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Contracts—Conflict of Laws-- Severability of Arbitration Clause.—Commonwealth Oil Refining Co. v. Lummus Co.

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wholesalers handled products other than Scripto's and thus were agents for several principals.[11] The sales and activities of the Florida wholesalers were deemed to be a sufficient emanation of the corporation in Florida to justify Florida's requirement that Scripto be its tax collector.

In the absence of any Congressional legislation[12] prohibiting a state from requiring an out-of-state vendor to be its tax collector in situations where the contact between the two is slim, the Court must determine in each case whether the minimum contact has been made so as not to be violative of due process.[13] The test is "simply the nature and extent of the activities"[14] of the corporation in the taxing state. The activities of Scripto through the Florida wholesalers were regular, systematic and productive of a substantial flow of goods from Scripto into Florida. The Court was correct in not allowing these activities to be clouded by the tagging of the Florida wholesalers as independent contractors.

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Contracts—Conflict of Laws—Severability of Arbitration Clause.—*Commonwealth Oil Refining Co. v. Lummus Co.*[1]—The Lummus Company is engaged in designing and constructing oil refineries. On the basis of certain cost and profitability estimates by Lummus, the Commonwealth Co. contracted in New York with Lummus in 1954 for the construction of an oil refinery and again in 1956 for expansion of the

effectiveness in securing a substantial flow of goods into Florida. . . . To permit such formal 'contractual shifts' to make a constitutional difference would open the gates to a stampede of tax avoidance."

[11] Id. at 211.

[12] Congress can, of course, under its power to regulate commerce, enact legislation which would deny a state the power to require a corporation engaged exclusively in interstate commerce to become the state's tax collector when the only nexus between the two is the active solicitation of sales by the corporation's agents. Legislation to this effect was introduced in both Houses of Congress after the Scripto decision was handed down. H.R. 12, 235, S. 3549, 86th Cong., 2d Sess. (1960).

[13] Although the amount of contact necessary to subject a foreign corporation to the jurisdiction of the state for a valid "in personam" judgment in causes of action arising out of the activities of the corporation within the state may not be co-extensive with the minimum contact necessary to permit a state to require the foreign vendor to be its tax collector, a close parallel between the two might be drawn. This is especially so where the cause of action in the "in personam" suit is not based upon a tort involving a dangerous instrumentality. Young v. Masci, 289 U.S. 253 (1933); Hess v. Pawloski, 274 U.S. 352 (1927). The test as promulgated in International Shoe Inc. v. Washington, 326 U.S. 310 (1945), for subjecting a foreign corporation to an "in personam" judgment is whether or not there is a certain minimum contact between the state and the corporation so that "traditional notions of fair play and substantial justice" are not offended if the corporation is to be required to defend a suit in the state where the cause of action arose. This test, in substance, is also applied to situations wherein a court must determine whether the Fourteenth Amendment has been violated when a state attempts to make an extrastate corporation its tax collector.

[14] 362 U.S. at 212.

[1] 280 F.2d 915 (1st Cir. 1960).

facilities. Both contracts provided for arbitration in New York of "any controversy or claim arising out of or relating to this agreement . . ." Commonwealth experienced severe losses and it refused to make further payments to Lummus who in turn served notice of arbitration with the American Arbitration Service.[2] Commonwealth, in the Puerto Rico Federal District Court, sought relief in damages and such rescission of the contract as was possible, alleging fraudulent inducement in the making of the substantive contract. Lummus then sought to compel arbitration in a Federal District Court in New York. The Puerto Rico Court upon motion by Commonwealth enjoined Lummus from further proceeding in that action, and when it refused to modify that injunction, Lummus took an interlocutory appeal from the order. The Circuit Court of Appeals for the First Circuit entered judgment vacating the orders of the Puerto Rico District Court. HELD: (1) that New York law should govern the controversy and (2) that although under New York law an arbitration clause is unseverable from the substantive contract true rescission was not properly sought and the question of damages for fraudulent inducement can and will be determined by arbitration.

While the history of the conflict of laws surrounding the arbitration of contracts is relatively short, it is both full and virile. The United States Arbitration Act[3] provided that a clause to arbitrate in contracts involving maritime matters or interstate commerce shall be valid, enforceable and irrevocable. Originally the Act was intended to serve as Congressional regulation of federal judicial procedure,[4] and thus arbitration enforcement was deemed remedial and applicable in any case before the federal courts. During the reign of *Swift v. Tyson*[5] a federal court exercising its jurisdiction on the ground of diversity of citizenship was free to look where it would for its substantive law. The celebrated decision of *Erie v. Tompkins*[6] held that in the interpretation of private contracts where no federal issue was involved the substantive laws of the forum state were controlling upon the federal courts. The application of this doctrine to arbitration clauses was not free from inconsistencies in the lower federal courts;[7] if the court

[2] This is not, however, the equivalent of, nor does it give rise to, a civil action brought in a court. Minkoff v. Scranton Frocks, 172 F. Supp. 870 (S.D.N.Y. 1959).

[3] The Act was originally enacted in 1925. 43 Stat. 833 (1925), 9 U.S.C. §§ 1-15. It was repealed and substantially reenacted in 1947. 61 Stat. 669 (1947), 9 U.S.C. §§ 1-14 (1958). Section 2 provides:

> " . . . 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 . . . shall be valid, irrevocable and enforceable save on such grounds as exist in law or equity for the revocation of any contract."

[4] H.R. Rep. No. 96, 68th Cong., 1st Sess. 1 (1924).

[5] 41 U.S. (16 Peters) 1, 18 (1842).

[6] 304 U.S. 64 (1938).

[7] Sturges, Some Confusing Matters Relating to Arbitration Under the United States Arbitration Act, 17 Law & Contemp. Prob. 580 (1953); Kochery, The Enforcement of Arbitration Agreements in the Federal Courts: Erie v. Tompkins, 39 Cornell L.Q. 74 (1953).

viewed arbitration as substantive, state law governed; if it was viewed as procedural, federal "common law" could be applied. The *Erie* effect was not precisely determined until *Bernhardt v. Polygraphic Co. of America*.[8] Here it was held that in those cases in which a federal court acquires jurisdiction as a result of the diversity of citizenship between the parties and where the contract containing the arbitration clause does not involve maritime matters or interstate commerce, the court must look to state law to determine whether or not the arbitration clause is specifically enforceable. It was important that the distinction be made between the validity and enforceability of an arbitration clause, and that particular set of procedural tools that is the manner of its enforcement. In *Bernhardt* the court declared: "The federal court enforces the state-created right by the rules of procedure which it has acquired from the federal government, and which therefore are not identical with those of the state courts. Yet in spite of the difference in procedure, a federal court enforcing a state-created right in a diversity case is as we said in *Guaranty Trust Co. of New York v. York*[9] in substance 'only another court of the state.' "[10] The court went on to point out that where a state court will not compel arbitration, for a federal court to do so would "substantially effect(s) the cause of action created by the state" which, in turn, might make a radical difference in the ultimate result.

The problem, then, of *Commonwealth v. Lummus* was: Whose law should the court apply? Federal jurisdiction was founded upon diversity of citizenship only and not upon any federal question[11] nor was the contract one which involved maritime matters or interstate commerce so as to make applicable the Federal Arbitration Act.[12] In this light, Judge Aldrich, recognizing the limitations of *Bernhardt*, turned to the law of a "state" but to the law of New York rather than that of Puerto Rico.

Commonwealth Co. contended that in the light of the decision in *Bernhardt* the court should have adopted not only the substantive law of the forum but its procedural and conflict of laws provisions as well. The court rejected this interpretation as well as rejecting the forum's express adoption of Puerto Rican law. Thus, while the arbitration clause was treated as unseverable from the substantive contract, as it would be under the law both of Puerto Rico and of New York,[13] the Court refused to look

[8] 350 U.S. 198 (1956).

[9] 326 U.S. 99, 108 (1945).

[10] Supra note 8, at 203.

[11] Suits involving the application of the Arbitration Act do not furnish an independent basis of federal jurisdiction. In addition to a "contract evidencing a transaction involving interstate commerce (or maritime matters)," there must be diversity or a right arising under the law of the United States plus the proper amount in controversy. San Carlo Opera Co. v. Conley, 72 F. Supp. 825 (S.D.N.Y. 1946), aff'd, 163 F.2d 310 (2d Cir. 1947). See Robert Lawrence Co. v. Devonshire Fabrics, Inc., 271 F.2d 402 (2d Cir. 1959), cert. granted, 362 U.S. 909 (1960), dismissed, 364 U.S. 801 (1960).

[12] This is apparently the construction made in the instant case. See Badgett Mines Stripping Corp. v. Pennsylvania Turnpike Commission, 173 F. Supp. 425 (M.D. Pa. 1959); Tejas Development Co. v. McGough Bros., 165 F.2d 276 (5th Cir. 1947).

[13] Commonwealth Oil Refining Co. v. Lummus Company, 174 F. Supp. 485, 488 (1959).

to the decision of the Puerto Rico District Court to stay arbitration and to hear the issue of fraud. In *Bernhardt* it was asserted that the court should give "special weight" to the findings and determinations of the judge of the forum.[14] In the instant case the judge of the forum found that a "substantial dispute" had arisen as to whether the contracts had been induced by fraud that would nullify both the contracts and the arbitration clauses that they contained.[15] Commonwealth argued that the denial of the remedy given by the Puerto Rico District Court is a denial gravely prejudicing its substantive rights. It is submitted that its contention is valid.

In his concurring opinion in *Bernhardt* Mr. Justice Frankfurter stated that the basic nature of diversity jurisdiction "is the enforcement of state created rights and *state policies* going to the heart of those rights."[16] (emphasis supplied.) The problem in that case was strikingly similar to that of *Commonwealth v. Lummus*. In both cases the contracts were made in New York and arbitration was to be held in New York. In both cases the issue of whether arbitration could be employed arose in a court other than New York. In *Bernhardt* the court indicated that the law of the forum should govern yet in *Commonwealth* the law of the place of the contract governed. In *Bernhardt* the court gave special weight to the findings of the local judge, yet here the court by-passed the determinations explicitly rendered by the court of the forum. The desirability of having arbitration where the parties intended is well established yet this consideration is necessarily subsequent to the decision of whether arbitration is to be granted at all.[17]

In the light of the court's adoption of New York law as governing, when it turned its attention to the issue of the severability of the arbitration clause from the substantive contract it accepted the dictates inherent in previous New York decisions. In *Wrap-Vertiser v. Plotnick*[18] the court asserted that had Plotnick asked for rescission the issue of fraud would have to have been decided first so as to determine whether there was a contract

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14 Supra note 8, at 204.

15 P.R. Laws Ann. tit. 32, § 3204 (1956).

16 Supra note 8, at 208-09.

17 Ross v. Twentieth Century Fox Film Corp., 236 F.2d 632 (9th Cir. 1956); Jackson v. Atlantic City Electric Co., 144 F. Supp. 551 (N.J. 1956); Miller v. American Insurance Co. of Newark, 124 F. Supp. 160 (W.D. Ark. 1954); Lorensen, Commercial Arbitration—International and Interstate Aspects, 43 Yale L.J. 716, 755-57 (1934). In the instant case, the denial of a judicial hearing on the issue of fraud was based upon the court's decision that there had not been a good faith manifestation by Commonwealth of its intention to rescind and return the benefits it received and that laches had set in. Notwithstanding the complications of what in fact could and should be returned under a construction contract, it seems that the Circuit Court has determined facts outside its appellate scope and invaded the function of the District Court. Fountain v. Filson, 336 U.S. 681 (1949); Byrd v. Blue Ridge Cooperative, 356 U.S. 525, 529-33 (1958). In its discretion and consideration of the facts the District Court had not passed on these defenses and by doing so, if it had not implicitly found differently, it had at least deferred them to be treated at the plenary trial of the alleged fraud.

18 3 N.Y.2d 17, 19, 163 N.Y.S.2d 639, 641, 143 N.E.2d 366, 367 (1957).

over which the arbitrators would have jurisdiction, as fraud makes the whole contract voidable.[19] The case held that even though the contract was affirmed, the particular clause[20] was not sufficiently broad to encompass the question of fraud in the inducement of the substantive contract. Subsequently New York has specifically recognized that an arbitration clause may be broad enough to include such fraud and that the contract need not be rescinded to recover.[21]

A leading federal case, *Robert Lawrence v. Devonshire Fabrics, Inc.*[22] held that where interstate commerce or maritime matters are concerned the United States Arbitration Act is controlling as substantive federal law and that under such federal law an arbitration clause is a severable agreement. Thus it is immaterial whether a contract is affirmed or rescinded, for the arbitration clause will be treated as a separate contract and without fraud going directly to it, fraudulent inducement will be arbitrated. The extent to which this notion is accepted in other federal courts, however, is uncertain.[23]

In *Commonwealth v. Lummus* the court interpreted Commonwealth's plea as an affirmation of the contract and an action for damages in tort for deceit, which was arbitrable. It is doubtful that the necessary implications of *Bernhardt v. Polygraphic Co.* were employed by the court in its decision. The case illustrates the increasing tendency of the courts to call upon the obvious advantages of a skilled and experienced arbitration panel to solve difficult and involved problems in a business context. It also serves the useful purpose of helping to clear the courts' congested dockets. Perhaps the court's haste to accomplish these two objectives is in part accountable for its decision.

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[19] See also, Cheney Bros. v. Joroco Dresses, Inc., 218 App. Div. 652, 219 N.Y. Supp. 96 (1926), rev'd on other grounds, 245 N.Y. 375, 157 N.E. 272 (1927); Manufacturers Chemical Co. v. Caswell & Strauss & Co., 259 App. Div. 321, 19 N.Y.S.2d 171 (1940); Metro-Goldwyn-Mayer Distrib. Corp. v. Dewitt Dev. Corp., 150 Misc. 408, 269 N.Y. Supp. 104 (Sup. Ct. 1931).

[20] The clause went to the "validity, interpretation or performance of this agreement." 3 N.Y.2d at 20, 163 N.Y.S.2d at 641, 143 N.E.2d at 367.

[21] Amerotron v. Maxwell Shapiro Woolen Co., 3 App. Div. 2d 899, 162 N.Y.S.2d 214 (1957); M. W. Kellogg Co. v. Monsanto Co., 9 App. Div. 2d 744, 192 N.Y.S.2d 869 (1959); see also, Maxwell Shapiro Woolen Co. v. Amerotron Corp., 339 Mass. 252, 158 N.E.2d 875 (1959).

[22] 271 F.2d 402 (2d Cir. 1959), cert. granted, 362 U.S. 909 (1960), dismissed, 364 U.S. 801 (1960).

[23] American Airlines, Inc. v. Louisville & Jefferson C.A.B., 269 F.2d 811 (6th Cir. 1959)—where the court maintained that an arbitration clause was valid and enforceable only "in accordance with ordinary contract principles under applicable State and Federal law" (at pp. 815-17); see also, Ross v. Twentieth Century Fox Film Corp., 236 F.2d 632 (9th Cir. 1956).