The U.S. Supreme Court Has Misinterpreted The Federal Arbitration Act

For parties aggrieved by another's refusal to arbitrate under a written agreement, the Federal Arbitration Act grants the ability to petition any court of the United States for an order compelling the parties to arbitrate the dispute. The FAA applies where (absent the arbitration agreement) federal courts would have jurisdiction over the subject matter. This article will overview the evolution of modern arbitration agreements, explore the flaws in the current federal law approach to arbitration, and suggest needed reforms.

The FAA

The first modern arbitration statute was enacted in New York in 1920. That statute made enforceable all arbitration agreements created in the state of New York, between parties residing in New York. This included agreements created to arbitrate future disputes.[1] Before the New York statute, states and federal courts followed English law. Under the English rule, a party to an arbitration agreement could refuse to arbitrate before an award was issued. If that occurred, the courts would refuse to enforce the arbitration agreement. But even after the 1920 statute, parties could not compel arbitration if the parties had diverse citizenship. This was because other state courts would not honor the arbitration clause.[2] Even if the New York party brought a federal diversity action, federal courts would not enforce the agreement.[3] The original FAA was modeled on this New York statute.[4]

***AT&T Mobility LLC v. Concepcion* Has Substantive Problems**

The U.S. Supreme Court upheld the FAA's preeminence over state law in *AT&T Mobility LLC v. Concepcion*.[5] In *Concepcion,* the court found a "liberal federal policy favoring arbitration" in the FAA.[6] But it explained that the FAA's saving clause (preserving state contract law defenses) is not evidence of "intent to preserve state-law rules that stand as an obstacle" to the FAA's objectives.[7] The court

reasoned that to allow a saving clause to preserve a common law right that is inconsistent with the act would permit the act "to destroy itself."[8] The court held that states cannot provide defenses that "apply only to arbitration" or defenses that "derive their meaning from the fact that an arbitration agreement is at issue."[9] Thus, when "state law prohibits outright the arbitration of a particular claim, the analysis is straightforward: The conflicting rule is displaced by the FAA."[10]

Now state courts may not interfere with the fundamental attributes of arbitration due to this "liberal federal policy favoring arbitration."[11] But that policy lacks foundation. In *Concepcion*, the Supreme Court cited *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp* (1983) as evidence of the liberal federal policy favoring arbitration. This is odd, because in *Moses H.* the court found an absence of case law to justify the supposed liberal federal policy favoring arbitration. The court saw the effect of Section 2 of the FAA as creating "a body of federal substantive law of arbitrability, applicable to any arbitration agreements within the coverage of the Act."[12] Other than simply quoting the statute itself, which does not mention a liberal policy favoring arbitration, the court does not provide any other evidence of the judicial precedent, or congressional intent for the supposed declaration of a liberal federal policy favoring arbitration. Without a well-founded liberal federal policy favoring arbitration, the constraints on a state's ability to decide what contracts exist under that state's laws lacks adequate support.

Concepcion Is Contrary To Congressional Intent

The FAA's drafters did not intend for the act to have the preemptive effect applied in *Concepcion*. Julius Cohen, one of its drafters, submitted a brief to Congress that said the act would not commit an "infringement upon the right of each State to decide for itself what contracts shall or shall not exist under its laws" and that whether "a contract exists is a question of the substantive law of the jurisdiction wherein the contract was made."[13] William Piatt, a member of the ABA's committee involved in drafting the FAA, testified before Congress that that "the statute was not intended to cover workers."[14] Piatt further explained to Congress that the proposed legislation was "[p]urely an act to give the merchants the right or the privilege of sitting down and agreeing with each other as to what their damages are, if they want to do it. Now that is all there is in this."[15] Those and other statements to Congress show

that it intended the legislation to vest state courts with power to decide whether an issue is suitable for arbitration.

This is consistent with constitutional doctrine at the time of the FAA's enactment, which viewed most employment contracts as intrastate matters rather than as interstate commerce. Piatt was also not in favor of contracts offered on a "take it or leave it" basis, stating "I would not favor any kind of legislation that would permit the forcing a man to sign that kind of a contract."[16] Courts must apply legislation as Congress intended.[17] Cohen and Piatt's statements evidence are consistent with the language contained in the statute, both of which favor respect for state sovereignty and disfavor mandatory preemption. Even if the FAA's terms were vague, the reports Congress reviewed before passing the FAA should be consulted.[18] Cohen and Piatt's statements resolve any ambiguity in favor of permitting state contract law defenses. The *Concepcion* decision failed to account for this evidence, which shows that Congress did not intend the FAA's reach to be so broad. Cohen's brief and Piatt's testimony both contain statements that prove the FAA's drafters did not intend the legislation to preempt state law.

Contemporary Doctrine When The FAA Was Drafted Contradicts *Concepcion*

The congressional power under the Commerce Clause to regulate interstate commerce is one of the broadest powers granted by the Constitution. Congress's ability to regulate all interstate commerce was first described in *United States v. Darby,* which held that Congress may regulate labor conditions. [19] The *Darby* court developed the close and substantial effect declaration, which empowered Congress to regulate activities that are purely "intrastate which have a substantial effect on commerce or the exercise of the Congressional power over it."[20] Despite *Darby*'s broad holding, the U.S. Supreme Court's FAA interpretation is incorrect, because *Darby* was decided long after the FAA was written.

Before *Darby* was decided in 1941, Congress and the court's view of the Commerce Clause was far narrower. When the FAA was enacted in 1925, Commerce Clause doctrine was dictated by *Hammer v. Dagenhart*, which held that Congress could not force states to exercise their police powers to prevent child labor.[21] This is because before *Darby* the court believed that commerce began when a good is

delivered "to a common carrier for transportation, or the actual commencement of its transfer to another state."[22] State control of commerce within their respective borders was the prevailing view of "commerce" when the FAA was enacted, and it was how the FAA's drafters and Congress viewed the matter. Under that view the FAA could not have the preemptive effect in received in *Concepcion*. The contemporary constraints imposed by the commerce clause limit the FAA's reach to arbitration agreements regarding interstate goods shipments. Under a historically appropriate definition of "commerce" states retain control of the contracts within their borders. This history belies *Conception*'s broad preclusion holding.

Concepcion **Ignored The** ***Erie*** **Doctrine**

The U.S. Supreme Court underweighted the *Erie* doctrine's effect on the FAA. *Erie* held that there is no federal common law, and in diversity actions federal courts must apply the venue's state law. *Concepcion* was an arbitration dispute, under federal diversity jurisdiction, venued in California. Properly applied, *Erie* would have barred FAA preemption because the federal court should have applied California law. At the time *Concepcion* was decided, California law operated under a prohibition on preventing class-wide proceedings, under which the arbitration clause would have been declared unconscionable.[23]

One could rationalize *Concepcion* by relying on the rule that federal courts apply federal procedural law in diversity cases, and the FAA could be read as a procedural statute. That theory was rejected in *Guaranty Trust Co.*, where the court endorsed the *Erie* doctrine and held that the terms "substantive" and "procedural" do not determine whether state law should be applied.[24] Instead, if the application of federal law would generate a different result from the application of state law, then the federal court must apply the state law.[25] That is so here: under California law the arbitration agreement was invalid, and under federal law it was not.

Concepcion also ignored the decision in *Bernhardt v. Polygraphic Co*. (1956), which concerned an arbitration agreement that owed "its existence to one of the States and not the United States."[26] *Bernhardt* held that when an arbitration dispute is being decided by a federal court in diversity jurisdiction, "the federal court enforcing a state-created right in a diversity case is . . . in substance only another

court of the State" and it may not "substantially affect the enforcement of the right as given by the State."[27] This is because if federal courts allow arbitration where state courts do not, "the outcome of the litigation might depend on the courthouse where the suit is brought"[28] The *Bernhardt* court then referenced *Erie* and its policy of avoiding forum shopping to justify that "the accident of a suit by a non-resident litigant in a federal court instead of in a State court a block away should not lead to a substantially different result."[29] The decision in *Concepcion* permits exactly that result.

Suggestions for Reform

It is concerning that such important issues regarding arbitration agreements have been decided judicially rather than legislatively. The U.S. Supreme Court has judicially crafted a version of the FAA suited to its preferences, which goes beyond the intended scope of the FAA enacted by the legislature and ignores the court's own precedent. That version of the FAA benefits business and corporate interests to the detriment of customers, employees, and traditional notions of state authority. The court should reconsider *Concepcion* and return to the drafter's intentions. A literal reading of the FAA, the evidence from Cohen and Piatt, and the court's previous decisions all support the view that under the FAA "each State [can] decide for itself what contracts shall or shall not exist under its laws."[30]

More fundamentally, the *Erie* and *Hanna* doctrines support the view that the court erred when it deviated from federalist principles by usurping state power to craft its own contract laws. Under *Erie*, when a court is sitting in diversity jurisdiction, "the law to be applied in any case is the law of the State. And whether the law of the State shall be declared by its Legislature in a statute or by its highest court in a decision is not a matter of federal concern."[31] If a constitutionally-compelled rule like *Erie* requires that states decide what contracts should exist under their laws, then a federal statute like the FAA must yield. And under *Hanna* if a state's laws place restrictions or bars on arbitration agreements, the application of the state rule would alter the mode of enforcement of state-created rights in a fashion sufficiently substantial to raise the equal protection problems at issue in *Erie*. This outcome-determinative test was intended to discourage forum-shopping, and to ensure similar results in federal and state courts. This rule also conflicts with *Concepcion*'s lack of

respect for state authority to craft contract laws.[32] Contrary to *Concepcion*, *Hanna*'s outcome-determinative test would grant states control over what arbitration contracts it allows in its borders.

The U.S. Supreme Court should retreat from its judicially-created version of the FAA and return to the FAA interpretation in *Bernhardt*. Doing so would conform to the drafter's intentions and the contemporaneous law, conform arbitration doctrine with other high court decisions, and restore the appropriate respect for traditional notions of state authority.

William T. Newman is a research fellow with the California Constitution Center and a third year law student at the UC Berkeley School of Law.

[1] Moses, Margaret L. Statutory Misconstruction: How the Supreme Court Created a Federal Arbitration Law Never Enacted by Congress, 34 Fla. St. U. L. Rev. 1, 101 (2006).

[2] *Id.*

[3] *Id.* at 102.

[4] *Id.*

[5] *AT&T Mobility LLC v. Concepcion* (2011).

[6] *Id.*

[7] *Id.* at 343.

[8] *Id.*

[9] *Id.*

[10] *Id.* at 334. There is some debate between federal and state courts about what this rule means. For example, the California Supreme Court held after *Concepcion*

that state courts can "continue to enforce unconscionability rules that do not 'interfere with fundamental attributes of arbitration.'" *Sonic II* (2012) at 1124.

[11] *Concepcion* at 1745.

[12] *Id*.

[13] 34 Fla. St. U. L. Rev. at 103.

[14] *Id.* at 105.

[15] *Id.* at 106.

[16] *Id*. at 107.

[17] *INS v. Cardoza-Fonseca* (1987) (when interpreting a statute, the justices are bound to "assume that the legislative purpose is expressed by the ordinary meaning of the words used").

[18] *Id*. at 452: "Where the plain language of a statute appears to settle the question presented, the United States Supreme Court will look to the statute's legislative history to determine only whether there is clearly expressed legislative intention contrary to that language, which would require the court to question the strong presumption that Congress expresses its intent through the language it chooses."

[19] *United States v. Darby* (1941).

[20] *Id*. at 120.

[21] *Hammer v. Dagenhart* (1918).

[22] *Id*. at 273.

[23] *Discover Bank* (2005).

[24] *Guaranty Trust Co. v. York* (1945).

[25] *Id*.

[26] *Id.* at 202.

[27] *Bernhardt* at 203.

[28] *Id*.

[29] *Id*. at 204.

[30] 34 Fla. St. U. L. Rev at 102.

[31] *Erie* at 78.

[32] *Hanna v. Plumer* (1965).