United States Supreme Court Decides Role Of Court And Arbitrators In Challenges To Validity Of Contracts Containing Arbitration Clauses

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The United States Supreme Court has ruled that challenges to the validity of a contract containing an arbitration clause are to be decided by the arbitrator. Conversely, a claim that only the arbitration clause itself is void is to be determined by a court. In so doing, Buckeye Check Cashing, Inc. v. Cardegna, ___ U.S. ___ (2006) ends a debate about the interplay between the judiciary and arbitration forums in challenges to agreements with arbitration clauses, and establishes the supremacy of the Federal Arbitration Act (“FAA”), 9 U.S.C. §§1-16, in this area of law.

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Factual Overview

Buckeye arose from transactions between Buckeye Check Cashing and various individuals (“Respondents”) in which Buckeye cashed personal checks made by Respondents for a fee. These transactions were governed by an agreement which provided that “[a]ny claim, dispute or controversy ... arising from or relating to this agreement ... or the validity, enforceability or scope of this Arbitration Provision or the entire agreement ... shall be resolved ... by binding arbitration.” Respondents filed a putative class action in Florida state court asserting that the agreement was in violation of various Florida statutes, including Florida lending and consumer protection laws. The trial court denied Buckeye’s motion to compel arbitration, holding that it was for the court to decide whether the agreement was void. The Florida Court of Appeals reversed – ruling that a challenge to the validity of the agreement as a whole (as opposed to only the arbitration provision) was to be decided by the arbitrators. Illustrating the disagreement in this area, the Supreme Court of Florida reversed the appellate court and reinstated the ruling of the trial judge. The Florida high court was concerned that enforcing a contract alleged to be unlawful would violate various state civil and criminal laws. The United States Supreme Court reversed, essentially reinstating the decision of the intermediate Florida appellate court.

The Federal Arbitration Act And Its Interpretation

The Supreme Court started its analysis with the FAA, noting that the FAA “embodies the national policy favoring arbitration and places arbitration agreements on equal footing with all other contracts....” The Court specifically quoted that portion of the FAA (§2) that makes agreements to arbitrate “valid, irrevocable and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.”

Challenges to agreements to arbitrate are of two types: the first attacks the contract as a whole, such as the agreement was induced by fraud, or one allegedly illegal provision renders the entire contract void; and the other challenges the validity of the arbitration clause itself within the agreement. (A third category, which the Supreme Court expressly excluded from the scope of its opinion concerns whether a contract ever came into existence at all – the Court left intact prior case law holding that it is for a judge to decide such issues.)

The Court went on to review and affirm two prior decisions which interpreted the FAA in this context. Specifically, in Southland Corp. v. Keating, 465 U.S. 1 (1984), the Court ruled that the FAA preempted contrary state law – i.e., state law cannot preclude enforcement of agreements to arbitrate otherwise valid under the FAA, even where the case involves state law claims brought in state court. Southland was itself based on an earlier decision of the Court, Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395 (1967) which held that a federal court could not consider “claims of fraud in the inducement of the contract generally,” but could rule on claims that the arbitration clause itself was fraudulently induced.

According to the Supreme Court, the

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Southland and Prima Paint decisions establish three points: (1) an arbitration clause is severable from a contract as a matter of substantive federal law; (2) the arbitrator is to decide the validity of the contract unless the challenge is to the arbitration clause; and (3) the first two points apply with equal force in federal and state courts.

More specifically, at issue in Prima Paint was a consulting agreement containing an arbitration clause. Plaintiff Prima Paint alleged that defendant had fraudulently represented that it was solvent and could perform under the agreement. Defendant served a demand for arbitration, which prompted Prima Paint to file suit in the United States District Court for the Southern District of New York “seeking rescission of the consulting agreement on the basis of the alleged fraudulent inducement.”

The District Court held a charge of fraud in the inducement was a question for the arbitrators and not for the court. The Court of Appeals for the Second Circuit agreed, and the United States Supreme Court affirmed. The Supreme Court quickly dispensed with the question of whether the FAA applied in the first instance. The Court found the agreement to concern the sale of a paint business serving clients in a number of states, and thus determined that “[t]here could not be a clearer case of a contract evidencing a relationship in interstate commerce.”

Having settled that question, the Court turned to the issue of the proper forum for the challenge of fraud. In summary, the Court ruled:

[If] the claim is fraud in the inducement of the arbitration clause itself – an issue which goes to the ‘making’ of the agreement to arbitrate – the federal court may proceed to adjudicate it. But the statutory language does not permit the federal court to consider claims of fraud in the inducement of the contract generally.

The Court based its holding on the following rationale: “[W]e not only honor the plain meaning of the [FAA] but also the unmistakably clear congressional purpose that the arbitration procedure, when selected by the parties to a contract, be speedy and not subject to delay and obstruction in the courts.”

At issue in Southland was whether claims under a state statute – here the California Franchise Investment Law – can be exempted from an otherwise enforceable arbitration clause subject to the FAA. Plaintiffs were 7-Eleven franchisees who brought various common law causes of action as well as claims under the Franchise Investment Law. The trial court refused arbitration of the statutory claims; the intermediate appellate court reversed, finding that such an interpretation violated the Supremacy Clause. The California Supreme Court found no supremacy clause concerns and reinstated the ruling of the trial court.

The United States Supreme Court reversed, and agreed with the California appellate court. In so doing, the Supreme Court made two primary rulings: any state statute which removes from arbitration a claim otherwise subject to arbitration under the FAA is void under the Supremacy Clause; and second, that the FAA applies in both federal and state courts. In summary, the Court held: “The Federal Arbitration Act rests on the authority of Congress to enact substantive rules under the Commerce Clause ... And since the overwhelming proportion of all civil litigation in this county is in the state courts, we cannot believe Congress intended to limit the Arbitration Act to disputes subject only to federal court jurisdiction” (emphasis in original).

Southland And Prima Paint Establish The Supremacy Of The FAA

Turning to the case before it, the Buckeye Court noted that the attack presented was a challenge to the contract as a whole: “the crux of the complaint is that the contract ... is rendered invalid by [a] usurious finance charge.” Accordingly, the Supreme Court ruled that the challenge should be considered by the arbitrators because Respondents attack the agreement “but not specifically its arbitration provisions ...”

In so holding, the Court rejected out of hand the Florida Supreme Court’s ruling that an arbitration clause cannot be separated from a contract otherwise illegal or unenforceable under state law. Prima Paint, noted the Court, “rejected application of state severability rules to the arbitration agreement....” So, too, Southland refused to find that the enforceability of an arbitration agreement turned on “the state legislature’s judgment concerning the forum for enforcement of the state-law cause of action.”

The Court expressly declined to adopt the position put forth by Respondents (the plaintiffs in the original state law suit) that Prima Paint’s “rule of severability” only applies in federal court. This is because, ruled the Court, section two of the FAA is based on “Congress’ broad power to fashion substantive rules under the Commerce Clause.” In other words, section two of the FAA applies in federal and state courts and governs any state law to the contrary, because Congress did not intend to limit the Arbitration Act to disputes subject only to federal jurisdiction.

As a final note, the Supreme Court rejected Respondents’ argument that contracts that are void ab initio under state law are not “contracts” at all, and thus are outside the scope of the FAA. Citing other federal statutes that refer to putative contracts, the Court held that “[i]t can be no doubt that ‘contract’ as used [in section two of the FAA] must include contracts that later prove to be void ... [the] use of ‘contract’ so obviously includes putative contracts....”

Conclusions

The message of Buckeye is clear: in finding that the arbitrator has jurisdiction to hear challenges to a contract containing an arbitration clause and in limiting the role of the courts to ruling on the validity of arbitration clauses, the Supreme Court reaffirmed the supremacy of the FAA – and all federal law – over conflicting state law provisions, and expressed a strong policy favoring arbitration. In short, by giving the arbitrator the power to rule on the validity of a contract, the Court not only affirmed the prominent role of arbitration in our system of dispute resolution, but also made it far more difficult for a person who has agreed to arbitrate to avoid its obligations by claiming the contract is void and thus having a case, that should otherwise be arbitrated, heard by an already overloaded judiciary. In this regard, Buckeye echoes the sentiment expressed over twenty years ago in Southland: “Contracts to arbitrate are not to be avoided by allowing one party to ignore the contract and resort to the Courts. Such a course could lead to prolonged litigation, one of the very risks the parties, by contracting for arbitration, sought to eliminate.” As such, Buckeye will not only impact arbitration law for years to come, but also will play a major role in the field of commercial law, indeed in all areas of the law where arbitration provisions are routinely used in contracts.