The Supreme Court of the United States held in Preston v. Ferrer (No. 06-1463, 128 S. Ct. 978, 2008 U.S. LEXIS 2011, Feb. 20, 2008) that when a contract broadly refers all disputes to arbitration under AAA rules, the Federal Arbitration Act ("FAA") pre-empts a state statute conferring exclusive jurisdiction on a state administrative agency. The FAA requires arbitration in this circumstance, the Supreme Court stated, even though the contract provides in general terms that it is governed by state law. Reaffirming its decision in Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52 (1995), the Court held that such a governing law clause, where the parties have also given arbitrators power to decide contract validity, should be interpreted to mean that the parties wished to apply state substantive law, but not state laws limiting the jurisdiction of arbitrators.

Preston arose in California from a fee dispute between an attorney and his client, who was a former Florida trial court judge pursuing a second career as a television actor. California regulates the relationship between "talent agents" and their clients, requiring talent agents to have licenses from the State. Here the client, Ferrer, claimed his contract with the attorney, Preston, was void under the California statute because Preston acted as a talent agent with obtaining the license, and, in turn, that the invalidity of the contract excused him from the obligation to pay the attorney's fees. Ferrer was able to obtain an injunction from a California trial court, staying arbitration pending a determination by the California Labor Commissioner on whether the contract was subject to the California statute and therefore unlawful. A California appellate court sustained the injunction and the Supreme Court of California denied review. The narrow question presented to the U.S. Supreme Court in the case was who - the arbitrator or the California Labor Commissioner - had primary power to decide whether the statutory definition of "talent agent" applied to Preston. The Supreme Court resolved the issue in favor of the arbitrator's power to decide.

Preston was resolved almost entirely by Mastrobuono and three other four notable prior arbitration decisions: First, in Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395 (1967), the Court held that as a matter of substantive federal arbitration law, the arbitration clause is severable from the rest of the contract. Second, in Southland Corp. v. Keating, 465 U.S. 1

See Preston v. Ferrer, in this Bulletin, pp. 600 et seq.
(1984), the Court held that a derivative rather than direct challenge to the arbitration clause (i.e. a challenge to the validity or legality of the entire contract) is for the arbitrator not the court to decide. Also in Southland, the Court held that the Federal Arbitration Act applies in state courts. And in Buckeye Check Cashing v. Cardegna, 546 U.S. 440 (2006), the Court held that the FAA prohibits state courts from giving state laws governing the validity of contracts a construction that would shift jurisdiction from arbitrators to state courts. In Preston, the question presented was whether a state legislature might shift arbitral jurisdiction to administrative agencies that are vested with substantive regulatory control over the type of contract involved. The Court found nothing about the legislative/regulatory context that mandated a different result.

Preston touches upon one of the more vexing issues in US arbitration law - how to reconcile the federal policy, based on the FAA, that favors arbitration where the parties have agreed to arbitrate, with the arbitration-impacting law (“pro” or “con”) of the individual U.S. state that the parties have chosen, in general terms, to govern their contract disputes.

The principle of federal law “pre-emption” of state law has its roots in the most self-evident context: a state statute (of Alabama) that invalidated all agreements to arbitrate and thus was irreconcilable with the Federal Arbitration Act. (Allied-Bruce Terminix Cos. v. Dobson, 513 U. S. 265). And the Supreme Court has since applied the pre-emption principle to negate state decisional law that limited arbitrators’ remedial powers (Mastrobuono, supra), and, now in Preston, state statutory law that conferred exclusive jurisdiction over a category of contract disputes on an administrative agency of the State.

But relatively few of the more difficult preemption questions have been addressed by federal appellate courts, i.e., the questions raised where state law does not entirely oust arbitral jurisdiction, or may indeed enhance powers of arbitrators, and/or where the choice of law clause is arguably not “generic.”

Federal appellate courts have held, for example, that a “generic” choice-of-state-law clause does not displace the FAA standard for vacating awards in favor of state statutes giving a wider berth for judicial review. The Sixth Circuit Court of Appeals, in so holding, observed that Mastrobuono establishes that federal policy favors not only arbitrability of disputes, but the discretion of the arbitrator in resolving them. (Jacada Ltd. v. Intl Marketing Strategies, Inc., 401 F.3d 701, 711 (6th Cir.), cert. denied, 126 S. Ct. 735 (2005)). Thus, a state rule limiting arbitral discretion should ordinarily yield,
under federal arbitration law, to the powers conferred on the arbitrator by the contract, if state law is more limiting of arbitral authority - absent specific evidence that the parties intended the state law arbitration rule to apply.

But what of pro-arbitration state statutes and rules?

Suppose, for example, that a state law provides arbitrators the power to impose contempt-like sanctions for non-compliance with arbitral rules and procedural orders. The FAA is silent on the subject, as are most institutional rules governing international arbitration (albeit such rules are often interpreted as not conferring such power, giving the panel only the power to allocate the costs of the proceedings). Does a “generic” choice of law clause make a state’s arbitral power-enhancing rule applicable? Having in mind that the FAA contains no general pre-emptive provision, and the fact that FAA pre-emption is a federal common law doctrine whose purpose is to oust state laws that conflict fundamentally with the principles and purposes of the Act, a court or arbitrator might well find no obstacle to applying the power-enhancing state law rule.

In Preston, the US Supreme Court has taken the fairly inevitable step of extending the primacy of arbitration to state laws that vest exclusive power in state administrative tribunals and appointed state regulators. Whether the Court will permit a wider berth for state regulation of the arbitral process, in contexts where the state law is not clearly anti-arbitration, will have to await future cases. The relationship between state and federal law in the US arbitration context remains a perplexing and evolving field.

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