way. This is not to say that the courts should abdicate their functions, but if the judges are going to base their decisions on the "intent" of Congress, that intent should be manifested as explicitly and, when necessary, as often as possible.

Congress has seemingly risen to the occasion with the Landrum-Griffin Act. It is only urged that, if clarification of this legislation is necessary, and it seems upon analysis that clarification *will* be necessary, Congress again rise to the occasion and express such clarification.



## SCOPE OF ARBITRATION CLAUSES IN COMMERCIAL CONTRACTS

*Introduction*

One of the most perplexing problems presented by a commercial arbitration clause is the scope of its applicability. The scope of the agreement will be discussed with respect to the type of agreement used and to the conflict of laws' difficulties presented by the choice of forum. This latter point will be limited to a consideration of the Federal Arbitration Act of 1925<sup>1</sup> and the New York Arbitration Act of 1920.<sup>2</sup> An attempt will be made to discover the boundaries of such agreements within the confines of the law and within the agreement itself. This article will consider that problem as it appears in a "future disputes" agreement, which is generally incorporated into the primary contract,<sup>3</sup> rather than in a submission which is a post-

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<sup>1</sup> U.S.C. §§ 1-14 (1958). The Federal Act as originally enacted made "future disputes" agreements valid, irrevocable and enforceable. 43 Stat. 883 (1925).

<sup>2</sup> N.Y. CIV. PRAC. ACT §§ 1448-69. The New York Act was amended in 1937 to provide that "future disputes" agreements were valid, enforceable and irrevocable. N.Y. Sess. Laws 1937, ch. 341, at 882.

<sup>3</sup> AMERICAN ARBITRATION ASSOCIATION, COMMERCIAL ARBITRATION RULES 2 (1954). A standard "future disputes" arbitration agreement supplied by the American Arbitration Association is as follows:

dispute agreement.<sup>4</sup> This limitation is imposed because "future disputes" agreements, which are widely employed today, present the greater problem in the area of arbitration insofar as they lack the definitiveness that ordinarily characterizes the presently existing controversy of a submission agreement.

### *Background*

Until fairly recent times the submission agreements were almost totally ineffective because of the quality of revocability which had been attached to them.<sup>5</sup> Likewise the more recent "future disputes" agreements were almost totally disregarded because they permitted parties to agree to arbitrate controversies which might develop after the contract was made. In part, this unfavorable attitude, specifically towards submission agreements, dates back to a dictum of Lord Coke in 1609, which expresses the inherent revocability of the authority given to an arbitrator.<sup>6</sup> In the 18th century a jealous desire to preserve judicial jurisdiction generated the much-abused policy basis of non-enforcement of arbitration agreements.<sup>7</sup> "Ouster of the courts' jurisdiction" became the prevalent basis in place of what were, at least, plausible contract and agency principles.<sup>8</sup>

This doctrine of revocability and non-enforcement became so imbedded in the common law that only legislative enactment could effectively correct it.<sup>9</sup> The first significant legislative effort was made

"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 of the American Arbitration Association, and judgment upon the award rendered by the Arbitrator(s) may be entered in any Court having jurisdiction thereof." *Ibid.*

<sup>4</sup> AMERICAN ARBITRATION ASSOCIATION, COMMERCIAL ARBITRATION RULES 2 (1954). A standard submission of existing disputes agreement is as follows:

"We, the undersigned parties, hereby agree to submit to arbitration under the Commercial Arbitration Rules of the American Arbitration Association the following controversy: (cite briefly). We further agree that the above controversy be submitted to (one) (three) Arbitrators selected from the panels of Arbitrators of the American Arbitration Association. We further agree that we will faithfully observe this agreement and the Rules and that we will abide by and perform any award rendered by the Arbitrator(s) and that a judgment of the Court having jurisdiction may be entered upon the award." *Ibid.*

<sup>5</sup> *Kulukundis Shipping Co. v. Amtorg Trading Corp.*, 126 F.2d 978, 982-83 (2d Cir. 1942). See Sayre, *Development of Commercial Arbitration Law*, 37 YALE L.J. 595, 598-605 (1928).

<sup>6</sup> *Kulukundis Shipping Co. v. Amtorg Trading Corp.*, *supra* note 5, at 982. See Sayre, *supra* note 5, at 598-602.

<sup>7</sup> *Kulukundis Shipping Co. v. Amtorg Trading Corp.*, *supra* note 5, at 983.

<sup>8</sup> See Sayre, *supra* note 5, at 603-04.

<sup>9</sup> H.R. Rep. No. 96, 68th Cong., 1st Sess. (1925), as cited in *Kulukundis Shipping Co. v. Amtorg Trading Corp.*, *supra* note 5, at 985. Part of the report reads:

in England in 1889.<sup>10</sup> This statute provided that submission agreements could be irrevocable, but specifically reserved for judicial review questions of law arising in the arbitration proceeding.<sup>11</sup>

Prior to the New York enactment in 1920, which was the first arbitration statute in the United States,<sup>12</sup> the courts followed the English common law as a matter of course.<sup>13</sup> However, there had been some lower federal court criticism of continuing a policy of non-enforcement of submission agreements during this period.<sup>14</sup> The severest criticism appears in a House of Representatives Committee Report which was made prior to the enactment of the Federal Arbitration Act in 1925.<sup>15</sup> Here was an indication that the pendulum of thought was swiftly shifting in favor of at least submission agreements. It would be well to point out that although the New York and federal acts were some thirty years behind the English Act of 1889, they did not contain the reservation as to questions of law.<sup>16</sup>

A recent authority has summed up the maturity of arbitration law in these words:

The jealousy and suspicion with which the law was once apt to regard arbitration have been succeeded by an attitude of tolerance and benevolence. The legislature has intervened to implement arbitration agreements and to enable the force of judgments to be given to arbitration awards, and the judges have evinced a readiness to construe generously the powers given to arbitration by statute, and to overlook irregularities where no miscarriage of justice is in-

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"An arbitration agreement is placed upon the same footing as other contracts, where it belongs . . . This jealousy survived for so long a period that the principle became firmly imbedded in the English common law and was adopted with it by the American courts. The courts have felt that the precedent was too strongly fixed to be overturned without legislative enactment, although they have frequently criticized the rule and recognized its illogical nature and the injustice which results from it . . ."

<sup>10</sup> Arbitration Act, 1889, 52 & 53 Vict., c. 49. See Ellenbogen, *English Arbitration Practice*, 17 LAW & CONTEMP. PROB. 656, 658 (1952).

<sup>11</sup> Arbitration Act, 1889, 52 & 53 Vict., c. 49; *Kulukundis Shipping Co. v. Amtorg Trading Corp.*, 126 F.2d 978, 982 n.8 (2d Cir. 1942). The Uniform Arbitration Act was approved by the National Conference of Commissioners on Uniform State Laws in 1925. Like the English Act it provided that either party could petition the courts to determine questions of law. See WHITNEY, *MODERN COMMERCIAL PRACTICES* § 440, at 628 (1958).

<sup>12</sup> See *Kulukundis Shipping Co. v. Amtorg Trading Corp.*, *supra* note 11, at 984.

<sup>13</sup> *Ibid.*

<sup>14</sup> See, e.g., *Atlantic Fruit Co. v. Red Cross Line*, 276 Fed. 319 (S.D.N.Y. 1921), *aff'd*, 5 F.2d 218 (2d Cir. 1924); *United States Asphalt Refining Co. v. Trinidad Lake Petroleum Co.*, 222 Fed. 1006 (S.D.N.Y. 1915).

<sup>15</sup> H.R. Rep. No. 96, 68th Cong., 1st Sess. (1925), as cited in *Kulukundis Shipping Co. v. Amtorg Trading Corp.*, 126 F.2d 978, 985 (2d Cir. 1942). This report characterized the old attitude towards arbitration as "an anachronism of our American law."

<sup>16</sup> See Sayre, *Development of Commercial Arbitration Law*, 37 YALE L.J. 595, 613 (1928).

volved. Indeed, the judges have frequently expressed their reluctance to be invoked at all by a party to an arbitration agreement . . .<sup>17</sup>

*Incidents of the "Future Disputes" Agreement*

Whether the agreement takes the form which makes all controversies referable to the contract arbitrable or which specifically limits the arbitrable issues,<sup>18</sup> the legal relationship of the parties is definitively altered.

Under the usual type of statute the parties acquire the right to stay legal proceedings pending the arbitration.<sup>19</sup> Specific enforcement of the arbitration agreement is available<sup>20</sup> in addition to court appointment of arbitrators, where necessary.<sup>21</sup> As to outcome, the arbitration award has the effect and validity of a judgment of a court of competent jurisdiction.<sup>22</sup>

Besides these statutory incidents there are many others, peculiar to the arbitration process itself. In this process there is a lack of the benefit of judicial instruction on the law<sup>23</sup> which is compensated, in part, by the competency of a specialized arbitrator, who may be better equipped to unravel the oftentimes perplexing fact disputes of a commercial controversy.<sup>24</sup> Also, the procedure is less formal,<sup>25</sup> the rules of evidence<sup>26</sup> are liberalized and the strict judicial doctrines pertaining to burden of proof<sup>27</sup> and testimony under oath<sup>28</sup> are relaxed. Beneath these surface deficiencies, however, lie the desiderata of the arbitration process. The procedure is designed for facility

<sup>17</sup> See Ellenbogen, *English Arbitration Practice*, 17 LAW & CONTEMP. PROB. 656, 658 (1952).

<sup>18</sup> See KELLOR, *ARBITRATION IN ACTION* 69 (1941).

<sup>19</sup> See, e.g., 9 U.S.C. § 3 (1958); N.Y. CIV. PRAC. ACT § 1451.

<sup>20</sup> See, e.g., 9 U.S.C. § 4 (1958); N.Y. CIV. PRAC. ACT § 1450. The Uniform Arbitration Act contains no such direct provisions in this respect. Of greater importance, however, is the fact that its provisions relate only to submissions and thereby leave agreements to arbitrate "future disputes" unenforceable as they were at common law. See WHITNEY, *MODERN COMMERCIAL PRACTICES* § 440, at 628 (1958).

<sup>21</sup> See, e.g., 9 U.S.C. § 5 (1958); N.Y. CIV. PRAC. ACT § 1452.

<sup>22</sup> See, e.g., 9 U.S.C. § 13 (1958); N.Y. CIV. PRAC. ACT § 1465.

<sup>23</sup> See *Bernhardt v. Polygraphic Co. of America*, 350 U.S. 198, 203 (1956).

<sup>24</sup> See Mentschikoff, *The Significance of Arbitration—A Preliminary Inquiry*, 17 LAW & CONTEMP. PROB. 698, 701, 707 (1952).

<sup>25</sup> AMERICAN ARBITRATION ASSOCIATION, *A BUSINESSMAN'S GUIDE TO COMMERCIAL ARBITRATION* 11 (1958).

<sup>26</sup> *Ibid.*

<sup>27</sup> *Ibid.* In effect, there is no legal burden of proof. The normal procedure requires each party to the arbitration to present his complete case; the burden is actually on both.

<sup>28</sup> AMERICAN ARBITRATION ASSOCIATION, *STANDARDS FOR COMMERCIAL ARBITRATION* 5 (1951). Testimony under oath may be taken but under the arbitration rules this is entirely discretionary with the arbitrator(s).

and is geared to the particular case and parties.<sup>29</sup> Speed is an essential part of the process. Contrast the ordinary award which is rendered within a few weeks with the prolonged wait which is encountered when a case is placed on a congested court calendar.<sup>30</sup> Another favorable characteristic is inexpensiveness: ordinarily expert witnesses are not required, there are no jury fees, no court costs, no expensive stenographic records and no costly transcripts of record on appeal.<sup>31</sup> Finally, limited review<sup>32</sup> provides finality, which is so necessary in the commercial world.

### *Scope of the "Future Disputes" Agreement*

A "future disputes" agreement may be limited in scope by: (1) general contract principles, (2) legislative enactments and (3) the agreement, itself.

#### 1. General Principles

One of the general principles applied to a "future disputes" agreement is that the validity of the agreement itself is initially subject to judicial determination. If this were not so, this anomaly would result.<sup>33</sup> If the validity of the agreement is considered as an arbitrable issue then a ruling in arbitration that the agreement was invalid would destroy the arbitral jurisdiction with the logical result that the ruling would be a nullity.<sup>34</sup> Other general non-arbitrable issues which do not normally present great problems include illegal claims,<sup>35</sup> claims which arise from a violation of criminal or penal statutes and claims which are contrary to a strong public policy.<sup>36</sup>

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<sup>29</sup> See Mentschikoff, *The Significance of Arbitration—A Preliminary Inquiry*, 17 LAW & CONTEMP. PROB. 698, 700 (1952).

<sup>30</sup> See WHITNEY, MODERN COMMERCIAL PRACTICES § 440, at 623-24 (1958). This observation may be somewhat exaggerated in the light of these facts. In the New York County Supreme Court, January, 1960 commercial jury cases are now being tried while commercial non-jury cases are up to date. In the Kings County Supreme Court the calendars are not so up to date. Commercial jury cases from June, 1958 are now being tried while the non-jury cases are up to date.

<sup>31</sup> *Id.* at 624.

<sup>32</sup> See *Wilko v. Swan*, 346 U.S. 427, 436 (1953).

<sup>33</sup> See *Kulukundis Shipping Co. v. Amtorg Trading Corp.*, 126 F.2d 978, 986 (2d Cir. 1942). See also Phillips, *The Paradox in Arbitration Law: Compulsion as Applied to a Voluntary Proceeding*, 46 HARV. L. REV. 1258, 1271 (1933).

<sup>34</sup> See *Kulukundis Shipping Co. v. Amtorg Trading Corp.*, *supra* note 33.

<sup>35</sup> See STURGES, COMMERCIAL ARBITRATIONS AND AWARDS § 60, at 202 (1930).

<sup>36</sup> *Id.* at 203.

## 2. Legislation

In the legislative area the Federal Arbitration Act will first be examined. Though there was diversity of opinion as to its scope,<sup>37</sup> it is a presently settled principle that the act is specifically limited to agreements in contracts evidencing a "maritime" or "commerce" transaction.<sup>38</sup> In addition, contracts of employment of seamen, railroad employees, or any class of workers engaged in foreign or interstate commerce are specifically excluded from the scope of the act.<sup>39</sup>

This specificity is, indeed, lacking in the area of conflict of laws. Herein lies the most uncertain limitation of the Federal Arbitration Act because there is difficulty in ascertaining whether the act is of a procedural or substantive nature<sup>40</sup> upon which the applicability of the *Erie R.R. v. Tompkins*<sup>41</sup> and *Guaranty Trust Co. v. York*<sup>42</sup> doctrines depends.<sup>43</sup>

The one settled principle in this area seems to be that the act does not provide a separate basis of federal jurisdiction so that if it is to be applied at all it will be because the parties have some other basis for resorting to the federal courts.<sup>44</sup> Section 4 of the act specifically indicates this principle by providing that jurisdiction will be in "any United States district court which, save for such agreement, would have jurisdiction under Title 28, in a civil action or in admiralty of the subject matter of a suit arising out of the controversy between the parties . . ." <sup>45</sup> As will become apparent, the problem involved in applying the statute is most acute where jurisdiction is bottomed on diversity of citizenship.<sup>46</sup>

Up to fairly recent times arbitration has been considered as a law of remedies.<sup>47</sup> The classic statement of Judge Cardozo, when

<sup>37</sup> For example, the Second Circuit construed § 3 of the act, which provided for a stay of judicial proceedings pending arbitration, to be separable from the rest of the act, thereby applying it to all arbitration agreements. The Supreme Court disagreed, stating that §§ 1, 2, and 3 are integral parts of a whole thereby making the restrictive clause of "maritime" or "commerce" transaction in § 2 equally applicable to § 3. See *Bernhardt v. Polygraphic Co. of America*, 350 U.S. 198, 201 (1956).

<sup>38</sup> See *Bernhardt v. Polygraphic Co. of America*, *supra* note 37.

<sup>39</sup> 9 U.S.C. § 1 (1958).

<sup>40</sup> See *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, 271 F.2d 402 (2d Cir. 1959).

<sup>41</sup> 304 U.S. 64 (1938).

<sup>42</sup> 326 U.S. 99 (1945).

<sup>43</sup> See *Bernhardt v. Polygraphic Co. of America*, 350 U.S. 198 (1956).

<sup>44</sup> See *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, *supra* note 40, at 408.

<sup>45</sup> 9 U.S.C. § 4 (1958).

<sup>46</sup> See *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, 271 F.2d 402 (2d Cir. 1959). In the *Bernhardt* case, this difficulty is clearly indicated in both the majority and concurring opinions, especially as it relates to the application of the *Erie* and *Guaranty Trust* doctrines. *Bernhardt v. Polygraphic Co. of America*, 350 U.S. 198 (1956).

<sup>47</sup> 271 F.2d 402 (2d Cir. 1959).

the validity of the New York Arbitration Act was sustained in *Berkovitz v. Arbib and Houlberg, Inc.*,<sup>48</sup> enunciated this attitude concisely:

The common-law limitation upon the *enforcement of promises to arbitrate is part of the law of remedies*. . . . The rule to be applied is the rule of the forum. Both in this court and elsewhere, the law has been so declared. Arbitration is a form of procedure whereby differences may be settled. It is not a definition of the rights and wrongs out of which differences grow. This statute did not attach a new obligation to sales already made. It vindicated by a new method the obligation then existing.<sup>49</sup>

In *Bernhardt v. Polygraphic Co. of America*<sup>50</sup> a significant departure from that strict attitude was indicated. The petitioner sought damages for wrongful discharge under an employment contract containing a "future disputes" agreement. The action was instituted in the state court in Vermont and then removed to the district court on grounds of diversity of citizenship. Defendant then moved to stay judicial proceedings pending arbitration<sup>51</sup> and the Court held that the stay could not be granted because the agreement did not satisfy the "maritime" or "commerce" requirement of the act.<sup>52</sup> But the Court went further by stating that since the case was based on diversity jurisdiction the *Erie* and *Guaranty Trust* doctrines would govern, making state law applicable. In this respect the Court also rejected the previously existing judicial attitude that arbitration "is merely a form of trial," finding that "the remedy by arbitration . . . substantially affects *the cause of action created by the State*"<sup>53</sup> so that the outcome must not differ from that of the state court, had the suit been brought there.<sup>54</sup>

It appears, therefore, that the Arbitration Act is neither procedural nor substantive but a combination of both. In effect, it is what may be termed an accommodation statute because parties, having an independent basis for jurisdiction, are offered remedies which will substantially affect their rights.<sup>55</sup>

<sup>48</sup> 230 N.Y. 261, 130 N.E. 288 (1921).

<sup>49</sup> *Berkovitz v. Arbib & Houlberg, Inc.*, 230 N.Y. 261, 270, 130 N.E. 288, 289-90 (1921). (Emphasis added.)

<sup>50</sup> 350 U.S. 198 (1956).

<sup>51</sup> This was done pursuant to 9 U.S.C. § 3 (1958).

<sup>52</sup> *Bernhardt v. Polygraphic Co. of America*, 350 U.S. 198 (1956).

<sup>53</sup> *Id.* at 203. (Emphasis added.)

<sup>54</sup> See *Bernhardt v. Polygraphic Co. of America*, *supra* note 52.

<sup>55</sup> See *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, 271 F.2d 402 (2d Cir. 1959). The inadequacy of the procedure-substance dichotomy has been much emphasized. *The Supreme Court, 1955 Term*, 70 HARV. L. REV. 137, 140-41 (1956). For example:

"A decision whether to grant a stay of judicial proceedings until arbitration, is, in effect, a decision whether plaintiff is to have a judicial or arbitral remedy for the alleged wrong. Although matters of remedy are in some contexts considered procedural, in light of the many significant



Against this background three significant cases have been decided. In *American Airlines, Inc. v. Louisville and Jefferson County Air Bd.*<sup>56</sup> the plaintiffs sought judgments declaring that certain lease agreements had expired and that the "future disputes" agreement was invalid. The action was commenced in the state courts of Kentucky and then removed to the district court on grounds of diversity of citizenship. The district court denied defendant's motion to stay the proceedings and order arbitration. In affirming this denial the Sixth Circuit finds that congressional intent clearly indicates the creation of an accommodation statute and that there is no intention that federal law will be determinative of fraud in the inducement. This court, following the directive of *Bernhardt*, holds that the district court properly applied the state law of Kentucky. Under that law the agreement was invalid and therefore the court never reached the question of whether the "commerce" or "maritime" requirement was met.<sup>57</sup>

The Ninth Circuit made a similar ruling a few months after the *Bernhardt* decision in *Ross v. Twentieth Century-Fox Film Corp.*<sup>58</sup> The controversy concerning the national distribution of a film was held to satisfy the "commerce" requirement of the act and therefore under *Bernhardt*, California state law was applied to the "future disputes" agreement in the primary contract.<sup>59</sup>

However, a contrary result was recently reached by the Second Circuit in *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*<sup>60</sup> The

differences between judicial and arbitral proceedings the enforceability of such a remedy can so substantially affect the vindication of a party's rights that it may be a matter of substance under the constitutional requirements of *Erie*." *Ibid.*

The Declaratory Judgments Act, 28 U.S.C. §§ 2201-02 (1958), presents a somewhat analogous situation. That act, like the Arbitration Act, has no separate basis of federal jurisdiction within itself. See *Canadian Indem. Co. v. Republic Indem. Co.*, 222 F.2d 601 (9th Cir. 1955); *Goldstein v. Johnson*, 184 F.2d 342 (D.C. Cir. 1950). It has been declared "procedural only," *Aetna Life Ins. Co. v. Haworth*, 300 U.S. 227, 240 (1937), yet the Court that made that pronouncement was quick to realize that this new type of relief also substantially affected the rights of the parties. *Id.* at 241. Professor Borchard has made this summary of the Declaratory Judgments Act: "it has the advantage of escaping the technicalities associated with equitable and extraordinary remedies, thus enabling the substantive goal to be reached in the speediest and most inexpensive form." See Borchard, *The Federal Declaratory Judgments Act*, 21 VA. L. REV. 35, 38 (1934). It is submitted that this indicates the *sui generis* nature of both the Arbitration Act and the Declaratory Judgments Act.

<sup>56</sup> *American Airlines, Inc. v. Louisville & Jefferson County Air Bd.*, 269 F.2d 811 (6th Cir. 1959). See note 74, *infra*.

<sup>57</sup> *Ibid.*

<sup>58</sup> 236 F.2d 632 (9th Cir. 1956).

<sup>59</sup> *Ibid.*

<sup>60</sup> 271 F.2d 402 (2d Cir. 1959). This court did not consider the *American Airlines* case, *supra* note 56, and it dismissed *Ross v. Twentieth Century-Fox*

fact situation in this case satisfactorily met the "commerce" requirement of the act; in *Bernhardt* neither the "commerce" nor "maritime" requirement was met. Like the *Bernhardt* case, however, jurisdiction in *Lawrence* was bottomed on diversity of citizenship. On a motion to stay judicial proceedings the court held that a federal substantive law governed and that under that law fraud in the inducement was an arbitrable issue.<sup>61</sup> This court states that the position that arbitration as part of the law of remedies is losing much of its fascination in modern times because mere catchwords do not suffice in declaring the law.<sup>62</sup> But then the court uses that same device in declaring its position. Relying on *Bernhardt's* rejection of arbitration as "merely a form of trial," the Second Circuit concludes that arbitration is of a totally substantive nature.<sup>63</sup> This interpretation does not consider the third possibility that arbitration is a composition of procedure and substance, while remaining a species of neither.<sup>64</sup>

It is submitted that the court's reasoning fails for many reasons. The court, first of all, distinguished the case from *Bernhardt* on the ground that it satisfied the "commerce" requirement of the act; the *Bernhardt* case was decided on the ground that it did not meet that or the "maritime" requirement.<sup>65</sup> Then it proceeds to establish the theory that new federal substantive rights were created by the act.<sup>66</sup>

This is a novel theory though not entirely unique. In 1957 the Supreme Court in *Textile Workers v. Lincoln Mills*<sup>67</sup> formulated a federal substantive law in conjunction with the existing procedural statute.<sup>68</sup> Facing the more difficult problem of where this federal substantive law was to be found, the Supreme Court stated that the law would be drawn from the policy of our existing national labor laws and specifically indicated the reliance that would be put on the substantive parts of the Labor Management Relations Act.<sup>69</sup> The concurring opinion, although accepting the formulation of a substantive law, specifically rejected the majority's conclusion that it is federal law. Nevertheless, the opinion adhered to the conclusion of

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Film Corp., 236 F.2d 632 (9th Cir. 1956), as being based on a misconstruction of the *Bernhardt* ruling. *Ibid.*

<sup>61</sup> Robert Lawrence Co. v. Devonshire Fabrics, Inc., 271 F.2d 402 (2d Cir. 1959).

<sup>62</sup> *Ibid.*

<sup>63</sup> See Robert Lawrence Co. v. Devonshire Fabrics, Inc., *supra* note 61, at 405, 409.

<sup>64</sup> See text accompanying note 55, *supra*.

<sup>65</sup> *Bernhardt v. Polygraphic Co. of America*, 350 U.S. 198 (1956).

<sup>66</sup> Robert Lawrence Co. v. Devonshire Fabrics, Inc., 271 F.2d 402, 404-09 (2d Cir. 1959).

<sup>67</sup> 353 U.S. 448 (1957).

<sup>68</sup> *Textile Workers v. Lincoln Mills*, 353 U.S. 448 (1957).

<sup>69</sup> *Id.* at 456-57. Brief for Respondent on Petition for Writ of Certiorari, pp. 5-6, Robert Lawrence Co. v. Devonshire Fabrics, Inc., 271 F.2d 402 (2d Cir. 1959), in citing the *Lincoln Mills* case fails to draw this distinction.

*International Bhd. of Teamsters v. Mead*<sup>70</sup> that some federal rights may be involved in section 301 and that upon this ground the constitutionality of the section was upheld by what has been termed "protective jurisdiction."<sup>71</sup> Mr. Justice Frankfurter, in a vigorous dissent, rejected the conclusion that the courts can formulate federal substantive laws. In disagreeing with the concurring justices he stated that even assuming the federal rights supposedly inherent in section 301 he would find the section unconstitutional in this application because those rights provided the sole basis for the exercise of federal jurisdiction.<sup>72</sup> From this summation of a very long and difficult case it is clear that this area of the law is still unclear and indefinite.

Yet the Second Circuit went one step further than the majority in *Lincoln Mills* by spinning federal substantive law out of the Arbitration Act without pointing to any fund of law upon which to draw. The court in *Lawrence* could point to no such fund because there are no national arbitration laws save as exist in the statutes at issue. In effect, the Second Circuit decided that there was a federal substantive law in the act and then the court itself created that very law, making it a mere arm of the Congress. As surprising as this conclusion appears, the reasoning of the court in *Lawrence* leaves no alternative solution.

As part of the authority for its theory the court relies heavily upon a broad construction of congressional intent. This construction is in direct conflict with the reasoning of *American Airlines, Inc. v. Louisville & Jefferson County Air Bd.*,<sup>73</sup> the Sixth Circuit case, which adopts a narrow interpretation of that intent.<sup>74</sup> Since the importance of the distinction between procedural and substantive law, as indicated in the *Erie* decision, was thirteen years in the future at the time of enactment, a narrow, cautious interpretation of the act would seem to be the better approach. It took many years for

<sup>70</sup> 230 F.2d 576 (1st Cir. 1956).

<sup>71</sup> *Textile Workers v. Lincoln Mills*, *supra* note 68, at 459-60.

<sup>72</sup> *Id.* at 460, 469, 484.

<sup>73</sup> 269 F.2d 811 (6th Cir. 1959). Summarizing the congressional intent the court said:

"While the language . . . might plausibly be read to support a broader construction, consideration of the legislative history reveals that what the Congress intended was merely to overrule by legislation long-standing judicial precedent, which declared agreements to submit judicial controversies to arbitration contrary to public policy, on the ground that enforcement of such agreements would oust the courts of their jurisdiction. Thus the congressional purpose was to make arbitration agreements within the scope of the Federal statute as effective [sic] enforceable as any other contract, and so permit contracting parties thereby to avoid, if they chose so to do, the 'delay and expense of litigation. . .'" *Id.* at 816.

<sup>74</sup> Compare *American Airlines, Inc. v. Louisville & Jefferson County Air Bd.*, 269 F.2d 811 (6th Cir. 1959), with *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, *supra* note 69.

Congress to finally enact arbitration laws; if those laws are now to be given greater breadth, it should be accomplished through the legislature and not through a broad judicial construction.

A double effect of the *Lawrence* case, which was the caution in *Bernhardt*, bears mention. A prevailing reason for the existence of the *Erie* and *Guaranty Trust* doctrines is to prevent and discourage forum-shopping.<sup>75</sup> But, *Lawrence* may afford a new opportunity to choose a favorable jurisdiction to the extent that the diverse plaintiff who is engaged in "commerce" may choose a more favorable substantive climate. The court's reply is that its theory is "a declaration of national law equally applicable in state or federal courts."<sup>76</sup> The effect of this position presents the constitutional problems that were forewarned by Mr. Justice Frankfurter, in his concurring opinion to *Bernhardt*.<sup>77</sup> The Second Circuit has explicitly chosen to reject that position as unfounded despite growing authority that the *Erie* doctrine rests not only on policy consideration but upon a strong constitutional foundation.<sup>78</sup>

Finally, the court found that the allegation of fraud did not affect the arbitration agreement which was separable from the primary contract.<sup>79</sup> A separate allegation in relation to the arbitration agreement, the court notes, was necessary in order to bring it within the ambit of the principle that the validity of the arbitration agreement is initially subject to judicial determination.<sup>80</sup> The court enunciates three reasons in support of its application of the separability doctrine: (1) historical precedent, (2) favorable construction of the statute and (3) the added factor that the Robert Lawrence Company had incorporated an identical arbitration provision in its own order.<sup>81</sup> Commercial usage, however, seems to be against the adoption of such a doctrine because arbitration clauses have become so common that they are rarely considered apart from the contract in the ordinary transaction.<sup>82</sup> The inspection of intent after the fact is, indeed, difficult but it tasks reason to accept that a businessman who is being "taken in" will consider anything relating to the transaction as valid.

<sup>75</sup> See *Bernhardt v. Polygraphic Co. of America*, 350 U.S. 198, 204 (1956).

<sup>76</sup> *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, 271 F.2d 402, 407 (2d Cir. 1959).

<sup>77</sup> *Bernhardt v. Polygraphic Co. of America*, *supra* note 75, at 208. Recognizing the possible constitutional basis for the *Erie* doctrine the opinion questions "whether Congress could subject to arbitration litigation in the federal courts which is there solely because it is 'between Citizens of different states,' U.S. CONST. Art. III, § 2, in disregard of the law of the state in which a federal court is sitting." *Ibid.*

<sup>78</sup> See *The Supreme Court, 1955 Term*, 70 HARV. L. REV. 137, 141 (1956).

<sup>79</sup> *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, 271 F.2d 402 (2d Cir. 1959).

<sup>80</sup> *Ibid.*

<sup>81</sup> *Id.* at 404, 410.

<sup>82</sup> Brief for Appellant on Petition for Writ of Certiorari, p. 11, *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, *supra* note 79.

The ramifications of this case will not be fully understood for many years but the Supreme Court will soon have the opportunity of clarifying some of the most difficult aspects of this infant body of law. Certiorari has been granted and two questions were certified:

- (1) Does Federal Arbitration Act or does New York law govern validity of arbitration clause in contract made in New York by Massachusetts buyer and New York seller that requires interstate shipment of goods;
- (2) Does Federal Arbitration Act require that dispute over fraud in inception of contract be submitted to arbitration if alleged fraud is not in connection with making of arbitration clause itself.<sup>83</sup>

The limitations of the New York Arbitration Act, which represents the genesis of arbitration statutes in the United States,<sup>84</sup> are less stringent than the federal act. For many years, however, a very broad limitation existed, which specifically prescribed that only justiciable controversies were arbitrable.<sup>85</sup> Article 80-B of the Civil Practice Act was intended to remedy this unfortunate situation but instead the difficulty worsened.<sup>86</sup> This anomaly resulted:

If the parties agree to a third party determination of a question without agreeing that the determination shall be made under the Arbitration Law, then in the event of breach, the court must direct that it be determined by arbitration under the Arbitration Law. But if the parties have expressly agreed to arbitrate, the agreement may be unenforceable, if the question is of the kind involved in *Matter of Kallus* [non-justiciable controversy]. . . .<sup>87</sup>

In 1959 the legislature after many requests amended section 1448 to include any dispute whether justiciable or not.<sup>88</sup> Presently then the New York statute is very broad and there exist only some minor

<sup>83</sup> Robert Lawrence Co. v. Devonshire Fabrics, Inc., 28 U.S.L. WEEK 3238 (U.S. Feb. 16, 1960).

<sup>84</sup> See *Kulukundis Shipping Co. v. Amtorg Trading Corp.*, 126 F.2d 978, 984 (2d Cir. 1942).

<sup>85</sup> *Matter of Fletcher*, 237 N.Y. 440, 143 N.E. 248 (1924); *Matter of Kallus*, 292 N.Y. 459, 55 N.E. 737 (1944) (decided after an attempted amendment to § 1448, which thereby proved fruitless).

<sup>86</sup> N.Y. CIV. PRAC. ACT § 1340. See 1959 N.Y. LEGISLATIVE ANNUAL 17-18, 1959 LEG. DOC. NO. 65(E), MEMORANDUM, N.Y. LAW REVISION COMMISSION.

<sup>87</sup> See 1959 N.Y. LEGISLATIVE ANNUAL 18-19, 1959 LEG. DOC. NO. 65(E), MEMORANDUM, N.Y. LAW REVISION COMMISSION.

<sup>88</sup> N.Y. CIV. PRAC. ACT § 1448 was amended to read in part:

"Such submission or contract may include *or be limited* to questions arising out of valuations, appraisals or other controversies which may be collateral, incidental, precedent, subsequent to or independent of any issue between the parties, *without regard to the justiciable character of such questions or controversies.*" (Words in italics indicate 1959 amendment to the section.)

restrictions relating to capacity to agree and to disputes involving real property held in fee for life.<sup>89</sup>

The New York Court of Appeals was faced with a problem similar to that of the *Lawrence* case in *Wrap-Vertiser Corp. v. Plotnick*.<sup>90</sup> The claimant seeking damages for fraud in the inducement and for breach of contract sought to have all the issues determined in arbitration. The court granted the opposing motion to stay arbitration pending a judicial determination of the claim for fraud in the inducement. But the court, in reversing the Appellate Division and the Supreme Court, relied heavily on the fact that the claimant while alleging fraud in the inducement was simultaneously affirming the contract in the claim for breach thereof.<sup>91</sup> It is feasible that absent this fact that case would have been decided differently in the light of the reversal of two lower courts, coupled with the vigorous dissent by Judge Burke, in which two other judges concurred.<sup>92</sup> Though that distinguishing fact exists, the Second Circuit seems to have extended the principle of the *Wrap-Vertiser* case to mean that fraud in the inducement, of itself, is not an arbitrable issue. The court's own words in *Lawrence* are:

We note that were we compelled to apply New York law to the problems involved in this case, we would have been forced to arrive at a contrary conclusion. Had this not been so, we would not have given such detailed consideration to the choice of the applicable law. But the pattern and substance of New York law appear to be different than what we have found the federal law to be.<sup>93</sup>

It is submitted that the *Lawrence* case may be distinguishable from the *Wrap-Vertiser* case on its facts and that therefore an unnecessary path was taken around New York law by the Second Circuit, bearing in mind, however, that the attitude of the New York courts does appear somewhat narrower than that evidenced by the Second Circuit.<sup>94</sup>

<sup>89</sup> See N.Y. CIV. PRAC. ACT § 1448.

<sup>90</sup> 3 N.Y.2d 17, 143 N.E.2d 366, 163 N.Y.S.2d 639 (1957).

<sup>91</sup> *Wrap-Vertiser Corp. v. Plotnick*, 3 N.Y.2d 17, 143 N.E.2d 366, 163 N.Y.S.2d 639 (1957).

<sup>92</sup> For lower court cases in New York holding that fraud in the inducement is an arbitrable issue, see *Matter of Amerotron*, 3 App. Div.2d 899, 166 N.Y.S.2d 214 (1st Dep't 1957) (memorandum decision), *aff'd mem.*, 4 N.Y.2d 722, 148 N.E.2d 319, 171 N.Y.S.2d 111 (1958); *Matter of Pan American Trade Development Corp.*, N.Y.L.J., Aug. 21, 1957, p. 3, col. 1 (Sup. Ct. 1957). The latter opinion, *inter alia*, states:

"The Court is of the opinion that the intent of the parties and the language of the arbitration agreement is broad enough to allow questions with regard to prior dealings in-so-far as they are related to the contract, to be decided by arbitration (*Matter of Wrap-Vertiser Corp'n*, 3 N.Y.2d 17, is not contrary)."

<sup>93</sup> *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, 271 F.2d 402, 412 (2d Cir. 1959).

<sup>94</sup> *Ibid.*

### 3. The Agreement

The third limitation on scope is perhaps the easiest to deal with. The agreement itself may limit the arbitral scope depending upon the intention of the parties as evidenced by the type of agreement employed. A problem of interpretation of the clause, be it general or specific, arises here. The courts seem to have formulated a workable rule for this problem: arbitrators may interpret and select any meaning which a reasonably intelligent person would accept, but a meaning which no intelligent person would accept is void.<sup>95</sup>

### *Conclusion*

As has been indicated the scope of a "future disputes" arbitration agreement may be broad or restricted, but in either case problems abound. Since questions of law under most of the American arbitration statutes are determined in the arbitration itself, the lawyer's significance is felt in the period when the contract is made. Therefore, the best method of removing barriers and of gaining effective arbitration is through expert draftsmanship in drawing the agreement. The penalty for failure in this respect is severe because the benefits of the arbitration process are otherwise lost in the milieu of arbitration, coupled with litigation.



## THE TAXATION OF QUALIFIED ANNUITY PLANS AND DEFERRED COMPENSATION AGREEMENTS TO THE EMPLOYEE AND HIS BENEFICIARY

The effect of our progressive tax structure is to foster plans which defer compensation to future years. Arrangements which mitigate the effect of our high marginal rates have been sought after with much vigor.<sup>1</sup> These plans are not inequitable. They provide more spendable income and at a time in the future when the individual's productive capacity has been curtailed. In recognition of this the Internal Revenue Service in March, 1960 promulgated Revenue Ruling 60-31 outlining the use of deferred compensation plans. This article will consider the deferred compensation arrange-

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<sup>95</sup> Marceau, *Are All Interpretations "Admissible"?*, 12 *ARB. J.* (n.s.) 151 (1957).

<sup>1</sup> For leading cases involving deferred compensation plans, see *Casale v. Commissioner*, 247 F.2d 440 (2d Cir. 1957); *Commissioner v. Oates*, 207 F.2d 711 (7th Cir. 1953); *Howard Veit*, 18 P-H Tax Ct. Mem. 811 (1949).