Marquette Law Review

Volume 86
Issue 3 *Winter 2002*

Article 5

Has Expansion of the Federal Arbitration Act Gone Too Far?: Enforcing Arbitration Clauses in Void Ab Initio Contracts

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HAS EXPANSION OF THE FEDERAL ARBITRATION ACT GONE TOO FAR?: ENFORCING ARBITRATION CLAUSES IN *VOID AB INITIO* CONTRACTS

"The Supreme Court has only itself to blame for the confusion and contradictory holdings that have followed its FAA rulings of the last forty years."[1]

I. INTRODUCTION

Arbitration is a means to privately resolve disputes in which a neutral third party is authorized to review the disputed claim and render a binding decision.[2] The American Arbitration Association (AAA) defines arbitration as a:

> [S]ubmission of a dispute to one or more impartial persons for a final and binding decision. The arbitrators may be attorneys or business persons with expertise in a particular field. The parties control the range of issues to be resolved by arbitration, the scope of the relief to be awarded, and many of the procedural aspects of the process. Arbitration is less formal than a court trial. The hearing is private. Few awards are reviewed by the courts because the parties have agreed to be bound by the decision of the arbitrator.[3]

The recent proliferation of arbitration in the United States is unprecedented.[4] It is nearly impossible to conduct day-to-day operations without consenting to a binding agreement to arbitrate one's

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1. Nancy R. Kornegay, Prima Paint *to* First Options*: The Supreme Court's Procrustean Approach to the Federal Arbitration Act and Fraud*, 38 HOUS. L. REV. 335, 358 (2001).

2. *See, e.g.*, David P. Pierce, *The Federal Arbitration Act: Conflicting Interpretations of its Scope*, 61 U. CIN. L. REV. 623 (1992).

3. American Arbitration Association (AAA) website, *A Beginner's Guide to Alternative Dispute Resolution*, *at* http://www.adr.org.

4. There were an astounding 198,491 cases filed with the AAA in 2000, representing a 41% year-to-year increase from 1999. 2000 ANNUAL REPORT 5 (2001), *available at* http://www.adr.org.

claims.[5] Employment contracts[6] and credit card agreements[7] are two of many situations in which arbitration has become common.

Given businesses' perceived advantages of arbitration, this proliferation "should not be surprising."[8] Arbitration, as opposed to litigation, arguably provides the "twin benefits" of efficient resolution and low cost.[9] Arbitration achieves this result by allowing parties to forgo numerous motions as well as discovery, opting instead for an informal process that de-emphasizes the adversarial nature of dispute resolution and enhances the importance of the parties' working together.[10] In a commercial arbitration, the arbitrator, in contrast to a judge, is free to facilitate communication between the parties, and is not bound by precedent. Rather, an arbitrator can use common sense in reaching a conclusion.[11]

The proliferation of arbitration in the United States is also due, in large part, to the Supreme Court's expansion of the Federal Arbitration Act[12] (FAA or Act). As will be shown, the Supreme Court's effort to expand the FAA has led to strained reasoning and "mysterious"

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5. *See* Jean R. Sternlight, *Panacea or Corporate Tool?: Debunking the Supreme Court's Preference for Binding Arbitration*, 74 WASH. U. L.Q. 637, 637 (1996) (warning readers that "the next time that you try to file a lawsuit . . . you may well find the door of the courthouse . . . barred").

6. *See, e.g.*, Circuit City Stores, Inc. v. Adams, 532 U.S. 105, 119 (2001) (holding that the Federal Arbitration Act (FAA) generally applies to employment contracts).

7. If you have not done so already, closely read the fine print of your credit card agreement. There is a strong likelihood that you have agreed to arbitrate any claims that you have against your credit card company.

8. Pierce, *supra* note 2, at 624.

9. *Id.* (citing N. Sue Van Sant Palmer, *Lender Liability and Arbitration: Preserving the Fabric of Relationship*, 42 VAND. L. REV. 947, 963 n.104 (1989) ("Speaking for those who have had experience and who are engaged in business, I may say this, that arbitration saves time, saves trouble, saves money." (quoting Mr. Bernheimer, chairman of Committee on Arbitration, Chamber of Commerce of New York)). Not everyone, however, is convinced that arbitration is the "panacea" for the ills that inhibit litigation as an effective form of dispute resolution. *See, e.g.*, Sternlight, *supra* note 5, at 674–97 (arguing that the Supreme Court's policy arguments for the expansion of the FAA are illegitimate). Professor Jean R. Sternlight, for instance, has noted that there is insufficient empirical data to support the argument that "arbitration is necessarily faster, cheaper, and otherwise better than litigation." *Id.* at 678. Sternlight has also noted that as the size and scope of the arbitration increases, so too does the parties' dissatisfaction with the process. *Id.* at 678–79 (citing Thomas J. Stipanowich, *Rethinking American Arbitration*, 63 IND. L.J. 425, 460 (1988)).

10. Pierce, *supra* note 2, at 625.

11. *Id.*

12. 9 U.S.C. § 1 (1994).

results.[13] This expansion has erroneously led circuit courts to believe that, through the FAA, Congress manifested a preference for arbitration over litigation in *all* circumstances.[14]

Strained efforts at expansion have led to particularly absurd results in one area of arbitration law. Recent circuit court cases have misconstrued the scope of the FAA's expansion by holding that a claim that a contract is *void ab initio*,[15] and therefore nonexistent,[16] is nonetheless arbitrable due to an arbitration clause embedded in that contract.[17]

The thesis of this Comment is simple: the FAA was not intended, and should not be construed, to compel enforcement of an arbitration agreement where the contract is void. Part II of this Comment will begin by giving a brief history of the FAA, focusing on Congress's intent in enacting the federal law mandating arbitration. Part III will focus on the Supreme Court's treatment of the FAA—from the Court's early reluctance to extend the Act beyond mutually consensual private arrangements to the cases that are responsible for its expansion. Part IV will subsequently narrow the focus of this Comment by reviewing the Supreme Court's holding in *Prima Paint v. Flood & Conklin Manufacturing Co.*,[18] the decision that is primarily responsible for the expansion of the FAA and also serves as a cornerstone for the discussion of whether a court or an arbitrator should decide challenges to contracts containing arbitration agreements. Part V will then engage in a discussion of the distinction between void and voidable contracts, and how expansion of the FAA has allowed courts to force arbitration of contracts that are *void ab initio* and, therefore, nonexistent.

Part VI of this Comment will argue that the enforcement of arbitration in void contracts is inherently unjust and well beyond the scope that Congress intended for three reasons: (1) it places an agreement to arbitrate on a higher footing than other contract provisions, which is inconsistent with Congress's initial intent in enacting

13. Alan Scott Rau, *The Arbitrability Question Itself*, 10 AM. REV. INT'L ARB. 287, 287–88 (1999). *See also infra* Part V.

14. *See* Sternlight, *supra*, note 5, at 639.

15. *Ab initio* is a Latin phrase meaning "from the beginning." BLACKS'S LAW DICTIONARY 4 (7th ed. 1999). Throughout this Comment the term "void" will be used to refer to a contract that is void "from the beginning," and thus nonexistent.

16. *See infra* note 134 and accompanying text.

17. *See* cases cited *infra* Part V.

18. 388 U.S. 395 (1967).

the FAA and the Supreme Court's holdings that have invalidated state laws that have put arbitration clauses on unequal footing; (2) it infringes on states' rights to govern contract law and protect its consumers; and (3) it places authority in an arbitrator who has no jurisdiction. Finally, this Comment will conclude by arguing that the Supreme Court needs to clarify its *Prima Paint* holding so as to extend only to cases where a valid contract actually exists. Only by doing so will the Court alleviate some of the confusion and contradiction surrounding arbitration law under the FAA.

II. HISTORY OF THE FAA

A. Enactment of the FAA—Congressional Purpose

The early American judiciary demonstrated an intense hostility toward arbitration.[19] Courts, following English precedent, would generally allow two willing parties to arbitrate their claims, but would refuse to enforce arbitration when a party changed its mind "on the ground that an 'agreement of the parties cannot oust [the] court of its jurisdiction.' "[20]

Judicial sentiment disfavoring arbitration did not change until the early twentieth century, when big business began to boom and businesses began lobbying for arbitration as a means to reduce the delay and expense of litigation.[21] Lobbyists initially focused on reforming state laws, but soon realized that such laws would be futile unless federal courts would honor them.[22] As a response, reformers working with the American Bar Association drafted the original FAA statute, adopted by Congress in 1925.[23]

The enactment of the FAA was clearly an intention by Congress to

19. Pierce, *supra* note 2, at 625.

20. Linda R. Hirshman, *The Second Arbitration Trilogy: The Federalization of Arbitration Law*, 71 VA. L. REV. 1305, 1309 (1985) (citation omitted). Although courts would typically honor an arbitrated decision, an agreement to arbitrate was "revocable at the option of either party prior to commencement of an arbitral proceeding. . . . [O]ne party to an arbitration agreement could not use the court system to compel arbitration." *Id.* at 1310–11.

21. Sternlight, *supra* note 5, at 645.

22. *Id.*

23. *Id.* at 645–46. The FAA was originally known as the U.S. Arbitration Act, but "increasingly came to be known as the Federal Arbitration Act." *Id.* at 639 n.12 (citing IAN R. MACNEIL, AMERICAN ARBITRATION LAW: REFORMATION, NATIONALIZATION, INTERNATIONALIZATION 231 N.48 (1992)). The current version of the FAA is now codified at 9 U.S.C. §§ 1–208 (2000).

force courts to honor arbitration agreements. The legislative history of the FAA indicates that Congress's purpose was to place private parties' agreements to arbitrate on the "same footing" as other contracts.[24] Accordingly, at the time of its enactment, there was widespread belief that the FAA would only apply to consensual transactions and not to arbitration agreements offered on a "take-it-or-leave-it basis to captive customers or employees."[25]

B. Relevant Provisions of the FAA

The FAA is currently codified at 9 U.S.C. §§ 1-208. The "keystone provision"[26] of the Act is section 2:

> A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter *arising out of such contract* or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy *arising out of such a contract*, transaction, or refusal, *shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.*[27]

Section 2 serves as the major substantive provision, providing a legislative answer to the judicial hostility that arbitration had received, by instructing that, where the agreement is in writing, it is to be honored by a court.[28] Section 2 also provides a savings clause, whereby a party may challenge the enforceability of the arbitration agreement just as any

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24. *See* Pierce, *supra* note 2, at 626–27 (citing Volt Info. Scis. v. Bd. of Trs., 489 U.S. 468, 474 (1989) ("stating that congressional policy was created ... to ensure that arbitration agreements would be placed on [the] same footing as other agreements")). As will be shown, this intention is currently being contradicted by allowing for the arbitration of contracts that are void from their inception. *See infra* Part V.

25. Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 407, 414 (1967) (Black, J., dissenting) (citing *Federal Arbitration Act Hearing on* S. 4213 *and* S. 4214 *Before the Subcomm. of the S. Comm. on the Judiciary*, 67th Cong., 4th Sess. 9–11 (1923)).

26. Pierce, *supra* note 2, at 627. Professor Sternlight refers to section 2 as the "centerpiece" of the Act. Sternlight, *supra* note 5, at 646.

27. 9 U.S.C. § 2 (1994) (emphasis added). Section 1 of the Act contains an exclusion provision as follows: "[B]ut nothing herein contained shall apply to contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign or interstate commerce." 9 U.S.C. § 1 (1994).

28. *Id.* § 2.

other contract would be challenged.[29]

Sections 3 and 4 are enforcement mechanisms ensuring that private, written agreements to arbitrate are enforced by courts.[30] Section 3 instructs a court, upon the application of either party to the arbitration agreement, to stay pending litigation that is the proper subject of the agreement to arbitrate.[31] Section 4 goes further by instructing any *United States district court* to compel arbitration when one of the parties has failed to allow a dispute that is subject to a written arbitration agreement to be arbitrated.[32] While these provisions are similar in that they both provide a legislative mandate for a court to facilitate arbitration, one important difference presents itself: whereas section 3 refers to "courts of the United States,"[33] section 4 refers to "any United States district court."[34] There is no explanation in the legislative history for this distinction.[35] This unclear distinction is just one example of the confusion that courts were left to grapple with in the practical application of the FAA. This confusion will be explored in greater detail below.

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29. *Id.*

30. *Id.* §§ 3, 4.

31. Section 3 reads:

> If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.

Id. § 3.

32. Section 4 reads, in pertinent part:

> A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition any United States district court .... The court shall hear the parties, and upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement.

Id. § 4.

33. *Id.* § 3.

34. *Id.* § 4.

35. Pierce, *supra* note 2, at 628.

III. THE SUPREME COURT'S EXPANSION OF THE FAA

A. Unanswered Questions

When the FAA was passed, unclear drafting and a sparse legislative history left many questions unanswered.[36] These questions would provide the Supreme Court with the maneuvering room necessary to expand the scope of the Act well beyond Congress's intentions. Overlying the confusion was the primary question of which of three possible powers Congress had relied upon to pass the legislation: (1) its power to regulate interstate commerce under the Commerce Clause; (2) its power to issue procedural edicts under Article III of the Constitution; or (3) its power at the time[37] to enact a federal rule of substantive law for federal jurisdiction cases.[38] The answer to this question would provide the basis for just how far the FAA could be expanded.[39]

Two additional questions resulted from the confusion regarding the power upon which Congress had relied. First, it was unclear whether the Act was to be applied in state courts as well as in federal courts.[40] The power that Congress relied upon would take on particular significance in answering this question after *Erie Railroad Co. v. Tompkins*,[41] which denied Congress the ability to formulate substantive rules of federal common law based solely on its Article III powers.[42]

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36. *See* Hirshman, *supra* note 20, at 1308 (noting that "[a]t the time of passage, Congress failed to perceive the constitutional problems latent in the legislation").

37. As will be illustrated, Congress no longer had the option of relying on this power after the Supreme Court's decision in *Erie Railroad v. Tompkins*, 304 U.S. 64 (1938).

38. *See, e.g.*, Pierce, *supra* note 2, at 629–30.

39. *See infra* Part III.C.

40. *See* Sternlight, *supra* note 5, at 649 (noting that while the legislative history is unclear, and the Supreme Court eventually decided otherwise, "virtually all those who have studied the history of the Act in its context have concluded that the FAA was viewed at the time as a procedural and remedial statute governing only federal courts") (citing, *inter alia*, Southland v. Keating, 465 U.S. 1, 21 (1984) (O'Connor, J., joined by Rehnquist, J., dissenting); Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 401 (1967) (Black, J., dissenting)). The discrepancy in wording between section 3 and section 4 certainly suggests that at least section 4 was intended to be applicable only in federal courts.

41. 304 U.S. 64 (1938).

42. Hirshman, *supra* note 20, at 1316 (citing *Erie*, 304 U.S. at 78 (finding unconstitutional congressional attempts to impose on states rules that are unsupported by specific constitutional provisions)). The *Erie* Court, in a personal injury case brought on diversity grounds, stated that "[e]xcept in matters governed by the Federal Constitution or by Acts of Congress, the law to be applied in any case is the law of the State. . . . There is no federal

Consequently, had the Court found that Congress was relying on this power, the FAA would have been strictly limited to application in federal courts. Second, it was unclear whether the Act "was intended to be a substantive or purely procedural mechanism."[43] As will be shown, the Supreme Court resolved both of these questions in a manner that would extend the FAA as far as possible, creating particular confusion in the Act's application to allegations that a contract is void, and therefore nonexistent.

B. "The Period of Original Intent"[44] and the Erie Doctrine (1925–1966)

Early decisions interpreting the scope of the FAA focused on the importance of voluntary, knowing consent by both parties.[45] The Supreme Court's 1953 decision of *Wilko v. Swan*[46] represented the first major interpretation of the scope of the FAA.[47] In *Wilko*, the Court prohibited arbitration of a customer's securities fraud action against a brokerage house, noting a concern that the arbitration agreement was not *mutually consensual* and did not serve the public interest.[48] Similarly, three years later, the Court further elaborated on the importance of protecting consumers and workers from non-consensual arbitration by finding an arbitration clause unenforceable as applied to a discharged employee who had not *knowingly agreed* to arbitrate his claims.[49]

Early decisions also reflected an intention to limit the Act to application in federal courts. From the Act's inception until 1945, no federal court even considered applying the FAA to an action brought in

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general common law. Congress has no power to declare substantive rules of common law applicable in a State." *Id.* at 1316 n.58 (quoting *Erie*, 304 U.S. at 78).

43. Pierce, *supra* note 2, at 629.

44. Sternlight, *supra* note 5, at 644. Professor Sternlight provides an excellent analysis on the history of the FAA and will be cited to extensively in this Section. Sternlight categorizes the evolution of the FAA into three eras: (1) "The Period of Original Intent (1925–1966)"; (2) "Seeds of Myths are Planted (1967–1982)"; and (3) "The Myths Fully Develop (1983–present)." *Id.* at 644, 653, 660. This Comment will focus primarily on the expansion of the FAA that took place after the Supreme Court's 1967 decision in *Prima Paint.*

45. As will be shown in the following paragraphs, the binding arbitration clauses contained in most credit card agreements would not have survived the Court's scrutiny during the period of "original intent."

46. 346 U.S. 427 (1953).

47. Sternlight, *supra* note 5, at 648.

48. *Id.* (citing *Wilko*, 346 U.S. at 438).

49. *Id.* (citing Bernhardt v. Polygraphic Co. of Am., 350 U.S. 198 (1956)).

a state court.[50] The Court's decision in *Marine Transit Corp. v. Dreyfus*[51] is illustrative of this, where the Court insinuated that the FAA was a procedural statute that would apply exclusively in federal courts.[52]

For the most part, courts had no reason to consider the applicability of the FAA in state courts.[53] This would change with the Supreme Court's decision in *Erie* that held that state substantive law rather than a federal common law would govern cases brought pursuant to diversity jurisdiction.[54] Suddenly, determining which of the three possible powers Congress intended to use when passing the FAA became significant.[55] Because the development of a federal common law of arbitration was no longer a viable option, the FAA was presumably either enacted under the Commerce Clause or it was merely a procedural edict.[56] Labeling the FAA as a mere procedural rule to be applied in the federal court system would limit its application to federal courts.[57] However, if it were determined that Congress was using its power to regulate substantive law under the Commerce Clause, the Act could be extended to state courts.[58]

In *Bernhardt v. Polygraphic Co. of America*,[59] a diversity suit in which litigation was stayed pending arbitration, the Court first began to analyze the "ramifications of *Erie* for the FAA."[60] First, the Court concluded that arbitration is "outcome determinative"[61] under the test set forth in *Guaranty Trust Co. of New York v. York*.[62] The Court

50. *Id.* at 650 n.63 (citing Ian R. Macneil, AMERICAN ARBITRATION LAW: REFORMATION, NATIONALIZATION, INTERNATIONALIZATION 127–28 (1992) (noting that "[a]rbitration actions brought in state courts were governed by the state's own arbitration laws," which were often less accepting of arbitration than the FAA)).

51. 284 U.S. 263, 279 (1932) (holding that the FAA is constitutional because Congress has the power to implement procedural remedies with respect to maritime matters).

52. Sternlight, *supra* note 5, at 650 (citing *Dreyfus*, 284 U.S. at 277–79).

53. *Id.* at 650–51.

54. *Id.* at 651.

55. *See supra* notes 37–38 and accompanying text.

56. *See supra* Part III.A.

57. *See id.*

58. *Id.*; Hirshman, *supra* note 20, at 1316–18.

59. 350 U.S. 198 (1956).

60. Sternlight *supra* note 5, at 651.

61. *Id.* (citing *Bernhardt*, 350 U.S. 198).

62. 326 U.S. 99 (1945). *Guaranty Trust* dictated that, due to a public policy of avoiding forum shopping, any outcome-determinative rule must be drawn from state law. 350 U.S. at 203. The *Bernhardt* Court determined that arbitration was outcome determinative, noting that "[i]f the federal court allows arbitration where the state court would disallow it, the

determined, however, that the arbitration agreement fell outside the substantive provisions of section 2 of the Act because the transaction was neither maritime, nor did it involve commerce.[63] This conclusion was made despite the fact that the arbitration agreement was entered into by a New York corporation and its employee who was to perform the contract in Vermont.[64] Such a determination allowed the Court to avoid deciding whether Congress had indeed used its Commerce Power to enact the FAA. The Court itself expressly noted that it construed the FAA narrowly to avoid the constitutional issue dealing with Congress's limited power under *Erie* to make arbitration enforceable in diversity suits despite contrary state law.[65] Writing for the Court, Justice Douglas expressly noted the importance of interpreting the FAA "narrowly to avoid impinging on states' rights to regulate substantive law."[66]

The Court was able to skirt the issue of which power Congress had relied upon when enacting the FAA. However, by determining that the FAA had a "substantive"[67] effect, the Court seemingly preempted the future opportunity to rule that Congress had used its power to issue a procedural edict under Article III of the Constitution.[68] Courts were consequently left to decide whether Congress had relied upon its commerce powers or Article III powers to provide rules for diversity cases.[69] If in the subsequent decision the Court chose the latter, it would have to reconcile the previous decision to the contrary in *Bernhardt*, as well as how the FAA could be imposed in an area that *Erie* had expressly forbidden.[70]

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outcome of litigation might depend on the courthouse where suit is brought." Hirschman, *supra* note 20, at 1320 n.82 (quoting *Bernhardt*, 350 U.S. at 203).

63. Hirshman, *supra* note 20, at 1319 (citing *Bernhardt*, 350 U.S. at 200).

64. Sternlight, *supra* note 5, at 651 n.74 (citing *Bernhardt*, 350 U.S. at 198) (suggesting that under today's more lenient standards this would certainly be considered a transaction involving interstate commerce)).

65. Hirshman, *supra* note 20, at 1319–20 (citing *Bernhardt*, 350 U.S. at 202). Justice Frankfurter, in his concurrence, suggested that the FAA should not be applied to diversity cases at all "to avoid having to decide whether it was unconstitutional for the federal government to require a state law claim to be taken to arbitration." Sternlight, *supra* note 5, at 651 n.75 (citing *Bernhardt*, 350 U.S. at 202–04).

66. Sternlight, *supra* note 5, at 651 (citing *Bernhardt*, 350 U.S. at 202–04). This concern is now being overlooked by some courts. *See infra* Part V.C.; VI.A.2.

67. *See* Hirschman, *supra* note 20, at 1320 (citing *Berhnardt*, 350 U.S. at 200–01); Sternlight, *supra* note 5, at 651 (citing *Berhnardt*, 350 U.S. at 200–01).

68. Hirshman, *supra* note 19, at 1320.

69. *Id.*

70. *Id.*

Courts could have escaped any *Erie* problem by construing the FAA as enacted pursuant to Congress's commerce power.[71] This solution, however, would have led to further confusion. For instance, creating a federal substantive right should qualify actions to enforce arbitration in federal courts, through federal subject matter jurisdiction.[72] Second, even if the Act is not construed as warranting federal question jurisdiction, it should take precedence in state courts under the Supremacy Clause.[73] In an effort to expand arbitration into all realms of society, subsequent decisions would prove that the Court had little concern for these issues.

C. Prima Paint: *Expansion and Truncation of State Law*

From 1925 until 1967, federal courts were reluctant to extend the FAA in a manner that would force arbitration on parties that had not knowingly agreed to arbitrate their claims or in a manner that would impinge on a state's rights to govern substantive law.[74]

In *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*,[75] this reluctance ended. In *Prima Paint,* the Court was finally forced to determine which power Congress had relied upon in enacting the FAA. In this federal diversity suit, the Court was unable, as it did in *Bernhardt*,[76] to read the contract so as to take it out of the aegis of section 2 of the Act.[77] Accordingly, the Court was forced to decide whether Congress relied on its commerce powers or its Article III powers to legislate rules of decision in cases where the parties were diverse, a power that it had enjoyed until the *Erie* decision. In an effort to avoid *Erie* problems, yet still expand the FAA, the Court swiftly determined that Congress had enacted the FAA pursuant to its commerce powers,[78] a contention that Justice Black, in his dissent,

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71. *Id.* at 1317.

72. *Id.* (citing 28 U.S.C. § 1331 (1982), which dictates that "[t]he district courts shall have original jurisdiction of all civil actions arising under the Constitution, *laws*, or treaties of the United States" (emphasis added)); *see also id.* at 1317–18 n.67 (noting that while section 2 standing alone could possibly support federal question jurisdiction, sections 3 and 4 mandate a congressionally-created limit on such jurisdiction).

73. *Id.* at 1317–18 n.67.

74. *See supra* Part III.B.

75. 388 U.S. 395 (1967). This Comment will engage in an extended discussion of the majority's holding in *Prima Paint* in Part IV, *infra.*

76. 350 U.S. 198 (1956); *see supra* note 63 and accompanying text.

77. 388 U.S. at 401.

78. *Id.*

vehemently disagreed with as being entirely unsupported by the legislative history of the Act.[79]

Classifying the FAA as a substantive law enacted under the Commerce Clause served as a breeding ground for the Act's subsequent expansion. Several Supreme Court cases in the 1980s continued the expansion of the FAA, including *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*[80] and *Southland Corp. v. Keating*.[81] These cases were the "logical consequence" of the Supreme Court's interpretation in *Prima Paint* that the FAA is a federal substantive law passed under Congress's commerce power.[82]

In *Moses H. Cone*, the Court granted certiorari to decide whether a federal court could, or should, compel arbitration under section 4 of the FAA when the opposing party filed a parallel action in state court.[83] The Supreme Court affirmed the Fourth Circuit's decision, holding that the district court erred in not compelling arbitration.[84] According to the Court:

> Questions of arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration.... The Arbitration Act establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability.[85]

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79. According to Justice Black, "there are clear indications in the legislative history that the Act was not intended to make arbitration agreements enforceable in state courts or to provide an independent federal-question basis for jurisdiction in federal courts." *Id.* at 420 (Black, J., dissenting) (citation omitted). Thus, the majority's view that Congress was creating a body of federal substantive law under its commerce powers was erroneous. *Id.*

80. 460 U.S. 1 (1983).

81. 465 U.S. 1 (1984); *see also* Perry v. Thomas, 482 U.S. 483 (1987) (reaffirming prior decisions that the FAA was enacted pursuant to the Commerce Clause and that it had created federal substantive law); Hirschman, *supra* note 20, at 1340 (citing Dean Witter Reynolds v. Byrd, 470 U.S. 213 (1985)).

82. *See* Hirshman, *supra* note 20, at 1307.

83. *Moses H. Cone*, 460 U.S. at 4; *see also* Hirshman, *supra* note 20, at 1306–07; Kornegay, *supra* note 1 at 346 (providing a general synopsis of the case).

84. *Moses H. Cone*, 460 U.S. at 24–26; *see also* Hirshman, *supra* note 19, at 1338 (commenting that the Court defined the "scope of the FAA in very expansive terms and twice opined that the Act governs in either state or federal court").

85. Sternlight, *supra* note 5, at 660 (citing *Moses H. Cone*, 460 U.S. at 24–25, and noting that "the Court did not provide an explicit rationale for *why* arbitration should be favored over litigation").

Suddenly, it was determined that, contrary to the Court's previous decision in *Wilko v. Swan*,[86] the FAA had created a federal policy favoring arbitration, "proclaiming... that... arbitration served a substantial public purpose and should be favored regardless of the parties' intentions."[87]

In *Southland,* the Court "found an opportunity to even further truncate state contract laws."[88] The California Supreme Court held that claims under the California Franchise Investment Law[89] were outside the scope of the FAA, and thus were not subject to the arbitration agreement.[90] The Supreme Court concluded that the FAA creates binding law that, under the Supremacy Clause, state courts must enforce. Because the California law directly conflicted with section 2, it "violat[ed] the Supremacy Clause" and was unconstitutional.[91] This finding was a further consequence of the Supreme Court's holding in *Prima Paint* that Congress had used its commerce powers to enact the FAA and confirmed Justice Black's concerns that, despite clear legislative intent to the contrary, the FAA would be forced upon states.[92]

The Court did not finish with the expansion of the FAA in the 1980s. In 1996, the Court extended its scope even further.[93] In *Doctor's Associates v. Cassorato*,[94] the Court held that a Montana requirement that an arbitration clause be "typed in underlined capital letters on the first page of the contract" was inconsistent with the FAA because it put the arbitration clause on unequal footing with the other provisions in

86. 346 U.S. 427 (1953) (declining to enforce an arbitration clause that was not mutually consensual and in the public's interest); *see supra* note 47 and accompanying text.

87. *See* Sternlight, *supra* note 5, at 660.

88. Kornegay, *supra* note 1, at 349 (describing the *Moses H. Cone* and *Southland* decisions as "[s]horten[ing] the States' [l]egs").

89. CAL. CORP. CODE § 31000 (West 1977). The California Supreme Court interpreted the statute as requiring claims to be brought in court rather than arbitrated. Sternlight, *supra* note 5, at 664 (citing *Southland*, 465 U.S. at 10).

90. *Southland*, 465 U.S. at 5.

91. *Id.* at 10 (alteration in original); *see also* Kornegay, *supra* note 1, at 349 (adding that the Court "went on boldly, and inexplicably, to claim that in enacting Section 2 of the FAA, 'Congress declared a national policy favoring arbitration and withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration.'") (quoting *Southland*, 465 U.S. at 10).

92. *See supra* note 79 and accompanying text.

93. 517 U.S. 681 (1996).

94. *Id.*

the contract.[95] According to the Court, "[w]hat states may not do is decide that a contract is fair enough to enforce all its basic terms . . . , but not fair enough to enforce its arbitration clause."[96] The Court went on to state that "courts may not . . . invalidate arbitration agreements under state laws applicable *only* to arbitration provisions."[97] Whereas *Moses H. Cone* and *Southland* made it clear that states could not require specific claims to be resolved through litigation rather than arbitration, *Doctor's Associates* further specified that any attempt by a state to protect its citizens by singling out an arbitration clause from the rest of the contract would be preempted by the FAA.[98]

D. A "Partial Restoration"[99] of State Power to Govern Contract Law

Moses H. Cone, *Southland*, and *Doctor's Associates* severely limited the states' long-time right to govern contract law, an essential area of the law when dealing with arbitration agreements.[100] At the same time, however, two Supreme Court cases served to lessen the harshness of the FAA's infringement into this essential state right, leading to confusion regarding just how much power states have retained in contract law relating to arbitration.

The first case, *Volt Information Sciences, Inc. v. Board of Trustees*,[101] confronted the issue left by *Prima Paint* of whether parties are free to agree to have state law govern their arbitration agreement.[102] In holding that parties are free to contract around the FAA, the Court cited *Bernhardt*, which stated that "the FAA does not 'reflect a congressional intent to occupy the entire field of arbitration' . . . . Congress's primary purpose was to make parties' arbitration agreements enforceable."[103]

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95. *See* Kornegay, *supra* note 1, at 357 (citing *Doctor's Assocs.*, 517 U.S. at 686); *see also* Sternlight, *supra* note 5, at 667 (citing MONT. CODE ANN. § 27-5-114(4) (1993)).

96. Kornegay, *supra* note 1, at 357 n.187 (citing *Doctor's Assocs.*, 517 U.S. at 686).

97. *Id.* at 357 n.186 (citing *Doctor's Assocs.*, 517 U.S. at 687).

98. *See* Sternlight, *supra* note 5, at 667.

99. *See* Kornegay, *supra* note 1, at 355.

100. Essentially, without a contract, there can be no arbitration agreement. According to the AAA, "[t]he arbitrator's authority is created by the contract, subject to applicable arbitration law. In effect, the parties breathe life into [the] arbitrator." American Arbitration, *A Guide for Commercial Arbitrators*, *available at* http://www.adr.org/index2.1.jsp?JSPssid=15727&JSPsrc=upload\LIVESITE\Rules_Procedures\ADR_Guides\comguide.html ; *see also* discussion *infra* Part VI.A.2.

101. 489 U.S. 468 (1989).

102. Kornegay, *supra* note 1, at 353 (citing *Volt*, 489 U.S. 468).

103. *Id.* at 353–54 (citing *Volt*, 489 U.S. at 477 (noting that the primary purpose of the

The greatest gains for a state's right to govern its contract law in the area of arbitration undoubtedly came in the Court's decision in *First Options of Chicago Inc. v. Kaplan*.[104] *First Options* involved an objection to an arbitration agreement on the grounds that one of the parties had not signed the agreement.[105]

The Court first determined that the question of "who has the primary power to decide arbitrability" is "fairly simple."[106] In what has been viewed as a contradiction to the Court's previous holding in *Prima Paint*,[107] the Court then concluded that the question of arbitrability should depend upon whether the parties had agreed to submit *that* question itself to arbitration.[108] In deciding this, the Court placed

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FAA was to overcome judicial hostility to arbitration)). It could be argued that this defines the scope that the Court intended in *Moses H. Cone* when it declared that the FAA created a federal policy favoring arbitration.

104. 514 U.S. 938 (1995). For an in-depth discussion of *First Options* and its impact on "The Arbitrability Question Itself," see Alan Scott Rau, *The Arbitrability Question Itself*, 10 AM. REV. INT'L ARB. 287, 308 (1999) (addressing the trouble courts and commentators have had in applying the framework that *First Options* provides for determining whether a court or an arbitrator will decide the question of whether the parties had actually agreed to arbitrate their disputes).

105. *First Options*, 514 U.S. at 941. Kaplan was the sole-owner of MK Investments, Inc. (MKI), which incurred substantial losses after the stock market collapse of October 1987. *Id.* at 940. MKI entered into a series of agreements with First Options, the clearinghouse firm to which it encumbered a substantial amount of debt. *Id.* Kaplan signed several of those agreements as the president of MKI, including one that contained an arbitration clause. *Id.* at 941. Kaplan also signed one agreement in his individual capacity, which did not contain an arbitration agreement. *Id.* When a dispute arose, First Options attempted to initiate arbitration against both MKI and Kaplan individually, which Kaplan resisted. *Id.*

106. Id. at 943; *see also* Rau, *supra* note 104, at 292.

107. It is important to note that the *First Options* Court does not cite *Prima Paint*. *Prima Paint* will be explored in greater detail *infra* Part IV, but at this point it is important to note that *Prima Paint* involved an allegation of fraud in the inducement of the contract itself as opposed to an allegation, as seen in *First Options*, that there had never been an agreement to arbitrate. Prima Paint Corp. v. Flood & Conklin Mfg. Co, 388 U.S. 395, 395 (1967). Whether the Court's holding in *Prima Paint*, that allegations of fraud on the contract generally should be decided by an arbitrator, is usurped by *First Options* has been the subject of much debate. *See, e.g.*, William W. Park, *Determining Arbitral Jurisdiction: Allocation of Tasks Between Courts and Arbitrators*, 8 AM. REV. INT'L ARB. 133, 136–37 (noting the problematic consequences of the dicta in *First Options*); Kornegay, *supra* note 1, at 356 (quoting *First Options*, 514 U.S. at 944, and suggesting that the language in *First Options* is potentially broad enough to apply to allegations of *fraud in the inducement* of a contract). The question of jurisdiction over the arbitration question itself is well beyond the scope of this Comment. The focus of this Comment is on those situations in which the agreement itself is not in dispute, rather, the contract in which the agreement contained is claimed to be void, and therefore, nonexistent.

108. *First Options*, 514 U.S. at 944; *see also* AT&T Technologies, Inc. v. Communications Workers, 475 U.S. 643, 649 (1986); Steelworkers v. Warrior & Gulf Nav.

significance on the fact that an agreement to arbitrate "flow[s] inexorably from the fact that arbitration is simply a matter of contract between the parties."[109] As will be shown later, this reliance on an existing contract between the parties has significant consequences when a contract can be considered void, and thus nonexistent.[110]

The Court next determined that "[w]hen deciding whether the parties agreed to arbitrate a certain matter (including arbitrability), courts . . . should apply ordinary state-law principles that govern the formation of contracts."[111] Consequently, *First Options* gives states the right to apply general principles of contract law in situations when one party resists arbitration by challenging the existence of any agreement, provided that the agreement itself did not dictate that the arbitrability question be arbitrated.[112]

Having reviewed the relevant decisions that have led to the rapid expansion of the FAA into the realm of state courts and state law, it is important to take a closer look at *Prima Paint* to determine how the Supreme Court's decision would eventually lead lower courts to apply the FAA to void contracts.

IV. *PRIMA PAINT* REVISITED

The facts at issue in *Prima Paint* were relatively simple. Prima Paint (Prima), a New Jersey corporation, entered into a contract with Flood & Conklin Manufacturing Company (F&C), a Maryland corporation, wherein F&C agreed to perform consulting services in connection with the transfer of its operations to Prima.[113] The contract contained a broad arbitration clause that stated that "any controversy . . . arising out of . . .

Co., 363 U.S. 574 (1960) (holding that parties may *agree* to arbitrate arbitrability).

109. *First Options*, 514 U.S. at 943.

110. *See* discussion *infra* Part V.B.

111. *First Options*, 514 U.S. at 944 (citing, *inter alia*, Volt Info. Scis., Inc. v. Bd. of Trs., 489 U.S. 468, 475–76 (1989)).

112. This holding, it would seem, allows an arbitration agreement to which both parties had not agreed, to nonetheless allow an arbitrator to determine his own jurisdiction based on the mere fact that the agreement contained pertinent language. How could a party refuse to agree to arbitration yet at the same time agree that a dispute regarding whether she did or did not agree be decided by an arbitrator? The Court addresses this to a certain extent by noting that "[c]ourts should not assume that parties agreed to arbitrate arbitrability unless there is 'clear and unmistakable' evidence that they did so." *Id.* (citing AT&T Techs., Inc. v. Communications Workers, 475 U.S. 643, 649 (1986)). As a result, the power to apply contract law principles in determining whether an agreement to arbitrate exists returns a semblance of power over arbitration law to states that had not clearly existed after *Prima Paint*.

113. Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 397 (1967).

this Agreement, or the breach thereof, shall be settled by arbitration."[114] Prima refused to pay when its first payment under the contract came due, claiming that F&C failed to disclose the fact that it was insolvent and planned to file for bankruptcy shortly after the contract was signed.[115] F&C filed the required notice for arbitration, while Prima filed a diversity action in federal court to rescind the consulting agreement and stay the arbitration proceeding based on a claim of fraudulent inducement of the contract.[116] The Court of Appeals for the Second Circuit "define[d] the FAA as a rule of 'national substantive law' that 'governs even in the face of contrary state' law" and stayed the action pending arbitration.[117] Prima appealed this decision to the United States Supreme Court.

The Supreme Court easily extinguished the commerce question. The Court determined that, because the transaction consisted of a transfer and selling of operations from a New Jersey corporation to a Maryland corporation, and because the company to be acquired had wholesale clients in a number of different states, it was clearly "a contract evidencing a transaction in interstate commerce."[118] Having made this determination, the Court turned to "the question [of] whether the federal court or an arbitrator is to resolve a claim of 'fraud in the inducement,'[119] under a contract governed by the [FAA]."[120] Here, the Court had to resolve a circuit split regarding whether the severability question is an issue to be determined by federal courts or to be governed by state contract law.[121]

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114. *Id.* at 398.

115. *Id.*

116. *Id.*; *see also* Kornegay, *supra* note 1, at 341.

117. Kornegay, *supra* note 1, at 342 (quoting *Prima Paint*, 388 U.S. at 399–400).

118. *Prima Paint*, 388 U.S. at 399–400.

119. Fraud in the inducement of a contract renders a contract "voidable." Burden v. Check Into Cash, 267 F.3d 483, 489 (6th Cir. 2001) (citing RESTATEMENT (SECOND) OF CONTRACTS § 163 cmt. a (1979); Langley v. FDIC, 484 U.S. 86, 93–94 (1987)). On the other hand, "[f]raud in the factum or execution, 'that is, the sort of fraud that procures a party's signature to an instrument without knowledge of its true nature or contents' renders a contract void." *Burden*, 267 F.3d at 489 (quoting *Langley*, 484 U.S. at 93–94).

120. *Prima Paint*, 388 U.S. at 396.

121. *Id.* at 402–03. The Second Circuit had expressed in this case that arbitration clauses were "separable" from the rest of the contract and that, unless the claim was directed at the arbitration agreement itself, a federal policy in favor of arbitration dictated that the arbitrator hear the claim. *Id.* The First Circuit, on the other hand, had determined that severability was an issue to be determined by state contract law. *Id.* (citing Lummus Co. v. Commonwealth Oil Ref. Co., 280 F.2d 915, 923–24 (1st Cir. 1960), *cert. denied*, 364 U.S. 911 (1960)).

The Court sided with the Second Circuit's decision that severability under the FAA is not a proper subject for state contract law.[122] In doing so, the Court cited section 4, which reads, in part: "The court shall hear the parties, and upon being satisfied that the *making of the agreement for arbitration* or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement."[123] According to the majority, this dictated that "[f]ederal courts are bound to apply rules enacted by Congress with respect to matters—here a contract involving commerce—over which it has legislative power."[124] In one fell swoop, the Court had determined that Congress had intended to use its commerce powers,[125] creating a federal body of substantive law rather than a mere procedural remedy in a diversity case. Furthermore, the Court's holding that claims of fraud in the inducement of the contract were to be decided by a court would eventually be extended to claims that the contract itself is void.[126]

V. CIRCUIT COURT INTERPRETATION OF THE FAA AND VOID CONTRACTS

A. Issues Raised and Left to be Resolved by Prima Paint

Prima Paint resolved several issues that, as has been shown, would provide the framework for the subsequent expansion of the FAA. First, the Court delineated that an arbitration clause is separable from the other clauses in the contract.[127] Second, the Court's decision that Congress had relied on its commerce power to create substantive law governing arbitration opened the door for subsequent expansion of the FAA into state courts.[128] Finally, the general tone of the Court's opinion would provide a precedent to later establish the FAA as a national

122. *Id.* at 404.

123. 9 U.S.C. § 4 (emphasis added).

124. *Prima Paint*, 388 U.S. at 406. For Justice Black's response in his dissent to this, see *infra* notes 224–27 and accompanying text.

125. By concluding that Congress had effectuated its commerce power, the Court was able to side-step the question of whether Congress could legislate federal rules of decision simply because the parties happen to be diverse. *See* discussion *supra* Part II.B; Hirshman, *supra* note 20, at 1321.

126. *See infra* Parts V.B.2. and V.C.

127. *See supra* notes 120–22 and accompanying text.

128. *See* Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 401 (1967); discussion *supra* Part III.C.

policy favoring arbitration.[129]

Prima Paint did, however, leave one issue for the rest of the judiciary to resolve. Before going further, it is important to note that the majority's holding specifically dealt with a party claiming *fraud in the inducement* of the contract as a whole when it decided that the FAA requires that issue to be determined by an arbitrator.[130] The Court further determined that if the claim goes to the making of the arbitration agreement itself, a court may proceed with adjudication.[131] As will be distinguished further below, fraudulent inducement of a contract renders a contract "voidable" at the option of one of the parties.[132] This is in contrast to *fraud in the factum*,[133] which renders a contract void.[134] The Court failed to make a distinction between "void" and "voidable," leaving lower courts to determine if this was a distinction inherent in the Court's analysis.

B. Fraud in the Factum and the Void-Voidable Distinction

1. Fraud in the Factum Distinguished from Fraud in the Inducement

The distinction between fraud in the factum and fraud in the inducement carries particular significance in the area of arbitration law. Fraud in the inducement has been referred to as "fraud in which the consent to the contract is not at issue but where the consent was obtained through fraudulent representations."[135] Fraud in the factum,

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129. *See, e.g.*, Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1 (1983) (determining that the FAA created a national policy favoring arbitration).

130. *Prima Paint*, 388 U.S. at 406–07.

131. *Id.* at 403–04.

132. *See supra*, note 118. The Restatement of Contracts defines a "voidable" contract as "one where one or more parties have the power, by a manifestation of election to do so, to avoid the legal relations created by the contract, or by ratification of the contract to extinguish the power of avoidance." RESTATEMENT (SECOND) OF CONTRACTS § 7 (1981).

133. *See infra* note 137 and accompanying text.

134. A void contract is essentially not a contract at all. *See* RESTATEMENT (SECOND) OF CONTRACTS § 7 cmt. a (1981) ("A promise for breach of which the law neither gives a remedy nor otherwise recognizes a duty of performance . . . is often called a void contract. However, such a promise is not a contract at all."). Fraud in the inducement includes, *inter alia*, common law contract defenses such as fraud, mistake, or duress. Three Valleys Mun. Water Dist. v. E.F. Hutton & Co., 925 F.2d 1136, 1140 (9th Cir. 1991) (citing RESTATEMENT (SECOND) OF CONTRACTS § 7 cmt. b (1981)).

135. Jeffrey W. Stempel, *A Better Approach to Arbitrability*, 65 TUL. L. REV. 1377, 1399 (1991).

on the other hand, "makes the consent to the contract ineffective."[136] One court recently outlined a succinct description of the distinction:

> Fraud in the factum occurs when a party makes a misrepresentation that "is regarded as going to the very character of the proposed contract itself, as when one party [causes] the other to sign a document by falsely stating that it has no legal effect." If the misrepresentation is of this type, then "there is no contract at all, or what is sometimes anomalously described as a *void, as opposed to voidable, contract.*" If the fraud relates to the inducement to enter the contract, then the agreement is "voidable" at the option of the innocent party. The distinction is that if there is fraud in the inducement, the contract is enforceable against at least one party, while fraud in the factum means that at no time was there a contractual obligation between the parties.[137]

The importance of distinguishing whether the object of the fraud was the very character of the proposed contract is an important distinction in arbitration law because where "there is . . . no contract at all,"[138] it follows that the arbitrator has no jurisdiction.[139]

2. Fraud in the Factum Applied

The Ninth Circuit provides an insightful analysis into the *Prima Paint* dilemma in an attempt to distinguish fraud in the inducement from fraud in the factum in *Three Valleys Municipal Water District v. E.F.*

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136. *Id.*

137. *Id.* at 1400 (citing Dougherty v. Mieczkowski, 661 F. Supp. 267, 274 (D. Del. 1987) (citations omitted) (emphasis added) (respectively quoting E. FARNSWORTH, CONTRACTS § 4.10, at 235 (1982); RESTATEMENT (SECOND) OF CONTRACTS § 163 cmt. a, § 164 (1981)). The Restatement provides that fraud in the factum occurs when:

> [B]ecause of misrepresentation as to the character or essential terms of a proposed contract, a party does not know or have reasonable opportunity to know of its character or essential terms, then he neither knows nor has reason to know that the other party may infer from his conduct that he assents to that contract. *In such a case there is no effective manifestation of assent and no contract at all.*

RESTATEMENT (SECOND) OF CONTRACTS § 163 cmt. a. (1981) (emphasis added).

138. *Id.* at § 7 cmt. a.

139. *See* First Options of Chicago, Inc. v. Kaplan, 514 U.S. 938, 943 (1995) (noting that "arbitration is simply a matter of contract between the parties").

Hutton & Co.[140] Three Valleys Municipal Water District (Three Valleys) filed suit against E.F. Hutton & Company (Hutton) for losing over $8 million in their investment accounts.[141] In turn, Hutton, pursuant to the agreement between the parties and under the ambit of sections 3 and 4, filed a motion to compel arbitration and stay the federal proceeding.[142] The district court compelled arbitration of the state law claims, but denied arbitration on the federal securities law claims.[143] Hutton contended that the client agreements that contained the arbitration clauses were void because they were signed by a person without authority to sign for the company.[144] The Ninth Circuit determined that the issue of whether the contract was void should be decided by a court, rather than an arbitrator.[145]

The court engaged in a narrow interpretation of *Prima Paint,* reading the Supreme Court's decision as "limited to challenges seeking to *avoid* or *rescind* a contract—not to challenges going to the very *existence* of a contract."[146] The court went on to state that "[u]nder this view, *Prima Paint* applies to 'voidable' contracts—those 'where one party was an infant, or where the contract was induced by fraud,[147] mistake, or duress, or where breach of a warranty or other promise justifies the aggrieved party in putting an end to the contract.'"[148] The court further stated that "a party who contests the making of a contract containing an arbitration provision cannot be compelled to arbitrate the threshold issue of the *existence* of an agreement to arbitrate; only a court can make that decision."[149]

While the Ninth Circuit in *Three Valleys* read *Prima Paint* narrowly, the Fifth Circuit in *Lawrence v. Comprehensive Business Services*[150] read that decision broadly. In that case, the Lawrences alleged that the franchise agreement in which they had entered was illegal under Texas

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140. 925 F.2d 1136 (9th Cir. 1991).

141. *Id.* at 1137.

142. *Id.* at 1138.

143. *Id.*

144. *Id.* A classic example of fraud in the factum.

145. *Id.* at 1140–41.

146. *Id.* at 1140 (emphasis added).

147. The issue found in *Prima Paint* itself.

148. *Three Valleys*, 925 F.2d at 1140 (quoting RESTATEMENT (SECOND) OF CONTRACTS § 7 cmt. b (1981)).

149. *Id.*

150. 833 F.2d 1159 (5th Cir. 1987).

law and that such illegality was not a proper subject for an arbitrator.[151] The court, emphasizing the "strong federal policy in favor of arbitration" as articulated in *Moses H. Cone*,[152] extended the reach of the FAA to contracts that are "void from . . . inception."[153] The vast contrast between the Fifth and Ninth Circuit's approaches in applying *Prima Paint* illustrates the necessity for the Supreme Court to clearly articulate that it had no intention that the FAA ever apply to nonexistent contracts by granting *certiorari* to a case that applies the FAA to a void contract.[154]

C. *Contracts that are Void as a Matter of State Law*

As illustrated by *Lawrence*, the second way a contract can be rendered void, in addition to fraud in the factum, is via a state's power to determine that certain contracts will be void as a matter of state law.[155] *Burden v. Check Into Cash*,[156] the most recent circuit court case to attempt to interpret the scope of *Prima Paint,* addressed such an issue. The Sixth Circuit's analysis and convoluted reasoning provide an excellent example of the difficulty lower courts have had in applying *Prima Paint* to allegations that a contract is void.

The facts of the case are straightforward. Beverly Burden was the trustee for four bankrupt estates in Lexington, Kentucky, while the defendant, Check Into Cash is incorporated and does business in Kentucky.[157] The issue in the case arose from transactions that were essentially "payday loans."[158] These loans were characterized by

151. *Id.* at 1160.

152. *Id.* at 1164 (citing Moses H. Cone Mem'l. Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24–25 (1983)).

153. *Id.* at 1162.

154. The Court recently declined to do so in *Burden v. Check Into Cash*, 267 F.3d 483 (6th Cir. 2001), *cert. denied*, 122 S. Ct. 1436 (2002), perhaps because it is waiting for the circuits to become even further divided on this subject.

155. As will be seen in *Burden*, states are typically inclined to make certain contracts void to protect its citizens from unscrupulous business practices. *See infra* note 164. This is a power granted to the states in the Tenth Amendment of the United States Constitution. U.S. Const. amend. X. ("The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.").

156. 267 F.3d 483 (6th Cir. 2001), *cert. denied,* 122 S. Ct. 1436 (2002).

157. *Burden*, 267 F.3d at 486.

158. *Id.* For a discussion of the case, see Justin Kelly, *Court Asked to Review Validity of Arbitration Clause in Void Contract*, ADR NEWS (January 4, 2002), *at* http://www.adrworld.com/opendocument.asp?doc+q2m3fjode. For a discussion of the

exorbitant interest rates and short-term borrowing periods, during which customers would pay approximately $19 for every $100 borrowed.[159] In 1997, Check Into Cash added an arbitration clause to the back of the customer agreements, which the plaintiffs in this case signed.[160] Despite this arbitration clause, Burden filed suit in the district court alleging, *inter alia*, violations of several Kentucky consumer protection statutes.[161]

In a separate case in 1999, the Kentucky Supreme Court answered a certified question, determining that when a check-cashing company accepts a check and defers deposit pursuant to an agreement with the maker of the check, the fee that is charged is "interest," rather than a service fee.[162] Accordingly, Check Into Cash was not exempted from the Kentucky statute licensing check-cashing businesses and was instead required to be licensed as a lender.[163] Because Check Into Cash was an unlicensed lender, under Kentucky law any loan contract in which it entered was void.[164] In January of 2000, Check Into Cash filed a motion in the district court under the FAA to compel arbitration and stay litigation pending the arbitration.[165] The district court denied this motion and the case was heard by the Sixth Circuit Court of Appeals.[166]

In its analysis, the Sixth Circuit seemed to rely heavily on the maxim: "As a matter of federal law, any doubts concerning the scope of

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"payday loan" industry, see infra Part V.B.1.

159. *Burden*, 267 F.3d at 486. This results in an annual percentage rate ranging anywhere from 500% to 900%. *Id.*

160. *Burden*, 267 F.3d at 487. The record indicates that the plaintiffs entered into transactions prior to, as well as after, the mandatory arbitration clause was added. *Id.*

161. *Id.*

162. *Id.*

163. *Id.* (citing KY. REV. STAT. ANN. § 368.100(2) (Michie 1998)).

164. *Id.* The relevant Kentucky Statute provided that:

> Any person who shall engage in the business regulated by this chapter without first securing a license therefore shall be guilty of a misdemeanor and upon conviction thereof shall be punished by a fine of not less than five hundred dollars ($500) nor more than five thousand dollars ($5,000). *Any loan contract made in violation of this chapter shall be void* and the lender shall have no right to collect any principal, charges or recompense whatsoever.

Id. § 288.991 (emphasis added).

165. *Burden*, 267 F.3d at 486.

166. *Id.* Beyond contending that these contracts should be considered void, plaintiffs also contended that prior to December of 1997, the loan agreements did not contain an arbitration clause and that they were never informed that such a clause was added. *Id.* at 487.

arbitrable issues should be resolved in favor of arbitration."[167] First, the court noted that, under *Prima Paint*, "arbitration clauses were 'separable' from the contracts in which they were included."[168] Because of this, a claim of fraud in the inducement had to be aimed at the arbitration agreement itself, rather than the contract as a whole.[169] The court then noted the trend in other circuits to make a distinction between "void" and "voidable" contracts.[170]

Despite its previous ruling to the contrary in *C.B.S. Employees Federal Credit Union v. Donaldson*,[171] in which the court had declined to follow the lead of fellow circuits in distinguishing between void and voidable contracts, the court accepted the void/voidable distinction because an arbitration agreement "cannot arise out of a broader contract if no broader contract ever existed."[172] According to the court, however, the line of cases that created this distinction was inapplicable because those cases dealt with "signatory power, not contract content."[173] The court cited to an example given in *Three Valleys* as evidence of this distinction:

> "Party A could forge party B's name to a contract and compel party B to arbitrate the question of the genuineness of its signature. Similarly, any citizen of Los Angeles could sign a

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167. *Id.* at 488 (citing Wilson Elec. Contractors, Inc. v. Minnotte Contracting Corp., 878 F.2d 167, 169 (6th Cir. 1989) (quoting Moses H. Cone Mem'l Hosp. v. Mercury Const. Corp., 460 U.S. 1, 24–25 (1983))).

168. *Id.* (citing Prima Paint Corp. v. Flood & Conklin Mfg. Corp. 388 U.S. 395, 402 (1967)).

169. *Id.* (citing C.B.S. Employees Fed. Credit Union v. Donaldson, Lufkin & Jenrette Sec. Corp., 912 F.2d 1563, 1567 (6th Cir. 1990)).

170. *Id.* (citing Sandvik AB v. Advent Int'l Corp., 220 F.3d 99, 107 (3d Cir. 2000)); Three Valleys Mun. Water Dist. v. E.F. Hutton & Co., 925 F.2d 1136, 1140 (9th Cir. 1991). As illustrated, on the opposite end of the spectrum, the Fifth Circuit, in *Lawrence v. Comprehensive Business Services Co.*, 833 F.2d 1159, 1162 (5th Cir. 1987), ruled that *Prima Paint* applies even to contracts that are "void from . . . inception." *Id.*

171. 912 F.2d 1563 (6th Cir. 1990). Although the court declined to accept the distinction between void and voidable, the court in *C.B.S. Employees*, relying on *Prima Paint*, nonetheless allowed the allegation of fraud to be decided by the court because the allegation was directed at the arbitration agreement itself. *See generally id.*

172. *Burden*, 267 F.3d at 483 (quoting *Sandvik*, 220 F.3d at 108).

173. *Id.* at 489. The court cites to the following cases in other circuits that determined that a claim that a contract was void from its inception based on a lack of signatory power should be decided by a court, rather than an arbitrator: *Sphere Drake Insurance Ltd. v. All American Insurance Co.*, 256 F.3d 587, 390–91 (7th Cir. 2001); *Sandvik*, 220 F.3d 99; *Chastain v. Robinson-Humphrey Co.*, 957 F.2d 851, 854 (11th Cir. 1992); *Three Valleys*, 925 F.2d at 1140; *I.S. Joseph Co. v. Michigan Sugar Co.*, 803 F.2d 396, 400 (8th Cir. 1986).

> contract on behalf of the city and Los Angeles would be required to submit to an arbitrator the question whether it was bound to the contract, even if its charter prevented it from engaging in any arbitration."[174]

The court only provided a cursory explanation as to why Burden's argument that Check Into Cash was unlicensed and therefore did not have authority to enter into the loan agreements did not constitute an argument based on signatory power.[175] The court reasoned that in *Three Valleys*, the party resisting arbitration did not possess signatory power, whereas here, the party attempting to compel arbitration did not possess signatory power.[176] Consequently, the court, without further explanation, concluded that *Three Valleys* was "of no moment."[177] This holding is in direct conflict with, *inter alia*, the Eighth Circuit, which had previously stated that "[c]ase law supports our holding that the enforceability of an arbitration clause is a question for the court when *one party* denies the existence of a contract with the other."[178]

The *Burden* court elaborated that the *Three Valleys* line of cases requires more than an allegation that the contract violated a statutory provision, but must concern a "misrepresentation as to the character or essential terms of a proposed contract."[179] Because the case at bar dealt with substantive law—a violation of Kentucky's usury interest laws—the court concluded that the district court incorrectly relied on *Three Valleys*.[180] Rather, it should have relied on the Sixth Circuit's precedent from *C.B.S. Employees*, which indicated that the "central issue" to consider is whether the alleged fraud dealt with the arbitration agreement itself, rather than the contract as a whole.[181]

The Sixth Circuit's analysis speaks volumes about the confusion that has developed in this area of arbitration law. The following rules can be gleaned from the Sixth Circuit's decision in *Burden*: (1) consistent with

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174. *Burden*, 267 F.3d at 490 (quoting *Three Valleys*, 925 F.2d at 1140).

175. *See id.*

176. *Id.*

177. *Id.*

178. *I.S. Joseph Co.*, 803 F.2d at 400 (emphasis added) (citing American Safety Equip. Corp. v. J.P. Maguire & Co., 391 F.2d 821 (2d Cir. 1968)).

179. *Burden*, 267 F.3d at 490 (citing RESTATEMENT (SECOND) OF CONTRACTS § 163 cmt. a (1979)).

180. *Id.* at 490.

181. *Id.* at 489.

Prima Paint, a claim of fraud in the inducement of the contract as a whole should be decided by an arbitrator; (2) a claim of fraud in the inducement of the arbitration clause itself should be decided by the court; (3) an action challenging the signatory power of the party that is resisting the arbitration should be decided by a court; (4) a challenge based on the signatory power of the party seeking to compel the arbitration clause, even though that party may have never had authority to enter into any contract at all, rendering the contract void, should, nonetheless, be decided by an arbitrator; and (5) an action challenging the substance of the contract, including whether the contract is void under state law, should be decided by an arbitrator.

Beyond its nearly impossible application, several disturbing consequences arise from this set of rules. First, a party that had no power or authority to enter into a contract to begin with, either under principals of agency law[182] or because they were unlicensed,[183] would nonetheless have the power to compel the arbitration of their transgressions, the very "bootstrapping" that the Ninth Circuit in *Three Valleys* was seeking to avoid.[184] Second, a party retains the power to compel arbitration even when a contract is void—or when there is no contract at all—which is in direct conflict with the idea that an "arbitrator's jurisdiction is rooted in the agreement of the parties."[185]

Because *Prima Paint* dealt only with an issue of fraudulent inducement of the contract, its authority over the Sixth Circuit in *Burden* is limited. On the other hand, Justice Black, in his *Prima Paint* dissent, seemingly spoke to a situation not all that dissimilar from the situation in *Burden*. Justice Black would undoubtedly disagree with the distinction made by the Sixth Circuit in *Burden*.[186] According to Black,

182. *Id.* at 489–90 (citing Sphere Drake Ins. Ltd. v. All Am. Ins. Co., 256 F.3d at 590–91 (determining whether the signatory had power to bind company); Sandvik AB v. Advent Int'l Corp., 220 F.3d 99, 110 (3d Cir. 2000) (determining whether the signatory had power to bind company); Three Valleys Mun. Water Dist. v. E.F. Hutton & Co., 925 F.2d 1136, 1140 (9th Cir. 1991) (determining whether a signatory had power to bind principals); *I.S. Joseph*, 803 F.2d at 400 (determining whether assignee of signatory had power to enforce arbitration agreement)). Under the Sixth Circuit's reasoning, all of these cases would have been decided differently had the party compelling arbitration lacked signatory power, despite the fact that none of these cases indicated that the holding was limited to the signatory power of the party resisting arbitration.

183. *See generally Burden*, 267 F.3d 483.

184. *Three Valleys*, 925 F.2d at 1145 (Hall, C.J., dissenting).

185. *Id.* at 1140 (quoting George Day Constr. Co. v. United Bhd. of Carpenters, Local 354, 722 F.2d 1471, 1474 (9th Cir. 1984) and *I.S. Joseph*, 803 F.2d at 399 (8th Cir. 1986)).

186. Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 407–25 (1967) (Black,

sections 2 and 3 of the FAA dictate that "an arbitration agreement is to be enforced by a federal court unless the court, not the arbitrator, finds grounds 'at law or in equity for the revocation of any contract.'"[187] While the issue in *Prima Paint* centered around fraudulent inducement of the contract, Black went on to state that the FAA merely provides for enforcement where there is a *valid contract.*[188] Black would unquestionably agree that a claim that a contract is void because it violates state law or a claim of fraud in the factum is an issue for the court. Such an issue is quite obviously a ground "at law or in equity for the revocation of any contract."[189]

Although the Ninth Circuit decided an issue of signatory power, the language in *Three Valleys* provides a strong indication that the court intended its holding to apply to any contract that is void, and therefore nonexistent. The court's analysis provides no indication that the fraud in the factum claim rests only in a challenge of signatory power. Conversely, the Sixth Circuit's haphazard analysis in *Burden* provides a clear indication that the circuit courts have clearly taken divergent paths in interpreting *Prima Paint.* By granting *certiorari* to a case that extends the reach of the FAA to a void contract, the Supreme Court would be able to address this divergence and delineate the FAA's inapplicability to void contracts.

D. State Regulation of Payday Loans

1. State Attempts to Regulate the Payday Loan Industry

The payday loan industry has increased exponentially over the last several years.[190] A recent study by the Wisconsin Department of Financial Institutions highlights the problem presented by these loans.[191] The transaction is simple: in return for cash, a borrower signs a loan agreement and provides the lender with a post-dated check or other

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J., dissenting).

187. *Id.* at 412 (citing 9 U.S.C. § 2) (Black, J., dissenting).

188. *Id.* (Black, J., dissenting).

189. 9 U.S.C. § 2 (1984).

190. In 2001 the State of Wisconsin licensed forty payday lenders, as compared to two in 1996. State of Wisconsin Department of Financial Institutions, *Review of Payday Lending in Wisconsin 2001*, at 4, *available at* http://www.wdfi.org/_resources/indexed/ site/newsroom/ press/payday_loan_may_2001.pdf.

191. *Id.* at 2.

checking information.[192] When the loan comes due, the borrower has a choice of rolling the loan over and incurring additional interest charges or paying in full.[193] The average annual percentage rate (APR) on these loans in Wisconsin in 2001 was a startling 542.20%.[194] In Wisconsin in 1999, there were 839,285 payday loans issued.[195] On average, 53% were rolled-over because the borrower was unable to pay after the initial term.[196]

The obvious potential for abuse in this industry leaves states with the task of protecting the public from unknowingly losing thousands of dollars. As evidenced in *Burden*, many states have provided that the fees charged by these companies are considered interest rather than service fees.[197] Accordingly, these lenders need to be licensed by the state.[198] Many state legislatures have dictated that contracts entered into by lenders charging interest rates without a license will be considered void, and the lender will have no right to collect.[199]

2. State Court Cases Addressing Arbitration Clauses in Contracts that are Deemed Void as Violating Payday Loan Statutes

In two recent cases, state supreme courts have addressed the role of arbitration clauses in contracts that are alleged to be void for violating payday loan statutes. First, the Alabama Supreme Court, in *Alabama Catalog Sales v. Harris*,[200] determined that "a party who contests the making of a contract containing an arbitration provision cannot be compelled to arbitrate the threshold issue of the *existence* of an agreement to arbitrate' . . . 'only a court can make that decision.' "[201] In

192. *Id.* at 1.

193. *Id.* at 6.

194. *Id.*

195. *Id.* at 4.

196. *Id.* at 7 (citing statistics from a review of 450 borrowers in 2000).

197. *See supra* note 162 and accompanying text.

198. *See supra* note 163 and accompanying text.

199. For example, the Alabama Small Loan Act, after addressing the illegality of collecting on loans without a license, provides that "[a]ny contract of loan in the making or collection of which any act shall have been done which violates this section *shall be void*, and the lender shall have no right to collect, receive or retain any principal, interest or charges whatsoever." ALA. CODE. 1975, § 5-18-4(d) (1975) (emphasis added).

200. 794 So. 2d 312 (Ala. 2000).

201. *Id.* at 317 (emphasis added) (citing NationsBanc Invs., Inc. v. Paramore, 736 So. 2d 589, 593 (Ala. 1999) (quoting Shearson Lehman Bros. Inc. v. Crisp, 646 So. 2d 613, 616–17

rejecting the defendant's reliance on *Prima Paint*, the court insightfully noted that "*Prima Paint* is inapplicable to challenges going to the very *existence* of a contract."[202]

The Alabama Supreme Court was obviously concerned about protecting its power to protect consumers from the payday loan industry. The court cited to a Supreme Court case, *Allied-Bruce Terminix Cos. v. Dobson*,[203] for the proposition "that a state retains the power to regulate contracts, including arbitration clauses, under general contract law principles, and may invalidate an arbitration clause upon such grounds as exist at law or in equity for the revocation of any contract."[204] The court also cited extensively to *Three Valleys*[205] without distinguishing, as the Sixth Circuit did, a line of demarcation between nonexistence of a contract due to signatory power and nonexistence due to a violation of a state law.[206]

In *Party Yards, Inc. v. Templeton*,[207] a Florida court of appeals took an even stronger stance against the arbitration of claims that a contract is void.[208] As with *Burden* and *Harris*, the issue in *Party Yards* centered around an allegation that a loan contract between businesses was void because it violated Florida's usury laws.[209] According to the court, "[a]s a matter of law, a usury violation does not arise under an agreement . . . [it] arises under state statutory law."[210] Noting that the claim went to whether the contract was illegal, and consequently, criminal, the court forcefully stated that "[a]n arbitrator cannot order a party to perform an

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(Ala. 1994))).

202. *Id.* at 315 (emphasis added).

203. 513 U.S. 265 (1995).

204. *Harris*, 794 So. 2d at 316 (quoting *Allied-Bruce*, 513 U.S. at 281 (citing 9 U.S.C. § 2 (1984)).

205. The court quoted its earlier opinion in *Shearson:* "Although *Prima Paint* has ostensibly been construed to require the arbitration of *any claim* 'unless there has been an independent challenge to the making of the arbitration clause itself,' it appears that the majority of courts have, on better reasoning, read *Prima Paint* more narrowly." *Harris*, 794 So. 2d at 314 n.2 (quoting *Shearson Lehman Bros.*, 646 So. 2d at 616 (citations omitted)).

206. *Id.* at 316.

207. 751 So. 2d 121 (Fla. Dist. Ct. App. 2000).

208. *Id.*; *see also* Fastfunding The Company, Inc. v. Betts, 758 So. 2d 1143 (Fla. Dist. Ct. App. 2000) (holding in a payday loan case that the court, rather than an arbitrator, determines an allegation that a contract is *void* when it violated state usury laws).

209. *Party Yards*, 751 So. 2d at 123.

210. *Id.*; *see also* Burden v. Check Into Cash, 267 F.3d 483 (6th Cir. 2001); Plaintiff's Petition for a Writ of Certiorari, *available at* http://www.tlpj.org/briefs/burdenbrief1-7-02.pdf (using *Party Yards* to argue for *certiorari* to the Supreme Court).

illegal act."[211] The Florida Supreme Court further noted that courts themselves should not lend assistance to carrying out illegal contracts.[212]

By applying the enforcement provisions of sections 3 and 4 of the FAA to contracts that state legislatures determine are void as violating payday loan laws, courts are undermining the ability of states to protect consumers. Allowing an unlicensed institution that engages in illegal lending practices to have its choice of jurisdiction by virtue of a void and nonexistent contract essentially renders a legislative effort to protect consumers void, and thus nonexistent.

VI. THE FAA SHOULD NOT BE EXTENDED WHEN NO AGREEMENT EXISTS

A. Ramifications of Extending the FAA to Void Contracts

The expansion of the FAA has led to a great deal of confusion. This confusion has recently led to its application to void contracts that essentially never existed.[213] Such an application carries absurd consequences.[214] The Supreme Court needs to address this situation and seize the opportunity to provide clarification to at least one area of law under the FAA.

1. Applying the FAA to Void Contracts Impermissibly Places Arbitration Clauses on a Higher Footing than Other Contract Provisions.

Several Supreme Court Cases have indicated that the primary purpose of the FAA was to replace the judicial hostility for arbitration.[215] In *EEOC v. Waffle House Inc.*,[216] the most recent case to address the scope of arbitration under the FAA, the Supreme Court relied heavily on the idea that "[t]he FAA directs courts to place

211. *Party Yards*, 751 So. 2d at 123 (citing Hill v. Norfolk & W. Ry. Co., 814 F.2d 1192, 1195 (7th Cir. 1987)).

212. *Id.*

213. *See, e.g.*, Burden v. Check Into Cash, 267 F.3d 483 (6th Cir. 2001), *cert. denied*, 122 S. Ct 1436 (2002); Lawrence v. Comprehensive Bus. Sys., 833 F.2d 1159 (5th Cir. 1987).

214. *See* notes 180–83 and accompanying text.

215. *See, e.g.*, Volt Info. Scis., Inc. v. Bd. of Trs., 489 U.S. 468, 478 (1989).

216. No. 99-1823, 2002 U.S. LEXIS 489 (Jan. 15, 2002) (determining that the EEOC retains the power to enforce statutory claims despite an employee's agreement to arbitrate claims against his employer).

arbitration agreements on *equal footing* with other contracts."[217] According to the Court, the FAA was enacted to "'reverse the longstanding judicial hostility to arbitration agreements that had existed at English common law and had been adopted by American courts.'"[218]

This "equal footing" has provided the basis for the Court's usurpation of state laws in expanding the scope of the FAA. In *Doctor's Associates*,[219] for example, the Court found that the FAA preempted a state statute that imposed disclosure requirements for arbitration agreements because the requirements put the arbitration clause on a lesser footing than the other clauses in the contract.[220] According to the Court in a previous decision:

> States may regulate contracts, including arbitration clauses, under general contract law principles and they may invalidate an arbitration clause 'upon such grounds as exist at law or in equity for the revocation of *any* contract.' What states may not do is decide that a contract is fair enough to enforce all of its basic terms . . . but not fair enough to enforce its arbitration clause. The [FAA] makes any such state policy unlawful, for that kind of policy would place arbitration clauses on an unequal 'footing,' directly contrary to the [FAA's] language and Congress' intent.[221]

Applying the FAA to a contract that never existed clearly runs contrary to the idea that the arbitration clause should be placed on equal footing as other provisions in a contract. By singling out the arbitration provision from the rest of the contract and allowing it to stand before there is a determination of whether a contract even exists, courts are placing arbitration agreements on a higher level than the other provisions in the contract and even the contract itself. Just as the

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217. *Volt*, 489 U.S. at 478 (emphasis added). According to the legislative history, the FAA was enacted to place arbitration clauses "upon the same footing as other contracts, where [they] belong[]." Dean Witter Reynolds v. Byrd, 470 U.S. 213, 219 (1985) (citing H.R. REP. NO. 96, 1 (1924)).

218. *Volt*, 489 U.S. at 478 (quoting Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 24 (1991)).

219. 517 U.S. 681 (1996); *see supra* Part III.C.

220. *Id.*; *see also* Burden v. Check Into Cash, 267 F.3d 483 (6th Cir. 2001); Plaintiff's Petition for a Writ of Certiorari, *available at* http://www.tlpj.org/briefs/burdenbrief1-7-02.pdf (arguing for certiorari to the Supreme Court because the Sixth Circuit's holding in *Burden* conflicts with prior interpretations that the FAA should be placed on equal, rather than higher footing than the other clauses in a contract).

221. Allied-Bruce Terminix Co. v. Dobson, 513 U.S. 265, 281 (1995) (citations omitted).

Supreme Court has held that the FAA preempts state laws that give the arbitration agreement a "suspect status,"[222] so too should the Court hold that decisions that give the arbitration agreement a "special status" are inconsistent with the intent of the FAA. It is inconceivable to believe that a court would allow any other provision in a contract to stand before determining whether, in fact, there actually was a contract.

2. Applying the FAA to Void Contracts Impermissibly Impinges on State's Rights to Govern Contract Law.

Prior to *Prima Paint*, the Supreme Court indicated an intention to prevent the expansion of the FAA into the realm of state substantive law.[223] Dissenting in *Prima Paint*, Justice Black rightfully forecasted the potential of that case to usurp states' traditional rights to govern contract law.[224] According to Black, the majority's decision that section 4[225] provided an "explicit answer" to the question of severability "took a procedural remedy and fashioned it into a substantive law that could and did interfere with state substantive law to the contrary."[226] Justice Black further stated that section 4 did not provide an "explicit answer," but rather posed the further question of "what kind of allegations put the making of the arbitration agreement in issue."[227]

This judicial expansion of the FAA has had extreme consequences on states' ability to govern contract law. It is important to remember that arbitration law is only a form of contract law.[228] Because of this, the FAA is not a complete code of arbitration law.[229] State contract law principles must also come into play.[230] Section 2 provides that

222. *Doctor's Assocs.*, 517 U.S. at 687.

223. *See* discussion *supra* Part III.B; *see also* Bernhardt v. Polygraphic Co. of Am., 350 U.S. 198 (1956) (interpreting the FAA narrowly to avoid impinging on states' rights to regulate substantive law); Marine Transit Corp. v. Dreyfus, 284 U.S. 263 (1932) (insinuating that the FAA was intended to be applied exclusively in federal courts).

224. Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 407–25 (1967) (Black, J., dissenting).

225. 9 U.S.C. § 4 (1994) ("[U]pon being satisfied that the *making of the agreement for arbitration* or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement.") (emphasis added).

226. Kornegay, *supra* note 1, at 344 (citing *Prima Paint*, 388 U.S. at 411 (Black, J., dissenting)) (footnotes omitted).

227. *Prima Paint*, 388 U.S. at 410 (Black, J., dissenting).

228. *See* Kornegay, *supra* note 1, at 359.

229. *Id.*

230. *Id.*

arbitration clauses "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."[231] To determine the "grounds [that] . . . exist at law or in equity for the revocation of any contract," courts necessarily need to turn to state contract laws.[232]

A close examination of the language of section 2 dictates that courts should defer to the states' right to determine when a contract is or is not void. This includes both situations where state common law principles render a contract void[233] and where a violation of a state statute dictates that the contract is void.[234]

As shown above, the payday loan industry is one area of the law in which it is necessary for states to exercise their power to govern contract law.[235] Any business that is extending loans at an annual interest rate of over 500% should be closely regulated by a state.[236] States have done this by requiring payday loan companies to be licensed as lenders.[237] It does not stand to reason, then, that unlicensed lenders can have their choice of jurisdiction honored merely because an arbitration clause was included in a nonexistent contract. Decisions in the Fifth and Sixth Circuits, however, allow for such absurd results.[238]

3. Where a Contract is Void, an Arbitrator Has no Jurisdiction

Several authorities stand for the proposition that an arbitrator's jurisdiction is grounded in the agreement between the parties.[239] According to the Supreme Court in *First Options,* arbitration "flow[s] inexorably from the fact that arbitration is simply a matter of contract between the parties."[240] The American Arbitration Association, for example, expressly states that "[t]he arbitrator's authority is created by

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231. *See supra* note 26 and accompanying text.

232. *See* Kornegay, supra note 1, at 359 (noting that "[t]he FAA depends upon general law of contracts to provide its 'infrastructure'").

233. Typically, a contract will be deemed void when there is "a misrepresentation as to the character or essential terms of a proposed contract." RESTATEMENT (SECOND) OF CONTRACTS § 163 cmt. a (1981).

234. *See supra* Part V.C.

235. *See supra,* Part V.D.

236. *Id.*

237. *Id.*

238. Burden v. Check Into Cash, 267 F.3d 483 (6th Cir. 2001), *cert. denied,* 122 S. Ct. 1436 (2002); Lawrence v. Comprehensive Bus. Servs. Co., 833 F.2d 1159 (5th Cir. 1987).

239. *See infra* notes 240–46 and accompanying text.

240. First Options of Chicago, Inc. v. Kaplan, 514 U.S. 938, 943 (1995).

the contract,... [i]n effect, the parties breathe life into [the] arbitrator."[241] Likewise, Justice Black, in his *Prima Paint* dissent, noted that when a contract is procured by fraud,[242] there is no contract and nothing can be arbitrated because sections 2 and 3 assume a valid contract.[243] These sections provide for the enforcement of the agreement only when a valid contract exists.[244] Further, according to the Ninth Circuit in *Three Valleys*, "because an 'arbitrator's jurisdiction is rooted in the agreement of the parties,' a party who contests the making of a contract containing an arbitration provision cannot be compelled to arbitrate the threshold issue of the *existence* of an agreement to arbitrate. Only a court can make that decision."[245] Finally, the Eighth Circuit has noted that an arbitrator "has no independent source of jurisdiction apart from the consent of the parties."[246]

The expansion of the FAA has had dramatic consequences on the law of arbitration in the United States. Applying the enforcement provisions of the FAA to agreements that do not exist would be the most absurd and dramatic consequence to date. The aforementioned authorities demonstrate that an arbitrator's authority rests solely on a

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241. *American Arbitration Association: A guide for Commercial Arbitrators, available at* http://www.adr.org/index2.1.jsp?JsPssid=15727&JSPsrc=upload/LIVESITE/Rules_Procedures/ADR_Guides/comguide.html.

242. Justice Black makes no distinction between fraud in the inducement and fraud in the factum. He extends the argument that this Comment is making, suggesting that any claim of fraud regarding the contract should be decided by a court before arbitration is compelled. Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 412 (1967) (Black, J., dissenting). While theoretically correct, given the recent proliferation of arbitration contracts, this would lead to a tidal wave of parties claiming fraudulent inducement in an effort to avoid arbitration.

243. *Id.* at 413. To support this assertion, Justice Black turned to the legislative history surrounding the Act, noting that one senator, in hearings on the bill, observed that "[t]he court has got to hear and determine whether there is an agreement of arbitration, undoubtedly, and it is open to all defenses, equitable and legal, that would have existed at law...." *Id.*

244. *Id.* at 412–13.

245. Three Valleys Mun. Water Dist. v. E.F. Hutton & Co., 925 F.2d 1136, 1140 (9th Cir. 1991) (quoting George Day Constr. Co.v. United Bhd. of Carpenters, Local 354, 722 F.2d 1471, 1474 (9th Cir. 1984)). The court went on to state that applying *Prima Paint* to an allegation going to the *existence* of a contract would require it to take *Prima Paint* "one step further" to a situation that the "majority did not address." *Id.* at 1141 n.4.

246. I.S. Joseph Co. v. Michigan Sugar Co., 803 F.2d 396, 399 (8th Cir. 1986); *see also Three Valleys*, 925 F.2d 1136, 1140 (9th Cir. 1991) (quoting Smith Wilson Co. v. Trading & Dev. Establishment, 744 F. Supp. 14, 16 (D.D.C. 1990) ("arbitrators derive their authority to resolve disputes only because the parties have agreed in advance to submit such grievances to arbitration")).

valid agreement. When a contract is void, whether as a matter of state statutory or general common law, it never existed,[247] thus an arbitrator has no jurisdiction to hear the claim. Compelling arbitration for a claim of void contract would impermissibly provide an arbitrator with jurisdiction.

B. The Supreme Court Should Grant Certiorari to a Case that Extends the FAA to a Void Contract to Provide Clarity to its Prima Paint *Holding*

The solution to the confusion and contradiction in the circuit courts' application of the FAA to *void ab initio* contracts is simple: the Supreme Court needs to grant *certiorari* to a case that compels arbitration of an allegation that a contract is void. Only by hearing such a case and holding that its *Prima Paint* decision was strictly limited to situations where a party claimed fraudulent inducement of a contract, thus rendering the contract "voidable," rather than "void," will the Court be able to add some clarity to its "confus[ing] and contradictory holdings that have followed its FAA rulings of the last forty years."[248]

VII. CONCLUSION

Arbitration has become a common judicial forum in the twenty-first century.[249] The unprecedented proliferation of arbitration in the United States is due, in large part, to the Supreme Court's expansion of the FAA.[250] What began as a response to judicial hostility to arbitration[251] has now infiltrated state courts. The contradictory and confusing holdings that have resulted from this rapid expansion have left "[d]iligent academics . . . delighted that the raw material essential to the exercise of their craft is being continually replenished."[252] Recent circuit courts that have applied the FAA to allegations that a contract is *void ab initio* present academics with more raw material with which to hone

247. *See supra* note 134.

248. Kornegay, *supra* note 1, at 358. The Supreme Court has once again been asked to clarify the confusion in this area in yet another case dealing with usurious interest rates being charged by a payday loan company that are allegedly violative of state law. *See* Snowden v. Checkpoint Check Cashing, 290 F.3d 631 (4th Cir. 2002), *petition for cert. filed*, 71 U.S.C.W. 3191 (U.S. Sept. 12, 2002) (No. 02-424). Although the Court recently declined to hear *Burden*, a very similar case, the fact that consumers are seeking clarification on this issue once again is evidence of the desperate need for the Supreme Court's voice on this issue.

249. *See supra* note 4.

250. *See supra* Part III.C.; IV.

251. *See supra* Part II.A; III.B.

252. Rau, *supra* note 13, at 287.

their craft.

Prior to 1967, such an absurd application of the FAA seemed entirely unlikely. *Prima Paint*, in delineating that claims of fraud in the inducement of the contract should be compelled to arbitration under the FAA, opened the door for subsequent confusion.[253] The *Prima Paint* rule is sensible, considering the multitude of fraud claims that a court would have to decide from parties trying to avoid an arbitration clause. Subsequent circuit court interpretations of this rule, however, have been far from sensible.

Applying the enforcement provisions of the FAA to void contracts leads to results that seemed unimaginable prior to the Court's holding in *Prima Paint*. As shown above, applying the FAA to a contract that is, or could be determined to be, void, and thus nonexistent, serves to extend the scope of the FAA well beyond the intentions of either Congress or the *Prima Paint* Court. Enforcing arbitration in a void contract impermissibly places arbitration clauses on a higher footing than other contract provisions, infringes on states' rights to govern the substantive area of contract law and to protect consumers, and gives legal authority to an arbitrator whose only jurisdiction lies in an agreement that does not exist. It is time for the Supreme Court to end the confusion over its holding in *Prima Paint*.

JOSHUA R. WELSH*

253. Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 406 (1967).

* The author would like to thank his wife for her constant love, support, encouragement, and criticism; Professor Andrea K. Schneider for her assistance on preliminary versions of this Comment; and his parents for their love and for supporting his decision to attend law school.