South Carolina Law Review

Volume 12 | Issue 2 Article 3

1960

The National Arbitration Act: Recent Decisions and Erie R.R. v. Tompkins

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LAW NOTES

THE NATIONAL ARBITRATION ACT: RECENT DECISIONS AND ERIE R.R. v. TOMPKINS

One of the more conspicuous developments in modern law has been the tendency to avoid formal judicial procedures in the settlement of disputes. An outstanding example of this trend may be found in the multiplicity of governmental quasi-legislative administrative agencies. Another facet of this movement appears in the increased emphasis upon the arbitration of disputes. Such arbitration has undergone vigorous development in two general fields: (1) the disposition of labor disputes through arbitration, and (2) the settlement of disagreements arising from the performance of contracts, generally known as "commercial arbitration". This note will deal with the latter problem, examining some of the current problems in the field of commercial arbitration, and emphasizing the interrelationships between the federal and state law in the field. The arbitration of labor disagreements is touched on only for purposes of analogy, and no attempt will be made to deal with factors prompting the movement away from traditional judicial processes for settling disputes.

There are two common types of contract arbitration agreements: (1) clauses providing for settlement by arbitration of future disputes arising between the parties to a contract, and (2) agreements for the submission of existing controversies under a contract to arbitration.[1] When a contracting party, subject to either of these types of agreement, refuses to arbitrate, the courts are faced with the problem of whether the agreement should be enforced. In both types, the courts have been conspicuously hostile — possibly, it is said, because of an instinctive desire to preserve their traditional jurisdictions.[2] Thus, the common law rule, both in this country and in England, is that a bargain to arbitrate will not be spe-

1. Sturges & Murphy, *Some Confusing Matters Relating to Arbitration Under the United States Arbitration Act*, 17 LAW & CONTEMP. PROB. 581 (1952).

2. *Id.* 581-582, n. 2, "Common law revocability and non-enforceability have been ruled into such agreements in almost all American jurisdictions . . . "; *cf.* Kulukundis Shipping Co., S/A v. Amtorg Trading Corp., 126 F. 2d 978, 982 (2d Cir. 1942).

cifically enforced, and that only nominal damages are available for its breach.[3]

In an attempt to avoid the harshness of the common law rule, many jurisdictions have enacted statutes which in some degree overcome the problem of the revocability and non-enforceability of contractual arbitration agreements.[4] Of these, the most significant is the United States Arbitration Act, originally enacted by Congress in 1925.[5] The Act must, of course, be considered as a unit in order to be properly evaluated. Sections 2 and 3, however, are the hub of the Act and have presented the greatest difficulties.

Section 2 of the Act 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, 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.[6]

Section 3 of the Act provides:

> 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

3. RESTATEMENT, CONTRACTS §550 (1932), "A bargain to arbitrate, though it is not illegal, is practically unenforceable unless it is made a condition (see §151), since the bargain gives rise to neither a right to substantial damages nor a right to specific performance."

4. Idaho, Missouri, Montana, North Dakota, Oklahoma, and South Dakota have statutes dealing with this area of the law. Colorado and Washington by judicial decision have disallowed common law revocability. Pennsylvania has denied revocability, at least where arbiters are named in the agreement. England has a statute which allows specific performance in virtually all cases. California, Connecticut, Louisiana, Massachusetts, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Rhode Island, Washington, and Wisconsin have statutes declaring at least certain classes of arbitration agreements enforceable and irrevocable.

5. 43 STAT. 883 (1925), 9 U. S. C. §§1-15 (1946); Legislative reports on the Act may be found at Committee Report 96, accompanying H. R. Rep. No. 646, 68th Cong., 1st Sess. 1 (1924); H. R. Rep. No. 96 and Sen. Rep. 536, 68th Cong., 1st Sess. (1924). The Act was repealed and reenacted in 1947, 61 STAT. 669 (1947), 9 U. S. C. §§1-14 (1954).

6. 9 U. S. C. §2 (1954).

> referable to arbitation 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.[7]

The history of litigation over these sections reveals the two chief problem areas. The first arises in cases present in the federal courts because of diverse citizenship of the litigants, since the court must decide whether to apply federal or local law under the doctrine enunciated in *Erie R. R. v. Tompkins*.[8] The second problem involves the extent and effect of the provisions of the Act.[9] This note discusses only the first problem, emphasizing the impact of the recent cases of *Robert Lawrence Co., Inc. v. Devonshire Fabrics, Inc.*[10] and *Bernhardt v. Polygraphic Co. of America, Inc.*[11]

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7. 9 U. S. C. §3 (1954).

8. 304 U. S. 64 (1938); *cf.* Kochery, *The Enforcement of Arbitration Agreements in the Federal Courts: Erie v. Tompkins*, 39 CORN. L. Q. 74, 78 (1953).

9. Sturges & Murphy, *op. cit. supra* note 1.

10. 271 F. 2d 402 (2d Cir. 1959). Briefly, the facts of the case may be stated as follows: Plaintiff sues for damages alleging that the defendant made fraudulent misrepresentations which induced the plaintiff to purchase and pay for a quantity of wool fabric. The defendant, after receiving the plaintiff's order, issued a confirmation that was different from the order in several respects. After a postponement, delivery was made to the plaintiff who accepted and paid for the goods. Plaintiff alleges that certain latent defects were subsequently discovered and attempts to rescind the contract and collect damages. Both the plaintiff's order and the defendant's confirmation contained a comprehensive arbitration clause. The defendant moved for a stay of proceedings and for the submission of the disagreement to arbitration under the terms of the contract. The District Court denied this motion. *HELD:* Reversed. As applied to commerce and maritime transactions, the federal Arbitration Act creates national substantive law which controls over local law and requires the enforcement of arbitration agreements by the courts. Petition for *cert.* filed, 28 U. S. L. WEEK (Feb. 2, 1960).

11. 350 U. S. 198 (1956). *Bernhardt* involved a contract of employment which contained a clause referring to arbitration any dispute between the parties. Petitioner subsequently brought an action for damages in a Vermont state court for his discharge under the contract. Respondent removed the case to the Vermont federal district court which had jurisdiction because of the diverse citizenship of the parties. Respondent's motion for a stay pending arbitration was refused, the court holding that Vermont law (which makes an executory arbitration agreement freely revocable) governed the case under *Erie R. R. v. Tompkins*. The Court of Appeals reversed, and the Supreme Court in an 8-1 decision reversed the Court of Appeals. Speaking for six justices, Mr. Justice Douglas initially ruled that the contract did not evidence a "maritime transaction" or a "transaction involving commerce" under Section 2, and that Section 3 was inapplicable since it applied only to the types of transactions enumerated in Section 2. He then held that arbitration in diversity suits is not merely a procedural matter gov-

In *Lawrence*,[12] the court once again faced a consistently troublesome question, i.e., whether the determination of the submission of contested contracts to arbitration under previous agreement of the parties is controlled by federal or state law. This question has previously been regarded as inseparable from the *Erie* doctrine,[13] as extended in subsequent cases,[14] that where federal court jurisdiction rests solely on diversity, the court must apply the substantive law of the state. For many years, the federal courts had escaped the limitations of this doctrine by treating the enforcement of arbitration agreements as a procedural matter, thus, controlled by the law of the forum.[15] In the 1956 *Bernhardt* decision,[16] the Supreme Court disposed of a phase of this controversy by holding that, where jurisdiction rests solely on diversity and the contested agreement is not one involving interstate commerce or a maritime transaction under Section 2 of the Arbitration Act, the *Erie* doctrine does apply. This holding rests on the broad proposition that diversity based proceedings in federal courts should not lead to substantially different results from those which would have been reached had the cases been brought in the proper state court.[17] Submission of a contract to arbitration, the Court said, sufficiently affected the outcome to make the matter one of "sub-

erned by the law of the forum (i.e., the federal court), but that because it "substantially affects the cause of action created by the state" so that "the outcome of litigation might depend on the courthouse where the suit is brought", state law must govern. The Court concluded that Vermont law clearly made arbitration agreements unenforceable, and therefore, did not remand on that point; however, a conflict of laws was remitted to the district court. Justice Frankfurter's concurring opinion agreed that the *Erie* rule dictated the Court's holding, since there would otherwise be a "serious question of constitutional law" if cases grounded solely on diversity are subject to federal arbitration law. For this reason he would construe the Act as inapplicable to diversity actions, meantime abstain from any consideration of (the Acts) provisions in cases which are in federal courts "on a jurisdictional basis other than diversity of citizenship". Dissenting Justice Burton thought arbitration was a procedural matter and that *Erie* did not apply.

12. 271 F. 2d. 402 (2d Cir. 1959).

13. 304 U. S. 64 (1939).

14. Guaranty Trust Co. v. York, 326 U. S. 99 (1945); Angel v. Bullington, 330 U. S. 183 (1947).

15. California Prune & Apricot Growers' Ass'n. v. Catz American Co., 60 F. 2d 788 (9th Cir. 1932); Lappe v. Wilcox, 14 F. 2d 861 (N. D. N. Y. 1926); For an excellent discussion of cases in this area, see Kochery, *op. cit. supra* note 8.

16. Bernhardt v. Polygraphic Co. of America, 350 U. S. 183 (1956).

17. Guaranty Trust Co. v. York, 326 U. S. 99 (1945).

stance" within the *Erie* doctrine,[18] thus requiring application of state law.

Bernhardt, however, left open important questions relating to the enforcement of arbitration agreements affecting commerce and maritime transactions. It is in this area that the *Lawrence* case is important.[19] The question may be simplified into two basic concepts. If the Arbitration Act merely established court procedure to enforce a state-created right to compel arbitration, then it is applicable only as a matter of procedure and, even in contracts involving commerce or maritime transactions where federal courts have jurisdiction based solely on diversity, *Erie* dictates that the substantive state law should be applied.[20] On the other hand, if the Arbitration Act creates a new body of federal *substantive* law relative to arbitration agreements affecting commerce or maritime transactions, then in such cases, the Act would be controlling and independent of state law. The *Lawrence* decision resolves the question in favor of the latter position.[21]

In arriving at the conclusion that the Arbitration Act creates a new body of federal substantive law, the Court relies upon the language of the Act[22] as well as its legislative history.[23] The court finds that the limitations of the Act in Sec. 2 indicate a congressional intention to rely upon the ad-

18. Mr. Justice Frankfurter's concurring opinion in the *Bernhardt* case notes that the categories of "substance" and "procedure" are, in relation to *Erie v. Tompkins,* less than self-defining. He agrees with the majority that the question of arbitration goes sufficiently to the merits of the outcome to make the matter one of "substance" under the *Erie* doctrine. See note 11. 350 U. S. 198 (1956).

19. 271 F. 2d 402 (2d Cir. 1959).

20. Bernhardt v. Polygraphic Co. of America, 350 U. S. 183 (1956).

21. 271 F. 2d 402 (2d Cir. 1959), "We, therefore, find federal law as derived from the Arbitration Act to be controlling." at p. 409.

22. See note 5 *supra.*

23. See note 5 *supra;* "As introduced into Congress section 2 of the Act provided for the validity and enforceability of arbitration agreements in any contract or maritime transaction or transaction involving commerce. The Senate Committee struck the word 'contract' from the section and rewrote the language in its present form, so as to cover only maritime transactions and transactions involving interstate and foreign commerce. Senate Report No. 536, 68th Congress, *Zip Mfg. Co. v. Pep Mfg. Co.,* D. C. 44 F. 2d 184. This was evidently done because it was realized that Congress had no power to legislate with respect to the validity of contracts generally but only as to the validity of those which related to matters subject to its control." Agostini Bros. Building Corp. v. United States, 142 F. 2d 856 (4th Cir. 1944); Compare, International Union United Furniture Workers v. Colonial Hardwood Flooring Co., 168 F. 2d 33 (4th Cir. 1948); See also Donahue v. Susquehanna Collieries Co., 138 F. 2d 3, 5 (3rd Cir. 1943).

miralty[24] and commerce[25] powers granted to Congress by the Constitution. It finds additional support for this position in the construction given to the Arbitration Act in the *Bernhardt* case.[26] Pointing to the jealousy with which the courts have looked upon arbitration agreements in the past, and their attempts to thwart this encroachment upon what they termed their "jurisdiction", the Court draws the inference that the Arbitration Act is an attempt by Congress to remove this hostility of the judiciary and to make the benefits of arbitration available to the business world, at least insofar as their power would legitimately enable them to accomplish this result.[27]

The Court is driven into rejecting earlier holdings in several federal jurisdictions which reason that the Arbitration Act pertains to remedies and, thus, is procedural only and within the exception to the *Erie* doctrine,[28] by the *Bernhardt* decision which rejects this rationale. The Court, however, seeks to sustain a broad enforcement of arbitration agreements under the Act, and in so doing, it advances beyond the artificial rationale of the former rule and rests its decision upon the more logical reasoning that, as applied to commerce and maritime transactions, the Act creates national substantive law which encompasses questions of the validity, revocability, and enforceability of arbitration agreements.[29]

In reaching this decision, the *Lawrence* case may be in conflict with the earlier decision of *Ross v. Twentieth Century-Fox Film Corp.*[30] The *Ross* case states that ". . . even if this contract is the sort contemplated by Section 3 of Title 9, the interpretation of the contract is still a matter of California law . . . " and that *Bernhardt* dictates that result. Accordingly, the Court "examined the contract and the law of California to determine whether this contract presents an en-

24. U. S. CONST. art. III, clause 2.
25. U. S. CONST. art. I, section 8, clause 3.
26. Robert Lawrence Co. v. Devonshire Fabrics, 271 F. 2d 402 (2d Cir. 1959).
27. Ibid.
28. See note 15, *supra;* the related theory that arbitration is a remedy and thus not subject to the *Erie* rule apparently stems from the concurring opinion of Justice Cardozo in Meachom v. Jamestown Franklyn & Clearfield Ry., 211 N. Y. 346, 105 N. E. 653 (1914); *cf.* Red Cross Line v. Atlantic Fruit Co., 264 U. S. 109 (1924). See, however, later cases rejecting this reasoning: Ross v. Twentieth Century-Fox Film Corp., 236 F. 2d 632 (9th Cir. 1956); Jackson v. Atlantic City Electric Co., 144 F. Supp. 551 (D. N. J. 1956).
29. Robert Lawrence Co. case, *supra* note 21.
30. 236 F. 2d 632 (9th Cir. 1956).

forceable agreement to arbitrate."[31] While *Lawrence* takes this case to be in conflict with its decision,[32] this result does not necessarily follow. A close reading of the statement from *Ross* leads to the conclusion that the Court turned to state law only for the interpretation of the contract. The unfortunate language relating this rule to the *Bernhardt* decision, and later to the "enforceable agreement to arbitrate", is misleading. The *Ross* holding may be taken to mean that the federal court will apply state law in interpreting a contract to determine if there is or is not an agreement to arbitrate, but that if there is such an agreement to arbitrate, the federal court will enforce the agreement under the Act. This result is, of course, not necessarily in conflict with *Lawrence*.

The possible conflict between *Lawrence* and *Ross*, however, points up difficult problems that may arise in accepting the *Lawrence* rationale. First of all, application of the Arbitration Act in a case where jurisdiction is based solely upon diversity is contrary to Justice Frankfurter's concurring opinion in *Bernhardt* which suggests that, in view of delicate constitutional questions, the Act should not be interpreted as governing diversity actions.[33] With deference to this respected and influential view, it was not adopted by Justice Douglas' opinion for a majority of the Court, and is, thus, not controlling against the *Lawrence* holding. Initially, it is hard to justify the position that such a broad and sweeping determination should rest upon finely drawn inference and interpretation. It is apparent, in the light of the expanded definitions placed upon the powers of Congress in the field of commerce,[34] that this decision will have far reaching consequences in the related areas of state law. Because much of the litigation which could be removed to the federal courts because of diversity will fall within the expanded concept of transactions involving commerce, under the *Lawrence* reasoning the federal courts may have relatively few occasions to give effect to state law in diversity cases.

31. *Ibid.*
32. 271 F. 2d 402, note 7 at 409, "We think the court in *Ross v. Twentieth Century-Fox Film Corporation*, 9 Cir., 1956, 236 F. 2d 632, misconstrued *Bernhardt* when it held that the contract in that case, which involved commerce, was required by the *Bernhardt* reasoning to be interpreted according to California law."
33. See note 18 *supra*.
34. See: Wickard v. Filburn, 317 U. S. 111 (1942); American Power and Light Co. v. Securities Exchange Commission, 329 U. S. 90 (1946); Mandeville Island Farms v. American Crystal Sugar Co., 334 U. S. 219 (1948).

A curious anomaly is thus presented. While federal substantive law applies in diversity-based cases in the federal court (including those removed from state courts), state law presumably would continue to apply to those cases where removal to federal courts is precluded by lack of complete diversity or inadequate jurisdictional amount. It may be argued that if the *Erie* rationale strives for uniform results in federal diversity and state cases, this desirable result is defeated under *Lawrence*. Of course, if complete diversity or the requisite jurisdictional amount is lacking, the parties have no occasion to "select" a forum to obtain a result, since the federal forum is unavailable. This does not eliminate the difficulty that contradictory legal doctrines may be applied in fact situations identical except for the accidental factors barring recourse to federal courts.

There is little or no basis for the sweeping argument that the Arbitration Act of its own force was intended to supplant state law in state courts, and it is doubtful whether such an intent should be inferred from the Act. Thus, in cases where both state and federal forums are available to litigants, the law which will be applied will depend upon the forum utilized.

It is also significant, as Judge Medina states, that the Act has generally been considered as furnishing no independent basis for federal jurisdiction.[35] It seems reasonable to presume that if Congress had intended to negate in large part the law of many states, it would have explicitly declared that the assertion or denial of those rights was a sufficient basis for the invocation of federal jurisdiction.[36]

The *Bernhardt* decision, together with the earlier case of *Transcontinental and Western Air, Inc. v. Koppal*,[37] may indicate a disposition to apply state law in the field of commercial arbitration, as distinguished from labor arbitration where the Supreme Court recently found in the Taft-Hartley Act a Congressional purpose to create a federal substantive law

35. "It is interesting to note that though new substantive federal rights were created, suits involving the application of the Arbitration Act do not furnish an independent basis of federal jurisdiction under 28 U. S. C. section 1331." Robert Lawrence Co., Inc. v. Devonshire Fabrics, Inc., *supra;* citing Kraus Bros. Lumber Co. v. Louis Brassert & Sons, Inc., 62 F. 2d 1004 (2d Cir. 1933); *In re* Warner, 31 F. 2d 283 (2d Cir. 1929); and others.

36. See for example: LABOR MANAGEMENT RELATIONS ACT, 61 STAT. 156, 29 U. S. C. 185 (1947).

37. 345 U. S. 653 (1953).

of arbitration.[38] It is therefore open to question whether the court should hold in commercial arbitration cases that the Act creates new substantive law in contracts involving commerce or maritime transactions. Such an approach becomes uncertain and difficult in the absence of an expressed Congressional intent to create sweeping changes in the law.

A careful reading of the Arbitration Act would seem to present only one interpretation which would lead to an unambiguous result. That interpretation is, that where a case involving an arbitration agreement is properly brought into the federal courts upon an independent federal question, the Arbitration Act shall apply. Thus, if the contract involved affects commerce or maritime transactions, the arbitration agreement is to be "valid, irrevocable, and unenforceable" *only* in cases wherein a federal question is contested. The Congressional purpose underlying the Act, as enacted, means only that in certain classes of federal cases, the common law rule of revocability is not to be followed by the federal courts. Since the Act itself does not confer independent jurisdiction, in diversity cases, including those affecting commerce, the state law should be applied by the federal courts unless their jurisdiction rests upon an independent federal basis.

This result would accord with Mr. Justice Frankfurter's concurring opinion in the *Bernhardt* case and would contradict no position taken in the majority opinion.[39] Whether the Act is treated as constituting procedure or substance, if its application is thus limited, the problems of the interrelationship of federal and state law are less difficult. On this approach Congress has not created generally applicable substantive law pre-empting state arbitration law. It has sought to set forth the substantive federal law for enforcing arbitration agreements in certain classes of cases involving federal questions.

This note does not attempt to expound the virtues or belabor the defects of the enforcement or non-enforcement of arbitration agreements. What it does contend is that such sweeping changes in both state and federal law should not be brought about by placing a strained interpretation upon a statute. If, as has been suggested, the Congressional intent

38. Textile Workers Union v. Lincoln Mills, 353 U. S. 448 (1957).
39. See note 11, *supra*.

behind the Arbitration Act is presently favorable toward a broad application of the Act, it may always achieve this result by an unambiguous statute to that effect. It is urged that the courts should not read into the ambiguous terminology of the Act such far reaching changes in the law.

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