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Arbitration of Fraud in the Inducement of a Contract

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The Arbitration Law of New York provides that an agreement to arbitrate either an existing or future controversy is "valid, enforcible and irrevocable, save upon such grounds as exist at law or in equity for the revocation of any contract"[1] and provision is made for compelling a recalcitrant party to proceed according to his contract. It is also provided that a party, before being compelled to arbitrate, be given the opportunity to have it summarily determined whether he has in fact agreed to arbitrate the question sought to be submitted to arbitration.[2] A recent case has come before the Appellate Division in New York which calls upon the court to decide whether an issue of fraud in the inducement of a contract is a matter for arbitration and whether it is a matter which must be decided by the court before arbitration can be compelled according to the New York statute. If a party can have such an issue of fraud tried by the court before

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[1]L. 1920, ch. 275. § 2. "*Validity of arbitration agreements.* A provision in a written contract to settle by arbitration a controversy thereafter arising between the parties to the contract, or a submission hereafter entered into of an existing controversy to arbitration pursuant to title eight of chapter seventeen of the code of civil procedure, or article eighty-three of the civil practice act, shall be valid, enforcible and irrevocable, save upon such grounds as exist at law or in equity for the revocation of any contract."

[2]§ 3, "*Remedy in case of default.* A party aggrieved by the failure, neglect or refusal of another to perform under a contract or submission providing for arbitration, described in section two hereof, 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. Eight days' notice in writing of such application shall be served upon the party in default. Service thereof shall be made in the manner provided by law for personal service of a summons. The court, or a judge thereof, shall hear the parties, and upon being satisfied that the making of the contract or submission or the failure to comply therewith is not in issue, the court, or the judge thereof, hearing such application, shall make an order directing the parties to proceed to arbitration in accordance with the terms of the contract or submission. If the making of the contract or submission or the default be in issue, the court, or the judge thereof, shall proceed summarily to the trial thereof. If no jury trial be demanded by either party, the court, or the judge thereof, shall hear and determine such issue. Where such an issue is raised, any party may, on or before the return day of the notice of application, demand a jury trial of such issue, and if such demand be made, the court, or the judge thereof, shall make an order referring the issue or issues to a jury in the manner provided by law for referring to a jury issues in an equity action. If the jury find that no written contract providing for arbitration was made or submission entered into, as the case may be, or that there is no default, the proceeding shall be dismissed. If the jury find that a written contract providing for arbitration was made or submission was entered into and there is a default in the performance thereof, the court, or the judge thereof, shall make an order summarily directing the parties to the contract or submission to proceed with the arbitration in accordance with the terms thereof.

being compelled to arbitrate, it offers ready means for delaying the proceedings and, therefore, to a certain extent enables the original purpose of expeditious settlement to be thwarted by one of the parties.

The case referred to is *Matter of Cheney Brothers v. Joroco Dresses, Inc., 218 App. Div. 652, 219 N. Y. Supp. 96 (1st Dept. 1926)*. An examination of the facts[3] shows that plaintiff sold some textiles to defendant under a contract containing a general arbitration clause and providing that the plaintiff would not sell the pattern selected to any other person. A dispute arose under the contract and plaintiff demanded arbitration. Defendant declined to proceed and thereupon plaintiff moved for an order compelling arbitration. Defendant then answered that the contract had been obtained by fraud and misrepresentation in that the salesman had not intended to and actually did not restrict the patterns to him. Upon reaching the Appellate Division the court, reversing the order of the Supreme Court, said, "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. If the contract was voided by fraud, the arbitration provision therein falls." Three of the judges dissented.

Before commenting upon the holding of the court from a legal point of view, it may be well to examine various ways of dealing with fraud from an hypothetical standpoint. For the purpose of discussion, it is suggested that a contract containing a provision for arbitration be regarded as divided into two parts, one a contract for sale or for services or what not, which we shall call the first contract, and the other, which we shall call the second, a contract to submit to arbitration disputes as to the first contract.

Where fraud is alleged as to the second contract, *i. e.*, the agreement for arbitration, the possible means for determining the issue are to have the question determined by the court before compulsion of arbitration, to have the arbitrators decide the matter, or to have it determined by the court after arbitration has been had and when it is sought to have the award enforced. It seems obvious that the validity of the agreement for arbitration should be determined before arbitration is compelled both from the point of view of the provisions in the Arbitration Law and from the point of fundamental justice.[4]

[3]The report does not state the facts of the case.

[4]In Matter of Gresham & Co., Ltd., 202 App. Div. 211, 195 N. Y. Supp. 106 (1st Dept. 1922), it was held that the question whether there had been a valid signing of an agreement by the agent who signed the contract was one for summary determination under sec. 3. Similarly in Matter of Palmer & Pierce, Inc., 195 App. Div. 523, 186 N. Y. Supp. 369 (1st Dept. 1921), summary determination as to whether the arbitration agreement had been in fact made was held demandable prior to arbitration.

And further, as a practical matter, a party could well be deemed to waive questions of fraud of this type by not raising them at that time.

Where fraud is alleged as to the first contract, the contract to which the arbitration provision is appended, the same propositions may be put, *i. e.*, whether the point should be determined by the court before arbitration is compelled, whether it should be settled by the arbitrators, or whether it should be determined after the arbitration when it is sought to have the award enforced. In this case, the answer is not so entirely obvious and requires somewhat detailed consideration.

In the *Cheney Brothers* case, the fraud was in the inducement of what we have called the first contract. (There was no fraud alleged as to the second.) The view of the Appellate Division was that the allegation of fraud, if made out, would invalidate the whole contract including the arbitration provision and on that ground the court decided that fraud as to the first portion of the contract had to be determined by the court before arbitration could be compelled under section 3 of the Arbitration Law. This decision seems convincing unless it can be shown that it is not necessary to consider a contract containing a provision for arbitration as an entirety, but that a contract containing an agreement for arbitration may be regarded as severable and as composed of a first contract and a second supplementary contract, somewhat as suggested above for discussion purposes.[5] It becomes a question for consideration, therefore, to determine which view is preferable, and so for the moment it may be well to consider how such contracts have been regarded in dealing with other matters.

At common law a general provision in a contract for arbitration of disputes which might arise out of the contract in the future, is considered invalid in the sense that it will not bar an action brought on the principal contract.[6] This shows at least that the provision for arbitration is not considered so tied up with the rest of the provisions of the contract as to permit its invalidity to affect the validity of the rest of the contract. But a suit thus brought is usually held

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[5]In ELLIOTT, CONTRACTS, (1913) § 3655, an agreement for arbitration in a building contract is called a "supplementary contract."

[6]In United States Asphalt R. Co. v. Trinidad Lake P. Co., 222 Fed. 1006 (S. D. N. Y. 1915), there is an excellent discussion as to the various reasons assigned for this rule and their lack of conviction, and as to the way the authorities are established in this country. For an exhaustive review of the change of view of the English courts on this point and the precedent established in this country, see JULIUS HENRY COHEN, COMMERCIAL ARBITRATION AND THE LAW (1918).

to constitute a revocation of the arbitration agreement[7] and the fact that disputes arising out of the principal contract were settled in court, contrary to the agreement of the parties, may be made the basis of an action for damages for breach of the contract to arbitrate.[8] This seems to infer separateness in the treatment of the arbitration provision.

Under the Arbitration Law, agreements to arbitrate are valid[9] and can be made a bar to an action on the principal contract.[10] Such provision for arbitration has peculiar significance, for where there is breach of contract, the arbitration provision is not subject to the usual rules as to right to rescind, absolution from obligation to perform, etc. For example, if, in the *Cheney Brothers* case, the Joroco Dresses, Inc., had merely sought to rescind the contract because Cheney Brothers had broken it in not giving them exclusive patterns, they would have been unable to rescind the arbitration agreement and would not be considered absolved from their duty to arbitrate. This vitality again seems to indicate that an arbitration agreement is regarded as distinct from the rest of the provisions of a contract and as standing upon an independent footing.

An agreement for arbitration is governed by the laws of contract and is in its nature a form of contract.[11] A contract for arbitration refers, of course, to some particular subject matter about which there may be dispute, but it is equally clear that an arbitration contract may be executed independently and that it may be in and of itself a complete and distinct contract. The consideration for such an independent contract consists in the mutual promises to abide by the award. Where an agreement for arbitration is executed together with and as part of another contract, it does not necessarily follow that it loses its character as an independent agreement, for execution as one instrument is not a test of singleness of contractual obligation. Suppose the case where parties make the contract for arbitration at a time subsequent to the making of the contract to which it refers. In such case, its independent footing would seem quite clear, yet as a matter of fact there is little actual difference between that case and

[7]There is a good discussion of this point in Williams v. Branning Mfg. Co., 153 N. C. 7, 68 S. E. 902 (1910), annotated in (1911) 31 L. R. A. (N. S.) 679. For direct holdings on the point, see Paulsen v. Manske *et al.*, 126 Ill. 72, 18 N. E. 275 (1888), and Crilly v. Philip Rinn Co., 135 Ill. App. 198 (1907).

[8]Call v. Hagar, 69 Me. 521 (1879); Miller v. The President of Junction Canal Co., 41 N. Y. 98 (1869); Union Ins. Co. v. Central Trust Co., 157 N. Y. 633, 52 N. E. 671 (1899).

[9]*Supra*, note 1.

[10] § 5 of the Arbitration Law, L. 1920, ch. 275.

[11]District of Columbia v. Bailey, 171 U. S. 161, 43 L. Ed. 118, 18 Sup. Ct. 868 (1879).

the case where the agreement is executed as part of one instrument.[12]

It is not particularly helpful to consider the case where an agreement for arbitration is appended to an illegal contract. In such case, the arbitration agreement is ineffective. The ineffectiveness, however, is not necessarily due to the fact that the arbitration clause shares the illegality of the principal contract, but more probably is due to the fact that an arbitration and award cannot create a valid obligation out of something that is inherently illegal, even though the contract for arbitration itself may be valid. And even though illegality be the issue, an award as to it is not conclusive.[13]

It may be well to distinguish at this point between a distinct supplementary contract and a separable part of a divisible contract. The term divisible contract as generally used refers to apportioned contracts.[14] Williston says, "A divisible contract, using that term properly, is always one contract and not several contracts. It differs in one respect only from other contracts—namely, that on performance on one side of each of its successive divisions, the other party becomes indebted for the agreed price of the division."[15] It is obvious then that a contract containing an arbitration clause is not what is technically called a divisible contract and it is, therefore, not helpful to consider the law applicable to such contracts. There is one class of divisible contract, however, that may be referred to argumentatively, namely, where there is an agreement in restraint of trade which is unreasonable in part and reasonable in part. Such a contract is often upheld as to the reasonable part and only considered unenforcible as to the remainder.[16] This might be the basis for arguing that a contract which is voidable on account of fraud in inducing one part of it, is unenforcible only as to the part concerning which the fraudulent representations are made.[17]

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[12]In United States Asphalt R. Co. v. Trinidad Lake P. Co., *supra* note 6, one of the provisions of a charter party was an ordinary agreement for arbitration and the court in commenting upon it said at page 1007, "There can be no doubt but that this was a submission to arbitration, and for that reason was a contract between the parties to this action."

[13]There is a detailed consideration of contracts to arbitrate illegal matters in Benton v. Singleton, 114 Ga. 548, 40 S. E. 811 (1901).

[14]Woodward, *The Doctrine of Divisible Contracts*, (1900) 39 AM. L. REG. (N.S.) 1.

[15]2 WILLISTON, CONTRACTS (1920) 1648, § 861.

[16]Edgecomb v. Edminston, 153 N. E. 99 (Mass. 1926).

[17]Further cases of somewhat similar effect, namely, that a contract bad in part but separable will be enforced as to the valid part, the rule in such cases being that where there is no imputation of *malum in se* the bad parts do not affect the good, are Gelpcke v. City of Dubuque, 1 Wall. 221 (U. S. 1863) and Southwell v. Beazley, 5 Or. 458, (1875).

In Kahn v. Orenstein, 12 Del. Ch. 344, 114 Atl. 165 (1921), there was specific performance of part only of a divisible contract, the test for severability being stated as separateness of consideration.

In examining sections 2 and 3 of the Arbitration Law in order to ascertain whether they are aimed at the entire contract in which an arbitration agreement appears or whether they are aimed merely at the agreement for arbitration, we find the language of section 2 to be, "A *provision* in a written contract to settle by arbitration a controversy thereafter arising between the parties to the contract, * * * shall be valid, enforcible and irrevocable, save upon such grounds as exist at law or in equity for the revocation of any contract."[18] Section 3 adopts this definition by referring to "a contract or submission providing for arbitration, described in section 2 hereof." The scheme of the Arbitration Law seems to be to make a contractual provision for arbitration valid and enforcible and to provide means for compelling arbitration according to an agreement to arbitrate. It is further the scheme of the act to give a party, before he is made to arbitrate, means for obtaining the decision of the court on the question whether he has in fact entered into a valid contract to arbitrate the dispute sought to be arbitrated. In *Matter of Bullard v. Grace Co.*[19] the court says *per* Pound, J., "On such application [under section 3], the other party may put in issue (a) the making of the contract to arbitrate the questions sought to be submitted to arbitration, or (b) the submission of such questions to arbitration, or (c) the failure to comply therewith." The subject of specific comment thus seems to be the arbitration agreement itself apart from the remaining provisions of the contract. Whether questions as to the validity of this agreement and as to its effect in binding a party to arbitrate may in some cases be dependent upon questions as to the validity of the contract to which it is appended, is not mentioned. As has already been pointed out, the court in the *Cheney Brothers* case said that it was so dependent. It has been the endeavor of this comment to show that that result is not necessary and that an agreement for arbitration may be considered as standing upon a separate footing. Such suggested interpretation of the contract not only does not seem out of line with the language and purpose of the Arbitration Law but seems rather to be what the framers of the act had in mind. Moreover, such a way of regarding arbitration agreements conforms to the way courts have handled such agreements in other matters and does not contravene the law in any way.

Another point that the *Cheney Brothers* case brings up is whether questions as to fraud in the inducement of the first contract, namely, the contract to which the arbitration agreement is appended, are

[18] *Supra* note 1. Italics are writer's.
[19] 240 N. Y. 388, 395, 148 N. E. 559 (1925).

included within the scope of a general agreement for arbitration. A contract for the arbitration of a particular matter essentially involves a relinquishing of the right to have that matter tried in court. The extent to which rights are relinquished depends upon the contract. Thus parties may contract to have questions of law as well as of fact tried by the court.[20] They can even agree that determination of the scope of matters included in the arbitration agreement is for the arbitrators.[21] Thus it would seem that parties can agree to have matters such as fraud in the inducement of the principal contract settled by arbitration. However, where there is a general arbitration clause not expressly mentioning fraud, some rule of construction for such a clause must be applied. In construing a contract, attempt is made to ascertain the intent of the parties or, if it is thought that the matter was not definitely considered by the parties, attempt is made to determine what would have been their probable intent if they had actually considered the question. A chief purpose in agreeing for arbitration is to secure expeditious settlement of a controversy between the parties. To have the question of fraud settled by the arbitrators is more expeditious than to have the matter tried by the court. So from this standpoint it would seem that, if the parties had considered the matter, they would have decided to have a controversy as to fraud settled by the arbitrators, the most expeditious way. Moreover, suppose that after an agreement for arbitration one of the parties refuses to go on with the contract to which the arbitration agreement refers because he says that such principal contract was induced by fraud, and the other denies the fraud. In such case, it would not seem improbable that the parties would consider the whole dispute between them as one for the arbitrators to decide.

It is hard to lay down a rule that can be applied uniformly because the language of arbitration clauses varies. For example, a clause to the effect that all questions as to the making and performance of the contract be submitted to arbitration, would quite clearly indicate that questions such as fraud are to be included within the scope of the submission, whereas a clause merely referring to disputes arising in the performance of the contract would not. In cases of ambiguity, a rule of presumption must be applied, and, as indicating the proper rule, the following general matters of policy may be considered, namely, that statutes on arbitration are liberally construed, that

[20]Matter of Wilkins, 169 N. Y. 494, 62 N. E. 575 (1902).
[21]See Piercy v. Young, 14 Ch. Div. 200 (1879).

the courts favor arbitration as a means of settling disputes, and that the law favors expedition in the settlement of controversies.[22]

Where the parties intend to have questions such as fraud arbitrated, it is clear that arbitration of them can be compelled according to section 3 of the Arbitration Law. On the other hand, where it is evident that it was not the intent of the parties to have fraud arbitrated, it is obvious that they cannot be compelled to have that issue arbitrated. Where it was not the intention of the parties to have fraud arbitrated but where arbitration is demanded as to questions other than fraud, the other party resisting arbitration because of fraud alleged in the inducement of the principal contract, the procedure is not so obvious. It is possible to argue that until the question of fraud as to the principal contract is determined there is doubt as to the existence of the contract to which the arbitration agreement refers and that a party has the right to have the doubt resolved by the court before he can be compelled to arbitrate anything. On the other hand it may be argued that it was the intention of the parties to have all controversies which might arise on account of reliance on the contract, *e. g.*, where there is part performance, adjusted by arbitration whether the principal contract was valid or not. Probably, however, in cases where it cannot be said, even with benefit of presumption, that questions of fraud in the inducement of the principal contract were included within the scope of the arbitration agreement, it is more in line with the probable intent of the parties to have such questions of fraud determined prior to arbitration.

In summarizing these comments on matters raised by the *Cheney Brothers* case, it is suggested as preferable to regard a contract containing a provision for arbitration as consisting of a principal contract and a supplementary contract for arbitration which stand upon independent footings as far as questions of validity are concerned and it is further suggested as preferable to presume that matters such as fraud in the inducement of the principal contract are embraced within the scope of a general arbitration clause.[22a] In addition to

[22]Wabash Ry. Co. v. American Refrigerator Transit Co., 7 Fed. (2d) 335, 350 (8th circuit 1925). MORSE, ARBITRATION AND AWARD, (1872) part 1, ch. 2, p. 57.

[22a] That an issue of fraud in the inducement of the principal contract is embraced within the scope of a general arbitration agreement, see De Long v. Stanton, 9 Johns. 38, 42 (1812), where the court said, "The submission in this case was general, and embraced 'every demand and cause of action, in law or equity.' No language could have been more comprehensive. If the allegation of fraud, in the sale of the farm, was true in fact, it was a cause of action embraced by the submission. (1 Salk. 211. 1 Lev. 102.) Parol evidence is not admissible to limit the extent of the submission, and to show that it was to be confined to matters actually in *dispute or controversy;* for this would be to con-

what has been said heretofore, it may be added that if the decision of the court in the Appellate Division is to stand, recalcitrant parties will in many cases be enabled to circumvent the provisions of a good arbitration agreement and also the purpose of the Arbitration Law by trumping up sufficient allegations to give facts constituting legitimate matter for arbitration the dressing of fraud in the inducement of the principal contract, which, according to that decision, would have to be decided by the court before any arbitration could be had.

While the one question of fraud has been considered thus far, the suggestions that have been made may be applied to other questions of validity. Of course reference is only made to those matters affecting the validity of what we have called the first or principal contract and the distinction must always be borne in mind between such matters and matters solely affecting the validity of the second contract, namely, the contract for arbitration in itself, which latter are obviously to be decided by a court before arbitration.[23]

Questions of construction are somewhat analogous to questions of validity in that they may be better handled by regarding a contract containing a provision for arbitration as divided into a first contract and a second supplementary agreement for arbitration. *Matter of Cheney Brothers v. Joroco Dresses, Inc.*, is an illustration of a case calling for the construction of the supplementary agreement, the particular point being whether or not it embraces the question of fraud in the inducement of the principal contract. Where a party, before arbitration raises a question as to the construction of the second contract, it seems clear that he should be entitled to have it construed by a court if it will affect the question whether he has agreed to arbitrate the matter or not.[24] In *Matter of Palmer & Pierce, Inc.*,[25] the phrase "arbitration in the usual manner" had to be construed in order to determine whether the arbitration agreed upon was one to be conducted by the board of arbitration of the Dried Fruit Association of New York, or pursuant to the laws of New York and

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tradict the bond. Nor can the defendant be admitted to show that there was no such fraud as was alleged, for that would be to open the merits of the award, and to try over again a matter which had been included in the submission and the award. It was for the arbitrators to decide, *secundum allegata et probata*, whether the charge of fraud was made out. Their decision upon the point was final, according to the doctrine laid down in *Barlow v. Todd.*"

[23]For example, Matter of Gresham & Co., Ltd., and Matter of Palmer & Pierce, Inc., *supra* note 4.

[24]Matter of Young v. Crescent Development Co., 240 N. Y. 244, 148 N. E. 510 (1925).

[25]195 App. Div. 523, 186 N. Y. Supp. 369 (1921).

the court decided that such matter of construction was necessary prior to granting an order.[26]

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[26]In order that a discussion of questions of construction be complete it should embrace questions regarding the construction both of the first contract and of the second contract as those terms have been used in the above comment. Also the procedure should be discussed where questions of construction are raised (1) prior to arbitration, (2) at the arbitration hearings, or (3) after arbitration when it is sought to have the award enforced.

We have seen in the concluding paragraph above, the result where questions of construction of the second contract are raised prior to arbitration. Where questions as to the construction of the second contract are raised for the first time at the hearings before the arbitrators, it seems that a party may put a stop to the proceedings and that the arbitrator he has chosen may withdraw until there is court determination as to the scope of the arbitration provision. Matter of Bullard v. Grace Co., 240 N. Y. 388 (1925). Where such matter is raised for the first time upon attempt to enforce the award it would seem that a party who has been so dilatory should deserve little consideration. Where, however, arbitrators place a construction upon the second agreement not subscribed to by the court, the court does not consider the decision of the arbitrators as conclusive. Halstead v. Seaman, 82 N. Y. 27, (1880).

Construction of the first or principal contract is sometimes demanded in order that a party may know whether the dispute which he is called upon to arbitrate arose out of that contract or not. In such case, if the question is raised prior to arbitration, it would seem that a party should not be compelled to proceed until the matter of construction is disposed of by the court. Matter of Kelly, 240 N. Y. 74, 147 N. E. 363 (1925). Where the matter is raised for the first time at the arbitration hearings, whether a party has the power to withdraw or whether the arbitrator has authority to decide it, is a question that raises some difficulty. There seems little objection, however, in allowing the arbitrator to decide the question. What view the courts would take of the question when brought up for the first time upon attempt to enforce the award is problematical.

Questions of construction of the principal contract which are involved in the general question of liability under the contract would seem to be for the arbitrators. Itoh & Co., Ltd., v. Boyer Oil Co., Inc., 198 App. Div. 881, 191 N. Y. Supp. 290 (1st Dept. 1921). Compare Hutcheson v. Eaton, 13 Q. B. D. 861 (1864), where the court held that the arbitrators were without authority to determine the existence of a trade custom which could be read into the contract. There was dissent in that case. The case was followed, in *Re* North-Western Rubber Co. (limited) and Huttenbach & Co., (1908) 2 K. B. 907 where there was again difference of judicial opinion. Both cases are discussed in 53 Sol. J. 158, "*Effect of an Award Based on the Existence of a Trade Custom*," where the holdings of the court were criticized and the view of the dissent upheld as to law and practicability.