RENDERED: October 11, 2002; 10:00 a.m.
NOT TO BE PUBLISHED

Commonwealth Of Kentucky

Court Of Appeals

NO. 2001-CA-000496-MR

LARRY A. JUDD; AND
JULIE N. JUDD — APPELLANTS

v.

APPEAL FROM JEFFERSON CIRCUIT COURT
HONORABLE STEPHEN P. RYAN, JUDGE
ACTION NO. 00-CI-003339

PAUL J. SINNOTT; SHERRI SINNOTT;
AND EDWARD BEATY — APPELLEES

OPINION
AFFIRMING
** ** ** ** **

BEFORE: DYCHE, JOHNSON AND KNOPF, JUDGES.

JOHNSON, JUDGE: Larry A. Judd and Julie N. Judd (the Judds) have appealed from an order entered by the Jefferson Circuit Court on February 6, 2001, which denied their motion to compel arbitration in a dispute arising out of a sale of real estate.[1] Having concluded that the Judds failed to meet their burden in proving that the United States Arbitration Act (Federal Arbitration Act)[2] applies to the contract in question, and that Kentucky law does

[1]While this appeal is interlocutory, it is authorized pursuant to Kentucky Revised Statutes (KRS) 417.220(1)(a).

[2]United States Arbitration Act of 1925, 9 U.S.C. §§ 1-15.

not permit the enforcement of an arbitration clause in a contract which has been fraudulently induced, we affirm.

The Judds sold their residence to Paul and Sherri Sinnott (the Sinnotts) pursuant to a contract executed by the parties on May 15, 1999. After taking possession of the home, the Sinnotts discovered serious problems with its plumbing system. On May 24, 2000, the Sinnotts filed a complaint in Jefferson Circuit Court, alleging that they had been fraudulently induced by the Judds to enter into the contract, and sought recission of the contract, compensatory damages for their extensive repair bills, and punitive damages. Specifically, the complaint alleged that the Judds had misrepresented and concealed the defects in the house's plumbing system. In support of their claims, the Sinnotts attached a copy of the disclosure form completed by the Judds prior to the sale, which stated that the sellers were not aware of any defect in their house. The Sinnotts also asserted a claim against Edward Beaty, alleging that he was negligent in performing an inspection of the house's plumbing.[3]

In response, the Judds filed a motion to dismiss the action for a lack of subject-matter jurisdiction because the Sinnotts had failed to exhaust their remedy of arbitration contained in the sales contract, which stated:

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[3]The claim against Beaty is not relevant to this appeal, as he was not a party to the sales contract which contained the arbitration clause.

> **BINDING ARBITRATION:** All claims or disputes of Sellers, Buyers, brokers, or agents or any of them arising out of this contract or the breach thereof or arising out of or relating to the physical condition of the property covered by this purchase agreement (including without limitation, claims of fraud, misrepresentation, warranty and negligence) shall be decided by binding arbitration in accordance with the rules for the real estate industry, then in effect, adopted by the American Arbitration Association unless the parties mutually agree otherwise. Notice of the demand for arbitration shall be filed in writing by registered or certified mail with the other parties to the contract and with the American Arbitration Association or other arbitrators which the parties may agree upon and shall be made within one year after the dispute has arisen. An actual oral hearing shall be held unless the parties mutually agree otherwise. The Kentucky Real Estate Commission still retains jurisdiction to determine violations of KRS 324.160. Any proceeding pursuant to KRS 324.420(1) to determine damages shall be conducted by an arbitrator pursuant to this clause and not in court. By signing below, the agents, on behalf of themselves and their brokers, agree to be bound by this arbitration clause, but are not parties to the contract for any other purpose. The terms of this Paragraph 15 shall survive the closing.

The Sinnotts responded to the motion to dismiss by arguing that the arbitration clause was rendered unenforceable by KRS 417.050, which provides in part that "[a] written agreement to submit any existing controversy to arbitration or a provision in written contract to submit to arbitration any controversy thereafter arising between the parties is valid, enforceable and irrevocable, save upon such grounds as exist at law for the revocation of any contract" [emphasis added]. Pointing to the

final clause from the above quote, the Sinnotts contended that their claim of fraudulent inducement constituted grounds for "the revocation of any contract," thus relieving them from the terms of the arbitration agreement. The Judds, on the other hand, contended that this clause from KRS 417.050 should be applied only when the validity of the arbitration clause itself is in question.

The trial court denied the Judds' motion to dismiss on July 21, 2000, stating that whether the contract was fraudulently induced was an issue of fact for a jury and that it would be improper to dismiss the action. The Judds appealed that order, citing CR[4] 65.07 as grounds for their interlocutory appeal. This Court found the interlocutory appeal to be improper and dismissed the appeal on October 16, 2000. The Judds then filed a motion to compel arbitration in the Jefferson Circuit Court. The trial court denied that motion on February 6, 2001, reiterating its reasoning from the order of July 21, 2000. This appeal followed.

The Judds first argue that the Federal Arbitration Act governs the transaction because the real estate sales contract in question affected interstate commerce; and that pursuant to Section 2 of the Federal Act, the arbitration clause contained in the sales contract is binding and enforceable. The Judds also argue that even if the Federal Arbitration Act is held not to

[4]Kentucky Rules of Civil Procedure.

apply to this transaction, under Kentucky law the arbitration clause is still binding and enforceable.

An agreement to arbitrate a dispute arising under a contract is valid and it is specifically enforceable by the stay of a judicial proceeding brought in Kentucky if the proceeding involves an issue referable to arbitration.[5] The U.S. Arbitration Act of 1925 will govern such actions — even in the courts of this Commonwealth — where the purpose of the action is to enforce a voluntary arbitration agreement in a contract evidencing a transaction in interstate commerce.[6] In reviewing whether a contract evidences a transaction in interstate commerce, courts have employed a "broad definition" of the term "interstate commerce."[7]

As a threshold matter, we must first consider whether the contract entered into by the Judds and the Sinnotts contemplated a transaction in interstate commerce. The Judds argue that the contract affects interstate commerce because the transaction was financed in part by an out-of-state lender, Navy

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[5]Kodak Mining Co. v. Carrs Fork Corp., Ky., 669 S.W.2d 917, 919 (1984).

[6]Fite & Warmath Construction Co., Inc. v. MYS Corp., Ky., 559 S.W.2d 729, 734 (1977); 9 U.S.C. § 2 (providing that: "A written provision in any . . . contract evidencing a transaction involving [interstate] commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract").

[7]Fite, supra.

Federal Credit Union located in Maryfield, Virginia, and that hazard insurance was obtained through this out-of-state lender. The Judds offered no other proof that the transaction involved interstate commerce. Based on this limited evidence of record, the trial court rejected the Judds' interstate commerce argument. From our review of the evidence, we conclude that the evidence did not compel a finding in favor of the Judds. Consequently, it cannot be said that the trial court's finding was clearly erroneous.[8]

The Kentucky cases that have held the Federal Arbitration Act to be applicable have involved much more compelling facts. In Fite, the parties to the contract were headquartered in different states, employees regularly crossed state lines to work on the project under contract, and out-of-state contractors and vendors charged almost $4 million. In Kodak Mining, the contracting parties were again incorporated in different states, the arbitration clause specified that the arbitrators would be selected by federal judges of different states, and the activity contemplated by the contract, coal mining, was an industry that was heavily regulated by federal law. The Court in Kodak Mining also emphasized that even local mining operations had a substantial affect on the national supply and price of coal.

[8]CR 52.01.

The case sub judice does not include any of these factors. Navy Federal Credit Union is an incidental party to the contract, and it did not play a significant role in negotiating the contract. Further, both the Judds and the Sinnotts are residents of Kentucky; and the house under contract was located in Kentucky. Unlike the law concerning the coal mining industry, real estate and property law are traditionally matters of state law and state regulation. Accordingly, the contract between the Judds and Sinnotts does not sufficiently affect interstate commerce, so as to compel a finding that it comes under the auspices of the Federal Arbitration Act.

In support of their contention that Kentucky law compels arbitration, the Judds argue that KRS 417.050 is nearly identical to its counterpart in the Federal Arbitration Act and the Uniform Arbitration Act,[9] and that the majority of federal and state courts have determined that the language in the savings clause ("save upon such grounds as exist at law for the revocation of any contract") applies only where a claim of fraudulent inducement is made with respect to the agreement to arbitrate and not to the underlying contract in general.[10] The

[9]The Uniform Arbitration Act has been largely adopted in most states, including Kentucky.

[10]See Marks v. Bean, Ky.App., 57 S.W.3d 303, 306 (2001) (citing Prima Paint Corp. v. Flood & Conklin Manufacturing Co., 388 U.S. 395, 87 S.Ct. 1801, 18 L.Ed.2d 1270 (1967); Quirk v. Data Terminal Systems, Inc., 379 Mass. 762, 400 N.E.2d 858 (1980); and Jay M. Zetter, J.D., Annotation, Claim of Fraud in the Inducement of Contract as Subject to Compulsory Arbitration
(continued...)

Judds also point out that Kentucky law generally favors arbitration agreements.[11] The Judds claim that the trial court erred by not following the majority doctrine and by not enforcing the arbitration agreement.

Contrary to the Judds' position, however, Kentucky adheres to the minority rule — that the arbitration agreement is not separable from the overall agreement, and thus a claim that questions the legitimacy of the contract as a whole also renders the arbitration clause unenforceable.[12] Marks, which was rendered by this Court on July 20, 2001, involved an identical fact pattern and the same arbitration clause, which is apparently used by the members of the Jefferson County Board of Realtors in their contracts for the sale of a home.[13] In that decision, this Court reasoned that:

> The contract executed by the parties is a standard form drafted by the Louisville Board of Realtors. Its arbitration clause is obviously designed to protect member real estate agents and brokers from litigation. These facts alone do not address the legal elements of whether the clause is enforceable. We believe that the [Appellants] interpretation of KRS 417.050

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[10](...continued)
Clause Contained in Contract, 11 A.L.R. 4th 774 (1982)).

[11]Kodak Mining, supra.

[12]Marks, supra at 306.

[13]The only difference between the two cases is that the Beans discovered serious problems with the brick veneer of their Jefferson County home rather than a problem with the plumbing. The complaint, procedural history, and even the order on appeal closely resemble each other.

> disproportionately elevates the policy favoring arbitration over the strong public policy against fraud. The clear and plain language of that statute dictates a legislative intent that innocent parties not be forced to comply with an arbitration provision in contracts tainted by fraud. It creates an explicit exception to the general enforceability of arbitration clauses: "save upon such grounds as exist at law for the revocation of any contract." KRS 417.050 (Emphasis added.) We do not believe the trial court's application of KRS 417.050 to the facts in this case in any way harms or undermines the arbitration process. As noted in Atcas, supra,
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> When the making of the agreement itself is put in issue, as is the result of a claim of fraud in the inducement, that issue is more properly determined by those trained in the law. Issues involving a breach or violation of the agreement, which are primarily issues of fact, can be more properly left to the expertise of those trained in the respective fields of arbitration. There is ample encouragement for both approaches within the terminology of the statute.[14]

Accordingly, we hold that Kentucky law does not require the arbitration of a claim where as a part of that claim fraudulent inducement has been properly alledged. The Jefferson Circuit Court was correct in denying the Judds' motion to compel arbitration and its order is affirmed.

DYCHE, JUDGE CONCURS IN RESULT ONLY.

KNOPF, JUDGE, CONCURS IN RESULT ONLY AND FILES SEPARATE OPINION.

KNOPF, JUDGE, CONCURRING IN RESULT: As the majority opinion correctly points out, Marks v. Bean, Ky. App., 57 S.W.3d

[14]Marks, supra at 307.

303 (2001), is currently the law of the Commonwealth and dictates the result in this case. I am compelled, accordingly, to concur in that result. I write separately, however, to register my dissatisfaction with Marks--a departure from the mainstream of American arbitration law that I do not believe the General Assembly intended--and to disassociate myself from any suggestion that arbitrators are less able than judges to perceive fraud or more willing to countenance it.

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