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OFFICE OF LEGISLATIVE COUNCIL

MEMORANDUM

To: Senate Committee on Economic Development, Housing and General Affairs

From: Damien Leonard, Esq.

Date: April 10, 2018

Subject: Preemption Under the Federal Arbitration Act

Questions Presented

- What does the Federal Arbitration Act preempt?
- How do the provisions of S.105 relate to the Federal Arbitration Act?

The Federal Arbitration Act

The Federal Arbitration Act (FAA)[1] is a federal law that provides for judicial facilitation of private dispute resolution through arbitration.[2] It applies in both state and federal courts where the transaction contemplated by the parties involves interstate commerce.

Under the FAA, an agreement to arbitrate "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."[3] The final phrase places agreements to arbitrate on equal footing with other contracts and "permits agreements to arbitrate to be invalidated by 'generally applicable contract defenses, such as fraud, duress, or unconscionability.'"[4] However, it does not permit arbitration agreements to be invalidated by "defenses that apply only to arbitration or that derive their meaning from the fact that an agreement to arbitrate is at issue." *Id.*

Preemption Under the Federal Arbitration Act

The U.S. Supreme Court has described section 2 of the FAA as "a congressional declaration of a liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural policies to the contrary."[5] There are two basic

[1] 9 U.S.C. § 1 et seq.
[2] *See Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 219 (1985).
[3] 9 U.S.C. § 2.
[4] *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 339 (2011).
[5] *Moses H. Cone Mem. Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983); *see also* 9 U.S.C. § 2.

situations in which the FAA might preempt a state law. First, a state law will be preempted if it expressly prohibits arbitration of a certain type of claim, such as an employment discrimination claim.[6] Second, a state law will be preempted if it interferes with the basic attributes of arbitration or regulates contracts in a manner that creates an obstacle to arbitration. For example, in *AT&T Mobility LLC v. Concepcion*, the U.S. Supreme Court invalidated a ruling that arbitration agreements containing class-action waivers were unconscionable under California law because requiring class-wide arbitration to be available in all instances would interfere with the terms of arbitration agreements and frustrate the efficient and speedy resolution of disputes.[7]

Relation of S.105 to the FAA

S.105 provides, in pertinent part, that a standard-form contract is presumptively unconscionable if it:

1. requires that resolution of disputes take place in an inconvenient venue (a different state from the one in which the individual resides or the contract was consummated);
2. waives the individual's right to assert claims or seek remedies provided by state or federal law[8];
3. waives the individual's right to seek punitive damages as provided by law;
4. establishes a limit on the time in which an action may be brought that is shorter than the statute of limitations or waives the statute of limitations; or
5. requires the individual to pay fees and costs substantially in excess of the fees and costs required by a court to bring a similar claim.

In the event that a court finds a term of a contract illegal or unconscionable, it can refuse to enforce the contract or the illegal or unconscionable term, or limit the application of the illegal or unconscionable term to avoid an illegal or unconscionable result.

S.105 likely avoids the issue of preemption under the FAA because it does not prohibit arbitration and does not create an obstacle to the resolution of disputes through arbitration. Instead, the presumption created by S.105 is applicable to provisions that could be present in a contract regardless of whether the contract also includes an arbitration agreement. In other words, under S.105 a contract provision requiring a civil action to be brought in another state is presumptively unconscionable in the same manner as a provision requiring arbitration to occur in another state.

[6] *Moses H. Cone Mem. Hosp. v. Mercury Constr. Corp.*, 460 U.S. at 341 (citing *Preston v. Ferrer*, 552 U.S. 346, 353 (2008)).
[7] 563 U.S. 333, 344-345 (2011).
[8] This provision could arguably be interpreted to bar arbitration agreements in instances where federal or State law provides for a private right of action. However, a court would likely rule that such an interpretation is preempted by the Federal Arbitration Act.