What Law Applies to an Agreement to Arbitrate?

By Terry L. Trantina

When asked to resolve a dispute arising out of a contract containing an arbitration provision, the first question a lawyer must answer is what law governs the obligation to arbitrate a dispute. And that answer could — and often does — determine the dispute’s outcome.

From experience, lawyers know that most contracts contain a boilerplate choice-of-law clause, so in searching for an answer, most lawyers immediately turn to that term in the parties’ agreement. Although this a logical place to start, stopping there can lead to a significant and costly mistake. The mistake many lawyers (and courts) make at that point is to assume that the state law identified in that clause governs all legal issues, including issues involving the arbitration of the parties’ disputes.

In fact, just the opposite is almost certainly the case because, with few exceptions, the state law identified in the contract is entirely preempted by the Federal Arbitration Act (FAA) and only the FAA will apply to the arbitration of the disputes arising under or related to the parties’ agreement.¹

In short, the FAA trumps all. The FAA applies to the parties’ agreement to arbitrate disputes whether or not it is expressly mentioned in that agreement — and is presumed to preempt the state law selected in a general choice-of-law provision unless the contract expressly evidences the parties’ clear intent that state arbitration law applies in place of or in addition to the FAA. This has been the applicable law since at least 1995,² but few practitioners know or understand the breadth of the FAA.

Common Assumptions and Mistakes

Three common misunderstandings about the FAA contribute to the mistaken assumption that state law applies. First, many practitioners assume that to be applicable, the FAA must be mentioned in the parties’ agreement. But the US Supreme Court made clear in Mastrobuono v. Shearson Lehman Hutton that the FAA does not have to be mentioned in the contract or arbitration provision to apply and preempt state law.³

Second, under the FAA, the arbitration provision in a contract is treated as a separate agreement of the parties.⁴ Therefore, a general choice-of-law provision is not viewed as applying to the agreement to arbitrate disputes (unless it expressly states that it does) and state law governs the substantive issues of the remainder of the contract.

Third, many practitioners also assume that the FAA is a procedural, rather than substantive, statute that applies only to transactions that are obviously interstate in nature. As a result, many often assume that the scope of the FAA’s applicability (and its preemptive effect) is narrower than it actually is. However, the FAA, first enacted in 1925 and restated in 1947, has been held by the US Supreme Court to be a small body of substantive law that applies to all written agreements to arbitrate disputes evidencing a transaction “involving interstate commerce.”⁵

This is far and away the most misunderstood part of the FAA. The scope of the FAA’s applicability and preemptive effect is drastically underestimated. The US Supreme Court has held that the “involving commerce” language of Section 2 of the FAA does not mean “in commerce” (which would narrow the FAA’s...
applicability to activity obviously interstate in nature) but rather that “involving commerce” has the same meaning as “affecting commerce.” Therefore, the US Supreme Court, in Allied-Bruce Terminix Cos. v. Dobson, found the FAA has the full reach of the US Constitution’s Commerce Clause and encompasses a wider range of activity than those “in commerce.” The FAA applies to activity “within the flow of interstate commerce.”

The FAA’s Scope

In Allied-Bruce, the Court enforced a consumer contract’s arbitration provision in a contract between parties in a state, Alabama, whose statutes banned consumer pre-dispute arbitration provisions, holding that the FAA applied to and enforced a homeowner’s obligation to arbitrate a dispute involving a contract to treat a home for insects because Allied-Bruce Terminix purchased the insecticide used to treat the home from an out-of-state source and the interstate sale of insecticide was something Congress could choose to regulate. The Court reached this conclusion in Allied-Bruce by finding that the FAA governs any agreement to arbitrate if some economic activity of one of the parties (not necessarily the parties’ transaction or the contract itself) has a nexus to interstate commerce.

In US v. Lopez, a case striking down a federal statute banning the possession of a gun near a school as not being within Congress’s power under the Commerce Clause (decided the same year but after Allied-Bruce), the Court summarized all of its prior decisions regarding the scope of the Commerce Clause. There was dicta in that case that caused some state courts with reservations about the FAA’s applicability and preemptive scope (including the Alabama Supreme Court) to question the continued viability of Allied-Bruce.

In 2003, in Citizens Bank v. Alafabco, Inc., per curium, the US Supreme Court reiterated the viability of the Allied-Bruce decision, holding that neither the parties’ agreement nor underlying transaction need be “in” interstate commerce; only the economic activity of the parties involved has to have some nexus to interstate commerce. The Court in Alafabco noted that even under any strict analysis, interstate commerce was involved because the parties’ agreement was a bank loan, which is clearly a general economic activity subject to federal control as “affecting” interstate commerce. However, the

In this day and age, few party relationships giving rise to a contract have no nexus to interstate commerce, and therefore, there are very few agreements to arbitrate that are not governed solely by the FAA, absent an express contractual statement of intent otherwise.

When State Law Governs

Although the FAA applies generally and broadly, the US Supreme Court has recognized in its Volt and First Options decisions that the FAA permits the contracting parties to change the arbitration process to suit their needs and that the FAA will enforce those changes if the parties’ intent to do so is expressly reflected or incorporated into their agreement. The Court has held that the parties may add portions of a state’s arbitration law to the FAA’s provisions or opt out of the FAA’s provisions entirely. However, the US Supreme Court has also held that a contract’s general choice-of-law clause’s selection of a particular state’s law is an insufficient expression of the intent required to opt out of the FAA or add portions of a state’s law to the FAA.
Therefore, a contract’s general choice provision selecting a particular state’s law to govern the contract as a whole, without more, is not sufficient to trump the applicability of the FAA to the contract’s arbitration obligation and preemption of the state law identified in the general choice of law provision.

The scope of the FAA’s preemption is itself a very important issue and has been the subject of many court decisions faced with challenges to the applicability of and preemption by the FAA. The FAA has been held to preempt any state constitutional provision, statute, court rule, or decision that is not generally applicable to all contracts. If a state statute, constitutional provision, court ruling, or public policy singles out agreements to arbitrate for special treatment, then it is preempted by the FAA. And even state provisions or rulings that are generally applicable to all contracts are preempted if they serve as an “obstacle to the accomplishment of the FAA’s objectives” (i.e., enforcement of the arbitration agreement in accordance with its terms).

The answer to the simple question of what law applies to an agreement to arbitrate is not the simple, contract-specified one that many lawyers might assume, and becoming familiar with the FAA and its body of substantive law is crucial for anyone working in this field who wants to be a skilled, competent practitioner. Until there is clear evidence to the contrary, practitioners will be better off assuming that the FAA, not state law, applies.

Endnotes

1 There is an express, but very limited statutory exception to the applicability of the FAA. Section 1 of the FAA, 9 U.S.C. § 1, expressly excludes arbitration agreements involving employment of any class of workers actually employed in foreign or interstate commerce, e.g., railroads, airlines, and telecommunications carriers.

3 See id. at 60, n.4 (1995).
7 Id. at 273-274 (citing Perry v. Thomas, 482 U.S. 483, 490 (1987).
8 Id.
11 Id. at 58.
12 Id. at 57, citing Katzenbach v. McClung, 379 U.S. 294, 304-305 (1964); see also Crawford v. West Jersey Systems, 847 F. Supp. 1232, 1240 (D.N.J. 1994) (the involving commerce connection is satisfied when the contract has only the smallest nexus with interstate commerce or when contractual activity affects this commerce, even if tangentially).
13 Volt Information Sciences, Inc. v. Bd of Trustees of Leland Stanford Junior Univ., 489 U.S. 468, 479 (1989) (The FAA’s central purpose is to ensure that private agreements to arbitrate are enforced according to their terms);
14 Mastrobuono id. at 62-64 (1995). Some have viewed the US Supreme Court’s decision in Volt as being inconsistent with Mastrobuono, but subsequent decisions, including Allied-Bruce, have determined otherwise and explained that in Volt the US Supreme Court was simply giving deference to the prior holding of the California Supreme Court as to the contracting parties’ intent, a subject that was not before the US Supreme Court. See R.R Package Sys, Inc. v. Kayser, 257 F. 3d 287 (3d Cir. 2001).