PREEMPTION AND THE FEDERAL ARBITRATION ACT: WHAT LAW WILL GOVERN YOUR AGREEMENT TO ARBITRATE?

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Corporate counsel are frequently called upon to negotiate or review contracts with arbitration clauses. Such clauses are seldom the focus of active negotiation. Rather, boilerplate clauses are cribbed from other contracts or lifted without modification from the standard, form provisions recommended by independent ADR providers. But counsel should beware; failure to take the time to consider and specify what law will apply to the arbitration may lead to serious, unintended consequences should a dispute arise.

The Federal Arbitration Act

The Federal Arbitration Act (FAA) "embodies a national policy favoring arbitration and places arbitration agreements on equal footing with all other contracts." As interpreted by the Supreme Court, the FAA creates a uniform "'body of federal substantive law'" regulating the enforceability of agreements to arbitrate that applies to all contracts involving interstate commerce in both state and federal court. Given the broad interpretation of interstate commerce adopted by the Supreme Court, the FAA will apply to most every contract.

However, the FAA does not necessarily dictate the procedural rules governing how arbitration itself is conducted. Rather, the parties to a contract are free to elect whether the FAA, state law, or other rules -- such as those promulgated by an independent ADR provider -- will govern their arbitration.

Federal Preemption

The FAA "contains no express pre-emptive provision, nor does it reflect a congressional intent to occupy the entire field of arbitration." Nevertheless, the Supreme Court has applied the FAA to preempt state laws that "undermine the goals and policies of the FAA." Thus, while "state law may be applied if that law arose to govern issues concerning the validity, revocability, and enforceability of contracts generally," courts may not "invalidate arbitration agreements under state laws applicable only to arbitration provisions."

Following this approach, the Supreme Court has applied the FAA to preempt state laws that bar arbitration of particular disputes. For example, in Perry v. Thomas, the Supreme Court held that the FAA preempted a California law permitting employees to sue for unpaid wages even where the parties had entered into an enforceable agreement to arbitrate. Similarly, in Southland Corp. v. Keating, the Supreme Court held that the FAA preempted a California law barring arbitration of certain state statutory claims.
The Supreme Court has also applied the FAA to preempt state laws that impose special conditions on the enforceability of agreements to arbitrate. Thus, in *Doctor's Associates, Inc. v. Casarotto*, the Supreme Court held that the FAA preempted a Montana law requiring arbitration clauses to be typed in capital letters, to be underlined, and to appear on the first page of the contract.\(^8\) The Supreme Court found that the statute directly conflicted with the federal mandate that agreements to arbitrate "be placed upon the same footing as other contracts" because it "condition[ed] the enforceability of arbitration agreements on compliance with a special notice requirement not applicable to contracts generally."\(^9\)

The goals and policies underlying the FAA have also led the Supreme Court to hold that "as a matter of substantive federal arbitration law, an arbitration provision is severable from the remainder of the contract."\(^10\) Under this rule, an agreement to arbitrate is enforceable even if the contract as a whole is void or otherwise unenforceable. State laws that do not recognize the "rule of severability" are preempted even if they declare all parts of a void contract unenforceable without distinguishing agreements to arbitrate. As a practical matter, the rule means that the arbitrator, not the court, must decide any challenge going to the validity or enforceability of the contract as a whole.\(^11\)

**Procedural Rules**

Knowing what the FAA preempts is only half of the equation. While the federal policy underlying the FAA ensures the enforceability of agreements to arbitrate, "[t]here is no federal policy favoring arbitration under a certain set of procedural rules."\(^12\) To the contrary, the Supreme Court has made clear that the FAA does not prevent "the enforcement of agreements to arbitrate under different rules than those set forth in the Act itself."\(^13\) Just as the parties "may limit by contract the issues which they will arbitrate, so too may they specify by contract the rules under which that arbitration will be conducted."\(^14\)

This flexibility allows contracting parties to select the most appropriate rules to govern their arbitration. But the consequences of failing to consider and specify the procedural rules that will apply can be significant.

*Volt Information Sciences, Inc. v. Leland Stanford Junior University* is instructive.\(^15\) In that case, the parties entered into a construction contract whereby Volt was to install a system of electrical conduits at the University in California. The contract included an arbitration provision providing that any claims arising out of the contract would be arbitrated "in accordance with the Construction Industry Arbitration Rules of the American Arbitration Association."\(^16\) The arbitration clause did not separately specify whether it was governed by the FAA's procedural rules or by state law. The contract did, however, include a general choice-of-law clause that called for application of "the law of place where the Project is located."\(^17\)

A dispute arose, and Volt made a demand for arbitration. The University responded by suing Volt in California state court. The University also sought indemnity from two other companies that were involved in the construction project, neither of whom had agreed to arbitrate. Volt moved to stay the litigation and compel arbitration under the FAA. The University moved to stay arbitration under § 1281.2(c) of the California Code of Civil Procedure.
which permits a court to stay arbitration pending resolution of related litigation. Applying § 1281.2(c), the trial court stayed the arbitration.\textsuperscript{18}

The case made its way to the Supreme Court, where Volt argued that § 1281.2(c) was preempted because it undermined the goals and policies of the FAA. The Supreme Court disagreed, interpreting the general choice-of-law provision "to mean that the parties intended the California rules of arbitration, including the § 1281.2(c) stay provision, to apply to their arbitration agreement."\textsuperscript{19} Giving effect to its interpretation of the parties intent, the Supreme Court concluded that "[w]here, as here, the parties have agreed to abide by state rules of arbitration, enforcing those rules according to the terms of the agreement is fully consistent with the goals of the FAA, even if the result is that arbitration is stayed where the [FAA] would otherwise permit it to go forward."\textsuperscript{20} One is left to ponder whether Volt truly intended that result in agreeing to the general choice-of-law clause.

By contrast, other cases refuse to give effect to a general choice-of-law clause -- even one contained within the arbitration clause itself -- that does not expressly specify that the state law rules for arbitration apply. For example, in \textit{Sovak v. Chugai Pharmaceutical Co.}, the parties "agreed to arbitrate all disagreements in Chicago pursuant to Illinois law and the rules of the American Arbitration Association."\textsuperscript{21} The Ninth Circuit concluded that even "a general choice-of-law clause within an arbitration provision does not trump the presumption that the FAA supplies the rules for arbitration."\textsuperscript{22} Rather, the court interpreted "the choice-of-law clause as simply supplying state substantive, decisional law, and not state law rules for arbitration."\textsuperscript{23} Although not expressed, it would appear that the decision in \textit{Sovak} was based, at least in part, on the fact that it originated in federal court, unlike \textit{Volt}. But again, it seems open to question whether the parties truly intended that the FAA would supply the procedural rules governing their arbitration.

Inconsistency between a general choice-of-law clause and the arbitration rules specified in the contract may also cause unintended consequences. In \textit{Mastrobuono v. Shearson Lehman Hutton, Inc.}, the plaintiffs entered a standard, form contract with a securities brokerage firm.\textsuperscript{24} The contract included a general choice-of-law clause incorporating New York law and provided that any disputes would be arbitrated under the rules of the National Association of Securities Dealers (NASD).\textsuperscript{25} A dispute arose and the parties went to arbitration where a panel of arbitrators found in plaintiff's favor and awarded punitive damages. Defendant petitioned the court to vacate the punitive damage award, relying on a New York law that allowed courts, but not arbitrators, to award punitive damages. Here, the Supreme Court found that the parties adoption of the NASD arbitration rules, which at least implicitly authorized recovery of punitive damages, overrode contrary New York law notwithstanding any ambiguity that might have been introduced by the general choice-of-law provision.\textsuperscript{26} Yet again, one can only speculate whether the brokerage firm meant to expose itself to the possibility of punitive damages by reference to NASD procedural rules.

\textbf{Drafting Agreements To Arbitrate}

These decisions teach two very important lessons for drafting any arbitration provision. First, take the time to understand the procedures that will apply to the arbitration under the FAA, under applicable state law, and under any independent ADR rules you may specify. Second,
once you analyze your options and decide on the rules you intend to govern arbitration, make
certain your contract leaves no room for disagreement regarding the procedural rules you intend
to govern your arbitration. It is oft said that arbitration is a procedure with too few lawyers in the
beginning and too many in the end. Taking the time to craft your arbitration provision on the
front end will help you achieve the desired benefits should a dispute arise.
4 Id. at 477-78.
7 465 U.S. 1, 10-17 (1984).
8 517 U.S. at 686-89.
9 Id. at 687 (internal quotation marks omitted).
12 Volt, 489 U.S. at 476.
13 Id. at 479.
14 Id.
16 Id. at 471.
17 Id. at 470.
18 Id. at 471.
19 Id. at 476.
20 Id. at 479.
21 280 F.3d 1266, 1268 (9th Cir. 2002)
22 Id. at 1270.
23 Id.
25 Id. at 58-59.
26 Id. at 58-63.