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THE ARBITRABLE ISSUE: THE PROBLEM OF FRAUD

INTRODUCTION

At common law an executory agreement to arbitrate was unenforceable as against public policy.[1] If the agreement was fully executed, however, the courts would recognize and enforce it.[2] With the passage of arbitration statutes in most of the states,[3] this common law rule was altered so that such agreements are now valid, enforceable and irrevocable "save upon such grounds as exist at law or in equity for the revocation of any contract."[4] Thus, generally speaking, if in a specific performance action to compel arbitration an issue of fraud, duress or misrepresentation is raised, the courts, before determining whether the parties are to proceed to arbitration, must first decide that issue.[5] A contract to arbitrate is almost universally appended to the substantive contract to which it relates.[6] Consequently, the question is raised as to what precisely is meant by the term "contract" as used in arbitration statutes. Is the term all inclusive, that is, does it encompass the substantive contract together with the appended arbitration agreement or does it merely relate to the arbitration agreement? If fraud is alleged as to the inducement for the substantive contract, must the court first decide that issue of fraud or is the court's jurisdiction limited to allegations directed specifically to the arbitration agreement?

THE NEW YORK RULE

In the Matter of Palmer & Pierce, Inc.,[7] one of the earliest cases construing the New York arbitration statute, the appellate division established what has

1. 6 Corbin, Contracts § 1433 (1951).

2. Merrit v. Thompson, 27 N.Y. 225 (1863).

3. Only South Dakota and Oklahoma currently do not have arbitration statutes.

4. The New York arbitration statute is contained in N.Y. Civ. Prac. Act §§ 1448-69. Section 1448 provides:

[T]wo or more persons may submit to the arbitration of one or more arbitrators any controversy existing between them at the time of the submission which may be the subject of an action, or they may contract to settle by arbitration a controversy thereafter arising between them and such submission or contract shall be valid, enforceable and irrevocable, save upon such grounds as exist at law or in equity for the revocation of any contract. . . .

N.Y. Civ. Prac. Act § 1450 provides in part:

A party aggrieved by the failure, neglect or refusal of another to perform under a contract or submission providing for arbitration . . . may petition the supreme court, or a judge thereof, for an order directing that such arbitration proceed in the manner provided for in such contract or submission. . . . The court, or a judge thereof, shall hear the parties and upon being satisfied that there is no substantial issue as to the making of the contract or submission or the failure to comply therewith . . . shall make an order directing the parties to proceed to arbitration in accordance with the terms of the contract or submission.

If evidentiary facts be set forth raising a substantial issue as to the making of the contract or submission or the failure to comply therewith, the court, or the judge thereof, shall proceed immediately to the trial thereof. . . .

5. N.Y. Civ. Prac. Act § 1450.

6. A contract to arbitrate is distinguishable from a submission. The latter term usually designates an agreement to arbitrate an existing controversy. 3 Am. Jur. Arbitration and Award § 15 (1936).

7. 195 App. Div. 523, 186 N.Y. Supp. 369 (1st Dep't 1931). See also In re General

subsequently become the generally accepted rule where the existence or non-existence of the agreement to arbitrate is in issue. The court held that it could not compel specific performance of an arbitration agreement unless there was an agreement to arbitrate, therefore, the question of whether the arbitration agreement was in fact made had first to be determined by the court. The question of whether an agreement to arbitrate exists or not is somewhat analogous to the question of the fraudulent inducement of the agreement, since in the latter case, if the innocent party seeks rescission, and fraud in the inducement is shown, there is no contract *ab initio*.

In the controversial case of *Cheney Bros. v. Joroco Dresses, Inc.*,[8] fraud was pleaded as a defense to an action for specific performance of an arbitration agreement. The appellate division, in a 3-to-2 decision, notwithstanding that the fraud was alleged only against the substantive contract, held that "the question as to whether or not the contract was fraudulently induced raises an issue of fact which must be tried before the right to arbitration under the contract may be enforced."[9] Under this reasoning, fraud as to the substantive contract, if proved, invalidates the entire contract inclusive of the arbitration clause. The *Cheney* rule for fraud raised as a defense has, until recently, been generally followed in New York among the lower courts.[10]

At common law the defrauded party to a contract had an election of remedies which were considered mutually exclusive.[11] He could rescind the contract and sue at law to recover the consideration paid. He could bring an action in equity to rescind the contract and obtain full relief. Lastly, the innocent party could keep what he had received under the contract and sue at law for damages.[12] In effect, this last remedy resulted in an affirmance of the contract. *In the Matter of Wrap-Vertiser Corp.*[13] the defrauded party sought to have arbitrated his demand for damages based on fraud and breach of contract.[14] The

Silk Importing Co., 200 App. Div. 786, 194 N.Y. Supp. 15 (1st Dep't), aff'd, 234 N.Y. 513, 138 N.E. 427 (1922).

8. 218 App. Div. 652, 219 N.Y. Supp. 96 (1st Dep't 1926), rev'd on other grounds, 245 N.Y. 375, 157 N.E. 272 (1927).

9. Cheney Bros. v. Joroco Dresses, Inc., 218 App. Div. 652, 653, 219 N.Y. Supp. 96 (1st Dep't 1926). However, the court of appeals, in reversing, unanimously held as a matter of law that fraud was not established by the facts alleged. Cheney Bros. v. Joroco Dresses, Inc., 245 N.Y. 375, 157 N.E. 272 (1927). The defendant merely made a general allegation of fraud without setting forth evidentiary facts. The statute itself requires sufficient evidentiary facts. N.Y. Civ. Prac. Act § 1450.

10. See, e.g., Manufacturers Chem. Co. v. Caswell, 259 App. Div. 321, 19 N.Y.S.2d 171 (1st Dep't), cert. denied, 283 N.Y. 679, 28 N.E.2d 404 (1940). The appellate division held that if a misrepresentation alleged against the substantive contract were proven, no arbitration could be had as the agreement to arbitrate would fall with the rest of the contract. See also Metro-Goldwyn-Mayer Distrib. Corp. v. Dewitt Dev. Corp., 150 Misc. 408, 269 N.Y. Supp. 104 (Sup. Ct. 1931).

11. 37 C.J.S. Fraud § 65 (1943).

12. Goldsmith v. National Container Corp., 287 N.Y. 438, 40 N.E.2d 242 (1942); Vail v. Reynolds, 118 N.Y. 297, 23 N.E. 301 (1890).

13. 3 N.Y.2d 17, 143 N.E.2d 366, 163 N.Y.S.2d 639 (1957).

14. Such a demand could now be made, even though at common law a suit for damages

court of appeals, though holding that the arbitration clause was not broad enough to encompass the issue of fraud,[15] clearly recognized the innocent party's right to arbitrate in view of his affirmance of the contract including the arbitration agreement by his suit for damages. The decision is unique in its preclusion of arbitration due to the particular wording of the arbitration clause involved.[16]

Whereas in *Wrap-Vertiser* the innocent party had sought arbitration, *In the Matter of Amerotron Corp.*[17] the alleged defrauding party, Amerotron, sought and was granted, pending arbitration, a stay of the innocent party's court action for damages. In confirming the arbitration award in favor of Amerotron, the appellate division held that "by all of its actions respecting its claim of fraud inducing the contract, including its complaint . . . respondent failed to rescind the contract and elected to recognize the contract and claim damages for fraud. Such a claim was arbitrable and should have been arbitrated under the contract."[18] The court of appeals affirmed without opinion.[19] Therefore, it may be postulated that the New York courts are willing to permit arbitration of fraud provided the innocent party affirms the contract and the arbitration agreement is sufficiently broad to include the question of fraud.[20] The *Wrap-Vertiser* decision suggests that the arbitration clause in this regard will be construed rather strictly.

The court of appeals, in the *Wrap-Vertiser* case, stated categorically in dicta that if the innocent party were seeking rescission, none of his demands could be arbitrated until the issue of the basis for rescission had been determined by the courts.[21] A consideration of recent New York lower court decisions indicates that the rule as to rescission is being altered in favor of its determi-

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would not entitle the avoiding party to the return of his down payment. Goldsmith v. National Container Corp., 287 N.Y. 438, 40 N.E.2d 242 (1942); Vail v. Reynolds, 118 N.Y. 297, 23 N.E. 301 (1890). The remedies for fraud have been altered in New York so that the return of the down payment and a suit for damages are no longer inconsistent. N.Y. Civ. Prac. Act § 112-c.

15. In the Matter of Wrap-Vertiser Corp., 3 N.Y.2d 17, 19, 143 N.E.2d 366, 367, 163 N.Y.S.2d 639, 641 (1957).

16. The arbitration agreement provided for arbitration of any question as to the "validity, interpretation or performance of this agreement." Id. at 20, 143 N.E.2d at 367, 163 N.Y.S.2d at 641. The court, in interpreting the agreement, reasoned that since the defrauded party was affirming the contract by the suit for damages, he could not bring his demand for damages due to the fraud within the "validity" clause of the agreement since the contract was now valid.

17. 3 App. Div. 2d 899, 162 N.Y.S.2d 214 (1st Dep't 1957), aff'd mem., 4 N.Y.2d 722, 148 N.E.2d 319, 171 N.Y.S.2d 111 (1958).

18. In the Matter of Amerotron Corp., 3 App. Div. 2d 899, 162 N.Y.S.2d 214, 215 (1st Dep't 1957).

19. In the Matter of Amerotron Corp., 4 N.Y.2d 722, 148 N.E.2d 319, 171 N.Y.S.2d 111 (1958).

20. See, e.g., Reo Garment, Inc. v. Jason Corp., 9 Misc. 2d 521, 170 N.Y.S.2d 412 (Sup. Ct. 1958).

21. 3 N.Y.2d at 19, 143 N.E.2d at 367, 163 N.Y.S.2d at 641.

nation by arbitration. In *Lugay Frocks, Inc. v. Joint Bd. Dressmakers' Union*,[22] notwithstanding that the petitioner sought rescission, the court held that so long as there was a signed contract in existence providing for arbitration the respondent had a right to demand arbitration. In the case of *In re East Meadow Sanitation Serv., Inc.*[23] the petitioner sought to stay arbitration by raising fraud as a defense. The court held that arbitration could be had, reasoning that the contract was valid when arbitration was sought, and only after it was sought did the petitioner raise the vitiating defense of fraud. The case presented generally the same factual situation as was involved in the *Cheney* case, *i.e.*, fraud raised as a defense to arbitration, and yet the court arrived at a contrary result. The court's theory was apparently one of estoppel.

Theories and Approaches

It is apparent that the problem of fraud and the arbitration agreement is not static.[24] The courts are struggling with a comparatively new problem. Some of the reluctance to permit arbitrators to decide the issue of fraud in the inducement of the substantive contract may be a vestige of the age-old opposition of the courts to arbitration in general. Some of the fault conceivably lies with the arbitration statutes themselves.

The avenues of approach to the problem of who shall decide the issue of fraud are several and, to a certain extent, depend on the factual situation involved. If fraud is alleged as to the arbitration agreement itself the courts must determine the question. Then the issue is incontrovertibly presented as to whether or not the agreement exists. On the other hand, it is logical to say that under such a situation the innocent party could affirm the fraudulently induced arbitration agreement and compel arbitration. It is also well settled, an allegation that the contract is void, whether it is alleged as to the substantive contract, the arbitration clause or both, must be decided by the courts.[25] To have the arbitrators decide issues under a void contract would be to give validity to the contract.

A more difficult question is the effect of an allegation of fraud as to the substantive contract upon the arbitration agreement. To this problem there are two possible solutions. First, it can be argued that the courts should decide the issue of fraud. The decisions, however, do not fully uphold this approach. Affirmation of the contract by the defrauded party gives the arbitrators juris-

22. N.Y.L.J., July 1, 1958, p. 3 (Sup. Ct.), aff'd, 6 App. Div. 2d 1000, 177 N.Y.S.2d 1008 (1st Dep't 1958).

23. N.Y.L.J., Feb. 25, 1958, p. 13 (Sup. Ct.).

24. The decisions of jurisdictions other than New York on the question of fraud and arbitration agreements are few. See Maxwell Shapiro Wollen Co. v. Amerotron Corp., 158 N.E.2d 875 (Mass. 1959) (arbitration of fraud proper where damages are sought). See also International Bhd. of Teamsters v. Shapiro, 138 Conn. 57, 82 A.2d 345 (1951); Sommer v. Mackay, 10 N.J. Misc. 644, 160 Atl. 495 (Sup. Ct. 1932).

25. See Metro Plan, Inc. v. Miscione, 257 App. Div. 652, 15 N.Y.S.2d 35 (1st Dep't 1939); In re Gale, 176 Misc. 277, 27 N.Y.S.2d 18 (Sup. Ct.), rev'd, 262 App. Div. 834, 28 N.Y.S.2d 270 (1st Dep't 1941).

diction provided it is within the scope of the arbitration clause.[26] This is not the case where rescission is sought. Whether the approach to be employed should be divergent depending on the remedy sought by the innocent party is doubtful, particularly in a jurisdiction like New York where damages and rescission are not inconsistent. Secondly, it is suggested that the arbitrators in every instance decide the issue of fraud when raised, irrespective of the remedy sought. This approach is valid if the arbitration agreement can be considered as severable from the remainder of the contract. Separability can be substantiated in two ways: (1) the very wording of the arbitration statutes makes it severable;[27] and (2) the mutual promises to arbitrate form a *quid pro quo,* severing the agreement from the substantive contract.[28]

In the leading federal case of *Lawrence v. Devonshire Fabrics, Inc.*[29] both of these theories were discussed. The court held that an allegation of fraud as to the substantive contract was properly to be decided by the arbitrators provided for under the terms of the contract. Although damages were sought, the court did not rely upon the affirmance of contract approach, but held the arbitration agreement severable from the substantive contract. The court, in dictum, intimated that the mutual promises to arbitrate might constitute a sufficient consideration to render the agreement of arbitration severable from the substantive contract. The court did not find it necessary to decide the case on that ground. Rather, it derived separability from the wording of the Federal Arbitration Act,[30] construing the word "contract" as used therein to refer only to the agreement to arbitrate and not as inclusive of the substantive contract. Consequently, to avoid arbitration the fraud alleged would have to be directed specifically against the arbitration agreement itself. Under the reasoning of *Lawrence,* it is immaterial whether the innocent party seeks damages or rescission.[31] The court in its decision alluded to the law of New York and stated "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."[32] It is submitted that under the precise facts of the *Lawrence* case New York courts would have ordered arbitration, not on the separability theory but rather on the affirmance of contract approach.

26. In the Matter of Amerotron Corp., 3 App. Div. 2d 899, 162 N.Y.S.2d 214 (1st Dep't 1957), aff'd mem., 4 N.Y.2d 722, 148 N.E.2d 319, 171 N.Y.S.2d 111 (1958).

27. Comment, 36 Yale L.J. 866 (1927).

28. Nussbaum, The Separability Doctrine in American and Foreign Arbitration, 17 N.Y.U.L. Rev. 609 (1940).

29. 271 F.2d 402 (2d Cir. 1959).

30. Arbitration Act § 2, 9 U.S.C. § 2 (1958).

31. The court said that "in the view we take of the case before us it is immaterial that Lawrence claims to have rescinded the contract and that Devonshire disputed this claim and asserts that Lawrence by later inconsistent acts waived any right to rescind. We say there was a valid agreement to arbitrate, that all there remains is to construe the agreement and that the controversy over fraud in the inducement, whether Lawrence affirmed or disaffirmed the contract and attempted to or did rescind it, is a 'complaint, controversy or question' which arose 'with respect to this contract.'" 271 F.2d at 411.

32. Id. at 412.

The separability theory based on the contract approach of mutual promises to arbitrate constituting an independent contract has to a great extent been recognized in the courts of Europe,[33] but as yet has found only slight approbation in this country. Other than the dictum in *Lawrence*, adherence to it can be found only in one New York case.[34] It would seem that separability on general principles of contract law cannot be maintained. Professor Williston observes that as to a severable contract, the essential requirement is "that on performance on one side of each of its successive divisions, the other party becomes indebted for the agreed price of the division."[35] The essential test as to a single contract is whether the parties assented to all the promises as a single whole. The parties clearly do not think in terms of a severable contract when they add an arbitration clause to a substantive contract. Lacking a clear intention to the contrary, separability should not be presumed.

Obviously, the parties can always expressly provide that the agreement of arbitration is severable. The same result would obtain if the agreement to arbitrate was executed at a subsequent time. Corbin, in his treatise on contracts, rejects separability:

> [I]f 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. If one party failed to express assent to the terms proposed by the other, no contract has been made. The proposal for arbitration lacks acceptance just as fully as do the other proposed terms.[36]

It appears that the separability approach derived from the statute itself is without merit. Assuming that the legislature in the enactment of the statutes fully realized that agreements to arbitrate future disputes are almost invariably appended to contracts of sale, if the intention was to have the term "contract" refer only to the agreement of arbitration, all that was required would have been to have the statute read "contract of arbitration." Under the rule that a statute in derogation of the common law must be construed strictly, an arbitration statute should not be interpreted in such a manner as to make contracts severable which were not such at common law.

CONCLUSION

All questions of voidability should be decided by arbitration if the parties have so agreed, *i.e.*, if the agreement by its terms is broad enough, irrespective of whether the injured party seeks rescission or damages. The rule when damages are sought is consistent with this view. As to rescission, however, the cases have been to the contrary, although for various reasons there is indicated

33. Nussbaum, The Separability Doctrine in American and Foreign Arbitration, 17 N.Y.U.L. Rev. 609, 610 (1940).

34. In re Albert, N.Y.L.J., March 12, 1936, p. 1276 (Sup. Ct.).

35. 3 Williston, Contracts § 861 (rev. ed. 1936).

36. 6 Corbin, Contracts § 1444 (1951).

a move in the other direction.[37] The doctrine of separability is legally untenable, although clearly beneficial from a pragmatic standpoint. It is suggested that the courts, as an alternative approach, consider the theory of estoppel. Since rescission is an equitable remedy, it is subject to suit being timely brought once the fraud is discovered. It can be argued that in a factual situation like the *Cheney* case, the alleged defrauding party, having sought specific performance of the agreement to arbitrate prior to any action or notice by the innocent party, has put himself in a position of reliance on the apparent validity of the contract from which he should not be forced to retreat. This theory apparently formed the basis for one recent New York lower court decision.[38] The court there said that "no action has been instituted to rescind or cancel this contract. The petitioner apparently did not question the validity until the demand for arbitration was made, accepting, in the meantime, any benefits arising from it. At this time the contract is valid, subsisting and binding upon the petitioner."[39]

The court, under this estoppel theory, should also consider as a necessary prerequisite to recission whether the parties can be restored to their original positions in light of performance already completed, both of the arbitration agreement and the substantive contract. If the answer to either of these questions is in the negative, arbitration should be compelled.

Adoption of these basic considerations will not fully clear the way for fraud to come within the scope of arbitration as a matter of course, for the courts will still retain, in a great many instances, the determination of fraud where, prior to any move by the alleged defrauding party, the innocent party seeks rescission in a judicial tribunal. There at least the claim is usually better founded and more colorable than when raised as a defense to arbitration.[40]

To attain the most desirable situation wherein the arbitrators would determine all issues of fraud would involve a change in the statutes. Meanwhile, the simplest approach under existing law is for the parties to expressly provide that the arbitration agreement is a severable contract or to include a specific disclaimer in the contract against fraud in the inducement. Such a provision was upheld in *Danann Realty Corp. v. Harris*.[41] The parties were prevented from alleging fraud for any reason since at the time of the contract they expressly denied the existence of any.

37. Lugay Frocks, Inc. v. Joint Bd. Dressmakers' Union, N.Y.L.J., July 1, 1958, p. 3 (Sup. Ct.), aff'd, 6 App. Div. 2d 1000, 177 N.Y.S.2d 1008 (1st Dep't 1958); In re East Meadow Sanitation Serv., Inc., N.Y.L.J., Feb. 25, 1958, p. 13 (Sup. Ct.).

38. In re East Meadow Sanitation Serv., Inc., N.Y.L.J., Feb. 25, 1958, p. 13 (Sup. Ct.).

39. Id. at 13.

40. It is interesting to note that in Cheney Bros. v. Joroco Dresses, Inc., 245 N.Y. 375, 157 N.E. 272 (1927), the court of appeals found the allegation of fraud to be untenable.

41. 5 N.Y.2d 317, 157 N.E.2d 597, 184 N.Y.S.2d 599 (1959).