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THE FEDERAL ARBITRATION ACT: FEDERAL PREEMPTION OF STATE LAW REGULATING ARBITRATION

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Introduction

Section 2 of the Federal Arbitration Act (“FAA”)¹ provides:

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.²

In *Southland Corp. v. Keating*, the United States Supreme Court declared that section 2 established a “national policy favoring arbitration” applicable in state as well as federal courts.³ Under this policy, a written arbitration agreement is “valid, irrevocable, and enforceable, *as a matter of federal law*,” unless the agreement is invalid under state law applicable to “contracts generally.”⁴ The FAA thus seeks to ensure that arbitration agreements, like other contracts, are enforced “in accordance with their terms,”⁵ and it preempts state law that conflicts with this purpose.

This bulletin discusses FAA preemption of state law and sets out the analytical steps state courts should follow in addressing issues of FAA preemption. After briefly introducing the

1. 9 U.S.C. § 1 *et seq.* The FAA was enacted as the United States Arbitration Act, *see* Act of February 12, 1925, ch. 213, 43 Stat. 883, codified as amended at 9 U.S.C. §§ 1-14, but is commonly called the FAA.

2. 9 U.S.C. § 2.

3. 465 U.S. 1, 10 (1984).

4. *Perry v. Thomas*, 482 U.S. 483, 492 n.9 (1987).

5. *Volt Info. Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 478 (1989).

FAA, the bulletin addresses when the Act applies, when the Act will preempt state law, and whether parties to arbitration agreements may “contract around” the FAA by choosing state law to govern their disputes. The bulletin discusses relevant North Carolina law and identifies several areas where North Carolina case law conflicts with the Supreme Court’s FAA cases. The bulletin concludes with a diagram of the preemption analysis.⁶

A Brief Introduction To The Federal Arbitration Act

According to the standard account of the FAA’s origin,⁷ Congress enacted the FAA “to reverse the longstanding judicial hostility to arbitration agreements that had existed at English common law and had been adopted by American courts, and to place arbitration agreements upon the same footing as other contracts.”⁸ This “longstanding judicial hostility” was reflected in a rule allowing either party to a pre-dispute arbitration agreement to revoke its consent to arbitration at any time before the arbitral award was rendered.⁹

6. For a thorough discussion of how to analyze FAA preemption issues (though without emphasis on North Carolina law or discussion of how to determine whether the FAA applies), see Christopher R. Drahozal, *Federal Arbitration Act Preemption*, 79 *Id. L. J.* 393 (2004).

7. See, e.g., Linda R. Hirshman, *The Second Arbitration Trilogy: The Federalization of Arbitration Law*, 71 *Va. L. Rev.* 1305, 1308-12 (1985).

8. *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 24 (1991) (discussing FAA after its extension to state court proceedings).

9. See, e.g., *United States Asphalt Ref. Co. v. Trinidad Lake Petroleum Co.*, 222 F. 1006 (S.D.N.Y. 1915) (pre-dispute arbitration agreement void); *Parsons v. Ambos*, 48 S.E. 696, 697 (Ga. 1904) (“A common-law agreement, therefore, to submit the validity and effect of a contract, or to submit all matters in dispute, to arbitration, may be revoked by either party at any time before the award.”); *Paulsen v. Manske*, 18 N.E. 275, 278 (Ill. 1888) (“[U]ntil an award was made the authority of the arbitrators was subject to revocation by either party to the submission.”). For a general discussion of the rule of revocability and an argument for applying that rule to modern contracts of adhesion, see Paul D. Carrington & Paul Y. Castle, *The Revocability of Contract Provisions Controlling Resolution of Future Disputes Between the Parties*, 67 *Law & Contemp. Probs.* 207 (Winter/Spring 2004). See also Sarah

The rule allowing revocation of arbitration agreements, however, may have had relatively limited practical effect on early commercial practices. Commercial arbitration – i.e., arbitration between merchants – seems to have been commonplace in the United States long before the passage of the FAA.¹⁰ Whether or not courts would enforce arbitration agreements, private incentives likely ensured a high rate of voluntary compliance. Arbitration satisfied a need for an efficient dispute resolution system that operated in accordance with the customs of the relevant business community, and merchants who disavowed their arbitration agreements might damage on-going relationships and their reputations within that community.¹¹ Moreover, so long as disputes involved merchants from the same geographic and economic community, there may have been little strategic advantage to forcing a trial, as neither disputant could hope for favorable treatment from local courts and juries.

The construction of railroads and other technological developments, however, made commercial relationships between geographically dispersed merchants commonplace. As commerce increasingly involved physically remote merchants, private incentives created by the need to maintain relationships and reputation in a local business community no longer ensured that merchants would honor their arbitration agreements.¹² Distant merchants, moreover, may have been skeptical of local courts and juries, and in this context courts’ unwillingness to enforce arbitration agreements may have posed a more serious problem.¹³

Thus, the standard explanation of the FAA’s enactment is that:

Rudolph Cole, *Uniform Arbitration: “One Size Fits All” Does Not Fit*, 16 *Ohio St. J. Disp. Resol.* 759, 760-64 (2001) (discussing origins of, and bases for judicial hostility to, FAA).

10. See, e.g., Bruce L. Benson, *An Exploration of the Impact of Modern Arbitration Statutes on the Development of Arbitration in the United States*, 11 *J. L. Econ. & Organ.* 479, 481-85 (1995).

11. See Cole, *supra* n. 9 at 760-62.

12. See *id.* 762 (“[A]s commerce grew beyond local fairs to national and then international venues, the informal marketplace sanctions that accompanied the failure to abide by an arbitral award were no longer sufficient alone to preserve the commercial community.”).

13. See Carrington & Castle, *supra* n. 9 at 215 (“After the construction of railroads, local communitarian sanctions no longer applied to commercial disputes, and distant merchants mistrusted local courts.”).

Confronted by hostile courts and an expanding marketplace, the commercial community in America turned toward Congress to assist them in their efforts to bypass the traditional legal system in favor of a more efficient system of arbitration. The passage of the FAA was an acknowledgment that a purely private approach was no longer workable in light of the developing concerns about enforceability that the market was no longer addressing and that the courts were exacerbating.¹⁴

This historical account, however, asserts that the FAA was merely the federal component to a struggle, also underway at the state level, to reverse the perceived judicial hostility to arbitration.¹⁵

According to this account, Congress intended the FAA to be a procedural statute that would require federal courts to specifically enforce arbitration agreements that were valid under state law.¹⁶

Nevertheless, the Supreme Court in *Southland* held that FAA section 2 creates a substantive rule of law applicable in state as well as federal court.¹⁷ In *Southland*, the California Supreme Court had ruled that the FAA did not preempt state law requiring a judicial forum for claims brought under a state statute regulating the franchisee/franchisor relationship. In reversing that ruling, the U.S. Supreme Court asserted that the FAA “declared a national policy favoring arbitration and withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration.”¹⁸

Southland has been widely – though not universally – criticized by scholars, many of whom believe, like Justice O’Connor in her *Southland* dissent,¹⁹ that Congress intended the FAA to be a

procedural statute applicable only in federal court.²⁰ Nevertheless, the Supreme Court has repeatedly refused to reconsider *Southland*,²¹ and has extended its “arbitration federalism”²² to invalidate an array of state laws deemed hostile to arbitration.

There remains, however, some uncertainty about the scope of FAA preemption. Moreover, the North Carolina cases do not yield a clear analytical approach to addressing preemption issues, and, on occasion, have conducted preemption analyses that are inconsistent with, and preempted by, the Supreme Court’s FAA cases. The remainder of this bulletin therefore suggests an analytical approach to deciding whether the FAA preempts state law.

14. Cole, *supra* n. 9 at 763.

15. See Stephen L. Hayford & Alan R. Palmiter, *Arbitration Federalism: A State Role in Commercial Arbitration*, 54 Fla. L. Rev. 175, 185 (2002) (“The FAA was to be the federal piece of the national, state-led movement to legitimize commercial arbitration jurisdiction by jurisdiction.”).

16. See *id.* at 182-86; Paul D. Carrington & Paul H. Haagen, *Contract and Jurisdiction*, 1996 Sup. Ct. Rev. 331, 343 (1996).

17. 465 U.S. 1, 16 (1984).

18. See *id.* at 10; see also *WMS, Inc. v. Weaver*, 602 S.E.2d 706, 710 (N.C. App. 2004) (“The FAA preempts conflicting state law, including state law addressing the role of courts in reviewing arbitration awards.”).

19. See 465 U.S. at 21-36.

20. See, e.g., Edward Brunet, *Toward Changing Models of Securities Arbitration*, 62 Brook. L. Rev. 1459, 1469 n.33 (1996) (“The *Southland* decision is remarkable for its preemption holding that blatantly ignores legislative intent.”); Paul D. Carrington & Paul H. Haagen, *Contract and Jurisdiction*, 1996 SUP. CT. REV. 331, 380 & n.239 (calling the *Southland* holding an “extraordinarily disingenuous manipulation of the history” of the FAA, and calling the Court’s treatment of that history “bogus”); 1 Ian R. Macneil et al., *Federal Arbitration Law: Agreements, Awards, and Remedies under the Federal Arbitration Act* § 10.2, at 10:5 (1999 Supp.) (herein “Macneil”) (calling *Southland* majority opinion “painfully misleading”). But see Christopher R. Drahozal, *In Defense of Southland: Reexamining the Legislative History of the Federal Arbitration Act*, 78 Notre Dame L. Rev. 101 (2002-2003) (defending result reached in *Southland*).

21. See *Allied-Bruce Terminix Cos., Inc. v. Dobson*, 513 U.S. 265, 272 (1995) (declining request by twenty state Attorneys General to overrule *Southland*); see also *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105, 122 (2001) (“The question of *Southland*’s continuing vitality was given explicit consideration in *Allied-Bruce*, and the Court declined to overrule it. . . . In *Allied-Bruce* the Court noted that Congress had not moved to overturn *Southland*, and we now note that it has not done so in response to *Allied-Bruce* itself.”) (citations omitted).

22. Hayford & Palmiter, *supra* n. 15 at 176.

Determining whether the FAA applies to an arbitration agreement

Is there a written arbitration provision in a “maritime transaction” or a “contract evidencing a transaction involving commerce?”

The FAA does not require courts to enforce all agreements to arbitrate. Rather, the Act applies to *written* arbitration provisions²³ in two categories of transactions. First, the Act applies to a written arbitration provision in “any maritime transaction.”²⁴ Second, the Act applies to a written arbitration provision in “a contract evidencing a transaction involving commerce.”²⁵ The first step in a court’s preemption analysis, then, is to determine whether the parties have a written arbitration agreement in a transaction that falls into one of these two categories. Maritime litigation is relatively rare in state courts,²⁶ so this bulletin focuses on contracts that “evidenc[e] a transaction involving commerce.”

What types of contracts “evidenc[e] a transaction involving commerce?” As noted above, many believe that Congress intended the FAA to be a

23. A “written arbitration provision” need not comply with any particular formalities, such as a signature requirement. *See, e.g., Nghiem v. NEC Elec., Inc.*, 25 F.3d 1437, 1439 (9th Cir. 1994); *Genesco, Inc. v. T. Kakiuchi & Co., Ltd.*, 815 F.2d 840, 846 (2d Cir. 1987); *see also* G.S. § 1-569.6(a) & 569.1(6) (requiring enforcement of arbitration agreements that are “contained in a record,” and defining record to mean “information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form”).

24. 9 U.S.C. § 2. The FAA defines “maritime transaction” broadly to include “charter parties, bills of lading of water carriers, agreements relating to wharfage, supplies furnished vessels or repairs to vessels, collisions, or any other matters in foreign commerce which, if the subject of controversy, would be embraced within admiralty jurisdiction.” 9 U.S.C. § 1.

25. 9 U.S.C. § 2.

26. Under 28 U.S.C. § 1333, federal district courts have exclusive original jurisdiction over “[a]ny civil case of admiralty or maritime jurisdiction, saving to suitors in all cases all other remedies to which they are otherwise entitled.” Although most maritime and admiralty claims are litigated in federal court, section 1333 “preserves remedies and the concurrent jurisdiction of state courts over some admiralty and maritime claims.” *Lewis v. Lewis & Clark Marine, Inc.*, 531 U.S. 438, 445 (2001).

procedural statute applicable only in federal court.²⁷ The Supreme Court, however, has interpreted the FAA to be an exercise of Congress’ power under the Commerce Clause of the U.S. Constitution,²⁸ thus transforming the FAA from a federal procedural statute into a substantive, “national policy favoring arbitration” applicable in state as well as federal courts.²⁹ The scope of FAA section 2 therefore depends on two questions. First, how expansive are Congress’ powers under the Commerce Clause? Second, does the language of section 2 – referring to “contract[s] evidencing a transaction involving commerce” – evidence Congress’ intent to exercise those powers to the fullest?³⁰

The scope of Congress’ power under the Commerce Clause

The Commerce Clause grants Congress power “[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.”³¹ While the extent of Congress’ Commerce Clause power, as interpreted by the U.S. Supreme Court, is subject to debate, Congress generally has power to regulate three categories of activity. Congress may:

- regulate the channels of interstate commerce;
- regulate and protect the instrumentalities of interstate commerce, or persons or things in interstate commerce, even from threats arising from purely intrastate activities; and

27. *See supra* nn. 15-22 and accompanying text.

28. *See Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 405 (1967) (“[I]t is clear beyond dispute that the federal arbitration statute is based upon and confined to the incontestable federal foundations of ‘control over interstate commerce and over admiralty.’”).

29. *Southland*, 465 U.S. at 10; *Moses H. Cone Mem’l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983) (“The basic issue . . . was the arbitrability of the dispute between [the parties.] Federal law in the terms of the Arbitration Act governs that issue in either state or federal court. . . . The effect of [§ 2] is to create a body of federal substantive law of arbitrability, applicable to any arbitration agreement within the coverage of the Act.”).

30. The FAA defines “commerce” broadly to include “commerce among the several States or with foreign nations, or in any Territory of the United States or in the District of Columbia, or between any such Territory and another, or between any such Territory and any State or foreign nation, or between the District of Columbia and any State or Territory or foreign nation.” 9 U.S.C. § 1.

31. U.S. Const. art. 1, § 8, cl. 3.

- regulate activities “that substantially affect interstate commerce.”³²

Note that the Commerce Clause confers upon Congress substantial authority to regulate even purely intrastate activity. This includes the authority to regulate an individual transaction even though the transaction, by itself, has no substantial effect on interstate commerce.³³ For example, the “Commerce Clause power ‘may be exercised in individual cases without showing any specific effect upon interstate commerce’ *if in the aggregate the economic activity in question would represent ‘a general practice . . . subject to federal control.’*”³⁴ So, for example, Congress may regulate local businesses that purchase substantial quantities of goods that have moved in interstate commerce,³⁵ or that cater to interstate travelers.³⁶ Likewise, Congress may regulate the terms of individual credit transactions where such transactions, taken as a whole, substantially affect interstate commerce.³⁷

Section 2 extends the FAA to the full reach of Congress’ power under the Commerce Clause.

Although it has substantial power under the Commerce Clause, the question remains whether

32. See *Gonzales v. Raich*, 125 S. Ct. 2195 (2005); *U.S. v. Morrison*, 529 U.S. 598, 609 (2000); *U.S. v. Lopez*, 514 U.S. 549 (1995).

33. See *Citizens Bank v. Alafabco, Inc.*, 539 U.S. 52, 56-57 (2003) (per curiam).

34. *Id.* at 56-57 (quoting *Mandeville Island Farms, Inc. v. American Crystal Sugar Co.*, 334 U.S. 219, 236 (1948) (emphasis added). Until *Gonzales v. Raich*, the Court’s more recent Commerce Clause cases had suggested that Congress’ power to regulate intrastate activity based on its aggregate effect on commerce is limited to intrastate economic activity. See *Lopez*, 514 U.S. at 560-61; *Morrison*, 529 U.S. at 611. *Raich*, however, arguably recognizes a broader Congressional power by adopting an expansive definition of “economic activity” – one that included, in *Raich*, the noncommercial, intrastate possession and use of marijuana for medical purposes.

35. See *Katzenbach v. McClung*, 379 U.S. 294, 304-05 (1964).

36. *Heart of Atlanta Motel, Inc. v. United States*, 379 U.S. 241, 250-51, 258 (1964).

37. *Perez v. United States*, 402 U.S. 146, 154 (1971); see also *Citizens Bank*, 539 U.S. at 58 (Congress may regulate commercial lending given that activity’s “broad impact . . . on the national economy”).

Congress intended to exercise that power to the fullest in enacting the FAA. Does the Act apply to every transaction Congress has the power to regulate? In *Allied-Bruce Terminix Cos., Inc. v. Dobson*, the U.S. Supreme Court has answered this question in the affirmative, holding that section 2 extends the FAA “to the limits of Congress’ Commerce Clause power.”³⁸ This holding effectively overrules a number of North Carolina cases that have interpreted the FAA more narrowly.

For example, in *Bryant-Durham Electric Co., Inc. v. Durham County Hospital Corp.*,³⁹ the North Carolina Court of Appeals held that, for the FAA to apply, “the transaction which is the subject of the contract [containing an arbitration clause] must be a transaction *in* interstate commerce.”⁴⁰ Courts typically interpret the phrase “in commerce” to include “only persons or activities *within the flow* of interstate commerce.”⁴¹ The U.S. Supreme Court, however, has rejected this limiting interpretation of the FAA.⁴² As noted previously, Congress may regulate even purely intrastate activities under its Commerce Clause power; it is not limited to regulating activities “within the flow of commerce.”⁴³

38. 513 U.S. 265, 268 (1995).

39. 42 N.C. App. 351, 256 S.E.2d 529 (1979).

40. *Id.* at 356, 256 S.E.2d at 532 (holding that construction of hospital was not an act in interstate commerce, and rejecting argument that FAA applied because materials used to perform contract were shipped in interstate commerce). This holding was later disapproved by the North Carolina Supreme Court in *Burke County Pub. Schools Bd. of Educ. v. Shaver Partnership*, 303 N.C. 408, 415-16 & n.9, 279 S.E.2d 816, 820-21 & n.9 (1981) (noting that FAA may govern a contract that does not contemplate or call for interstate shipment of goods, citing authority consistent with that position, and listing *Bryant-Durham* as a contrary case). *Shaver Partnership*, however, applies a second test disapproved by the U.S. Supreme Court. See *infra* n. 44.

41. *Allied-Bruce*, 513 U.S. at 273. (quotation omitted); see also *Gulf Oil Corp. v. Copp Paving Co., Inc.*, 419 U.S. 186, 195 (1974) (referring to the term “in commerce” in the Clayton and Robinson-Patman Act: “the distinct ‘in commerce’ language . . . appears to denote only persons or activities within the flow of interstate commerce – the practical, economic continuity in the generation of goods and services for interstate markets and their transport and distribution to the consumer.”).

42. See *Allied-Bruce*, 513 U.S. at 268.

43. See *Sillins v. Ness*, 164 N.C. App. 755, 760, 596 S.E.2d 874, 877 (2004) (recognizing that FAA’s use of

In another limiting interpretation of FAA section 2, some North Carolina cases have held that a contract will “evidenc[e] a transaction involving commerce” if, “at the time [the parties] entered into [the contract] and accepted the arbitration clause, they *contemplated* substantial interstate activity.”⁴⁴ Under this interpretation, whether the FAA applies depends on the parties’ expectations when they entered their contract. In *Allied-Bruce*, however, the Supreme Court expressly rejected the “contemplation of the parties” test, holding instead that the FAA will apply whenever the parties’ transaction “turn[s] out, *in fact*, to have involved interstate commerce.”⁴⁵ As a result, North Carolina cases applying the “contemplation of the parties” test – some of which were decided after *Allied-Bruce*⁴⁶ – are no longer valid. The FAA applies whether or not the parties contemplated a transaction involving interstate commerce when they entered their agreement.

Citizens Bank v. Alafabco, Inc.,⁴⁷ illustrates the extent of Congress’ authority under the Commerce Clause. In *Citizens Bank*, the Supreme Court held that the FAA applied to an arbitration clause in contracts restructuring a commercial loan agreement between a lender and a construction company borrower. Although both the lender and the construction company were Alabama residents, and they had executed the restructuring agreements in Alabama, the Court concluded that the parties’ transaction was “well within our previous pronouncements on the extent of Congress’ Commerce Clause power.”⁴⁸

According to the Court, the borrower was engaged in business throughout the southeastern United States using the restructured loans and had

“involving commerce” is broader than the term “in commerce”).

44. *Boynton v. ESC Med. Sys., Inc.*, 152 N.C. App. 103, 110, 566 S.E.2d 730, 734 (2002) (quotation omitted). Other North Carolina cases applying the “contemplation of the parties” test include *Shaver Partnership*, 303 N.C. at 417, 279 S.E.2d at 822 (personal services contract that “contemplates substantial interstate activity” is a contract evidencing a transaction involving commerce), *Paramore v. Inter-Regional Financial Group Leasing Co.*, 68 N.C. App. 659, 663, 316 S.E.2d 90, 92 (1984) (applying “contemplation of the parties” test), and *In re Cohoon*, 60 N.C. App. 226, 229, 298 S.E.2d 729, 730-31 (1983) (same).

45. *Allied-Bruce*, 513 U.S. at 277, 281.

46. See *Boynton*, 152 N.C. App. at 110, 566 S.E.2d at 734.

47. 539 U.S. 52 (2003) (per curiam).

48. *Id.* at 57.

also pledged its assets, including inventory assembled from out of state parts, as security for the restructured debt. These facts alone demonstrated that the restructuring agreements evidenced a transaction involving commerce.⁴⁹ More importantly, even if the particular restructuring agreements at issue had no substantial effect on interstate commerce, the Court emphasized that Congress was nevertheless entitled to regulate commercial lending given that activity’s “broad impact . . . on the national economy.”⁵⁰ Thus, because the parties’ transaction belonged to a class of transactions (commercial lending) subject to Congressional regulation, the FAA applied whether or not the parties’ transaction itself had a substantial effect on interstate commerce.

Determining whether the FAA applies to particular arbitration agreements

Given the extent of Congress’ power under the Commerce Clause, the FAA will apply to many – perhaps most – arbitration agreements.⁵¹ Whether the FAA applies to a particular agreement must be decided on a case-by-case basis by the trial court.⁵²

49. See *id.* The Court also rejected the analysis conducted by the state Supreme Court, which had looked for evidence that some of the restructured debt was attributable to an interstate transaction, or that some of the loan funds had originated from out of state, or that the restructured debt was “inseparable from out of state construction projects.” *Id.* at 56. While such evidence might be necessary to prove that the parties’ transaction occurred “in commerce” – i.e., “within the flow of interstate commerce” – the FAA was not so limited. *Id.* at 56 (citing *Allied-Bruce*, 513 U.S. at 273).

50. *Id.* at 58.

51. See *Collie v. Wehr Dissolution Corp.*, 345 F. Supp. 2d 555, 560 (M.D.N.C. 2004); *DeLuca v. Bear Stearns & Co.*, 175 F. Supp. 2d 102, 106 (D. Mass. 2001); *Snow v. BE & K Constr. Co.*, 126 F. Supp. 2d 5, 9 (D. Me. 2001).

52. See *Eddings v. Southern Orthopedic and Musculoskeletal Assocs., Inc.*, 356 N.C. 285, 569 S.E.2d 645 (2002) (adopting dissenting opinion in *Eddings v. Southern Orthopedic and Musculoskeletal Assocs., P.A.*, 147 N.C. App. 375, 555 S.E.2d 649 (2001)); see also G.S. § 1-569.7 (upon motion to compel arbitration court shall “proceed summarily to decide” whether there is an enforceable agreement to arbitrate). The comments to the Revised Uniform Arbitration Act – enacted with some modifications in North Carolina and applicable to agreements to arbitrate made on or after January 1, 2004, or by party consent to agreements made before that date,

Courts have consistently applied the FAA to contracts bearing a relatively indirect relationship to interstate commerce, including:

- An agreement pursuant to which a North Carolina resident agreed to act as exclusive sales representative, in North Carolina and South Carolina, for a Washington corporation;⁵³
- Cash management and individual retirement account agreements between customers and their investment advisor;⁵⁴
- A dealer agreement under which plaintiffs agreed to market defendant's wireless cellular communication services;⁵⁵
- An employment agreement between a Tennessee physician and his North Carolina employer, where the employer treated out-of-state patients, received payments from out-of-state insurance carriers, and purchased supplies and services from out-of-state; the employee had also moved from Tennessee to begin work;⁵⁶
- An employment agreement between a health care company and its medical director, when the director participated in sales presentations in multiple states, reviewed proposals from out-of-state service providers, and worked with officials from

see G.S. § 1-569.3 – suggest that the court makes this determination without a jury. *See* RUAA § 7, comment, 7 U.L.A. 13 (Supp. 2002) <http://www.law.upenn.edu/bll/ulc/ulc_frame.htm> (last checked August 11, 2005).

53. *See Boynton*, 152 N.C. App. 103, 566 S.E.2d 730. As noted previously, *supra* n. 44, *Boynton* incorrectly states the test for whether a contract evidences a transaction involving commerce as whether “at the time [the parties] entered into [the contract] and accepted the arbitration clause, they contemplated substantial interstate activity.” *Id.* at 110, 446 S.E.2d at 734 (quotation omitted). The result in *Boynton*, however, is consistent with the more expansive approach to FAA preemption taken by the U.S. Supreme Court.

54. *See Park v. Merrill Lynch*, 159 N.C. App. 120, 582 S.E.2d 375 (2003).

55. *See WMS, Inc. v. Weaver*, 602 S.E.2d 706 (N.C. App. 2004).

56. *See Eddings v. Southern Orthopaedic and Musculoskeletal Assocs., P.A.*, 605 S.E.2d 680 (N.C. App. 2004).

national companies in the benefits review process;⁵⁷

- Service agreements between a HMO and its members, when the agreements contemplated coverage when members were out of state, many HMO providers were recruited from out of state, and necessary supplies and medical equipment were shipped from out of state;⁵⁸
- A subcontract contemplating construction of a gas pipeline within the state of New York, when the parties were residents of different states, materials and equipment used on the project were from out of state, and the pipeline was intended to connect to an international pipeline;⁵⁹
- A breach of contract suit by a school board against a multistate architectural firm;⁶⁰ and
- A franchise agreement between a North Carolina franchisee and Florida franchisor, where the franchisee received materials, training, and advice from Florida and twice attended the franchisor's annual convention there.⁶¹

Not every contract, of course, will evidence a transaction involving interstate commerce.⁶²

57. *See Towles v. United HealthCare Corp.*, 524 S.E.2d 839 (S.C. Ct. App. 1999).

58. *See Toledo v. Kaiser Permanente Med. Group*, 987 F. Supp. 1174, 1180 (N.D. Cal. 1997) (stating that FAA governs if contract “has any effect on commerce”).

59. *See St. Lawrence Explosives Corp. v. Worthy Bros. Pipeline Corp.*, 916 F. Supp. 187, 190 (N.D.N.Y. 1996) (also stating that under FAA definition of commerce, “only the slightest nexus between the contract and interstate commerce is required”).

60. *See Shaver Partnership*, 303 N.C. 408, 279 S.E.2d 816. *Shaver Partnership* predates the Supreme Court's opinion in *Allied-Bruce* and applies the “contemplation of the parties” test later rejected by the Supreme Court. *See supra* note 44. The result in *Shaver Partnership*, however, would remain the same under *Allied-Bruce*.

61. *See Szymczyk v. Signs Now Corp.*, 606 S.E.2d 728, 732 (2005).

62. *See, e.g., Cecala v. Moore*, 982 F. Supp. 609 (N.D. Ill. 1997) (real estate contract did not evidence transaction involving interstate commerce where property and plaintiffs were in Illinois, no transactions took place outside Illinois, and only sellers were located outside Illinois; however, Congress likely has the power to regulate local real estate sales given that activity's aggregate effect on

Nevertheless, if the transaction “evidenced” by a particular agreement is one that Congress could regulate under its Commerce Clause power, the FAA will apply.⁶³ And that power is substantial – permitting regulation of purely intrastate commercial activity, if, for example, that activity belongs to a class of activities that, in the aggregate, has a substantial effect on interstate commerce.⁶⁴ North Carolina cases limiting the FAA’s reach to transactions that occur “in commerce,”⁶⁵ or to transactions that the parties “contemplated” would involve interstate commerce,⁶⁶ are no longer valid.⁶⁷

interstate commerce, so the result in *Moore* is arguably incorrect); *Paramore v. Inter-Regional Financial Group Leasing Co.*, 68 N.C. App. 659, 316 S.E.2d 90 (1984) (concluding that FAA did not apply to agreement under which North Carolina plaintiffs leased tractor, for use in North Carolina, from Minnesota corporation; lease was solicited by corporation’s agent in North Carolina, and plaintiffs picked up tractor from dealer in North Carolina but sent payments to defendant’s Montana office. Note, however, that *Paramore* applies the invalid “contemplation of the parties” test and that its result arguably conflicts with *Citizens Bank*, since Congress likely has the power to regulate equipment leasing transactions, given that activity’s aggregate effect on the national economy. See 539 U.S. at 58.)

63. See *Allied-Bruce*, 513 U.S. at 277.

64. *Citizens Bank*, 539 U.S. at 56-57.

65. See *Bryant-Durham Elec. Co., Inc.*, 42 N.C. App. at 356, 256 S.E.2d at 532.

66. See *supra* n. 44.

67. In addition, some North Carolina cases state that “importation into one state from another is the indispensable element, the test, of interstate commerce.” *Szymczyk*, 606 S.E.2d at 732 (2005) (quoting *Snelling & Snelling, Inc. v. Watson*, 41 N.C. App. 193, 197-98, 254 S.E.2d 785, 789 (1979) (interpreting phrase “transacting business in interstate commerce” then used in G.S. § 55-131(b)(8), now G.S. § 55-15-01)). The Supreme Court’s cases, however, reveal that the FAA may apply even if the parties’ transaction does not involve the physical movement of goods or people from one state to another. In *Citizens Bank*, for example, the Court noted that the FAA would govern an individual commercial loan transaction even if the transaction itself had no substantial effect on interstate commerce, because commercial loan activity, in the aggregate, had such an effect. 539 U.S. at 56.

Is the arbitration agreement contained in the employment contract of a worker engaged in foreign or interstate commerce?

Notwithstanding the FAA’s broad applicability, section one excludes from the Act’s coverage “contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign or interstate commerce.”⁶⁸ Although this clause, like section 2, arguably represents an attempt to exercise Congress’ Commerce Clause power in full, thereby exempting nearly *all* employment contracts from the FAA, the Supreme Court has held that only transportation workers – i.e. workers who are “engaged in transportation” – are exempt.⁶⁹

Other than “seamen [and] railroad employees,” what classes of worker are “engaged in transportation?” Courts have interpreted section 1 narrowly, generally applying the exclusion “only [to] those other classes of workers who are actually engaged in the movement of interstate or foreign commerce or in work so closely related thereto as to be in practical effect part of it.”⁷⁰ The following cases are illustrative:

- Section 1 did not exempt a guard employed by a company responsible for security at Union Station in Washington, D.C.⁷¹
- Section 1 did not exempt warehouse worker employed by manufacturing company, who was responsible for receiving products from out-of-state manufacturers and for packaging and loading products for shipment. Worker was engaged in interstate commerce, but not in work substantially similar to that performed by seamen or railroad employees.⁷²

68. 9 U.S.C. § 1.

69. See *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105, 121 (2001); *Sillins v. Ness*, 164 N.C. App. 755, 757, 596 S.E.2d 874, 876 (2004).

70. *Palcko v. Airborne Express, Inc.*, 372 F.3d 588, 593 (3d Cir. 2004) (quotation omitted); see also *Cole v. Burns Int’l Security Servs.*, 105 F.3d 1465, 1472 (D.C. Cir. 1997) (§ 1 applies to only those workers involved in the “‘flow’ of commerce, i.e., those workers responsible for the transportation and distribution of goods”).

71. See *Cole*, 105 F.3d 1465.

72. See *Kropfelder v. Snap-On Tools Corp.*, 859 F. Supp. 952 (D. Md. 1994). But see *Lenz v. Yellow Transp., Inc.*, 352 F. Supp. 2d 903, 906-07 (S.D. Iowa 2005) (noting that worker in *Kropfelder* worked for manufacturing

- Section 1 did not exempt temporary employees assigned to “manual day labor” in various jobs, including construction, landscaping, stevedoring, and warehousing, among others. Although some assigned jobs were “related to the interstate transportation of goods,” there was no evidence that a “majority or even a plurality of plaintiffs’ daily activities were in transportation-related industries.”⁷³
- Section 1 exempted delivery driver who contracted with courier service to provide “small package information, transportation, and delivery service throughout the United States.”⁷⁴
- Section 1 exempted employee responsible for directly supervising drivers who transported packages for an interstate and international shipping company.⁷⁵

Because section 1 requires a relatively direct connection between the worker and foreign or interstate commerce, the exemption will not apply to most contracts of employment,⁷⁶ particularly those involving workers outside the transportation industries. If the exemption applies, however, state law, not the FAA, will likely govern the enforceability of any arbitration agreement.⁷⁷

Have the parties contracted to apply state law to their dispute?

Thus far, we have seen that the FAA requires enforcement of written arbitration agreements in contracts “evidencing a transaction involving commerce,” other than employment contracts of transportation workers. If it applies, the FAA will preempt much state arbitration law. The following sections of this bulletin discuss how courts should analyze whether the FAA preempts particular state laws.

company, rather than for an employer in the transportation industry).

73. *Adkins v. Labor Ready, Inc.*, 303 F.3d 496, 499 & 505 (4th Cir. 2002) (quotation omitted).

74. *Harden v. Roadway Package Sys., Inc.*, 249 F.3d 1137, 1139-40 (9th Cir. 2001).

75. See *Palcko*, 372 F.3d at 593 & 594 n.2.

76. See *Wehr Dissolution Corp.*, 345 F. Supp. 2d at 560.

77. See *Palcko*, 372 F.3d at 596 (rejecting argument that FAA preempted state law requiring arbitration under contracts exempt under FAA § 1); see also *Cole*, 105 F.3d at 1472.

Before turning to this topic, note that contract parties may agree to apply state arbitration law to their disputes. If they so agree – incorporating state arbitration law into their contract – the FAA will not preempt the incorporated law. The decision whether a contract incorporates state arbitration law, however, itself raises issues of FAA preemption. Indeed, in some cases, the FAA may preempt a finding that a contract incorporates state law. Thus, this bulletin defers further discussion of this topic until after the following discussion of the scope of FAA preemption.

Does the FAA preempt the challenged state law?

The Supreme Court has traced Congress’ power to preempt state law to Article 6, clause 2 of the U.S. Constitution (the “Supremacy Clause”).⁷⁸ Whether a given federal statute in fact preempts state law is a matter of Congressional intent.

The courts have generally divided preemption into two overarching categories: express and implied. Courts use the term express preemption to describe federal statutes that explicitly state their intended preemptive effect.⁷⁹ If the relevant federal law contains no express preemption language, state law may nevertheless be preempted by implication: i.e., preempted because courts infer Congress’ intent to preempt state law from the general statutory scheme, “purpose,” or legislative history.

Courts further subdivide “implied preemption” cases into two categories: “field preemption” and “conflict preemption.” In field preemption cases, courts infer an intent to preempt state law “from the depth and breadth of a congressional scheme that occupies the legislative field.”⁸⁰ In such cases, courts

78. See generally *Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525, 540-41 (2001); *Gade v. Nat’l Solid Wastes Mgmt. Ass’n.*, 505 U.S. 88, 108 (1992); *Chicago & N.W. Transp. Co. v. Kalo Brick & Tile Co.*, 450 U.S. 311, 317-318 (1981). Some scholars would instead locate any Congressional preemption power in the Necessary and Proper clause, U.S. Const. art. I, § 8, cl. 18. See, e.g., Stephen A. Gardbaum, *The Nature of Preemption*, 79 Cornell L. Rev. 767 (1994).

79. See, e.g., *Reilly*, 533 U.S. at 541 (“State action may be foreclosed by express language in a congressional enactment.”). Congress may specify the extent to which the federal enactment will preempt state law – e.g., whether the federal law displaces all state regulation or only state law that conflicts with the federal scheme. See, e.g., *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 517 (1992).

80. *Reilly*, 533 U.S. at 541.

deem Congress to have prohibited all state regulation in a particular field, whether or not state law conflicts with federal law. Courts generally attribute such broad preemptive intent to Congress only in areas of dominant federal interest or where the federal statute creates a “pervasive” regulatory scheme.⁸¹

In cases of “conflict preemption,” state law is preempted “by implication because of a conflict with a congressional enactment.”⁸² Such a conflict may arise either because it is impossible to comply with both state and federal law⁸³ or because state law “stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.”⁸⁴ This latter type of implied conflict preemption is termed “obstacle preemption.”⁸⁵

FAA preemption is a form of obstacle preemption.

No provision of the FAA expressly states whether, or to what extent, the Act preempts state law.⁸⁶ Moreover, the Supreme Court has recognized that the FAA does not “reflect a congressional intent to occupy the entire field of arbitration.”⁸⁷ Indeed, the structure of the Act itself suggests a role for state arbitration law. The Act’s substantive provisions are chiefly concerned with the enforceability of

81. *Pacific Gas & Elec. Co. v. State Energy Comm’n*, 461 U.S. 190, 203-04 (1983).

82. *Reilly*, 533 U.S. at 541.

83. *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142-43 (1963) (implied conflict preemption occurs when “compliance with both federal and state regulations is a physical impossibility”).

84. *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941).

85. *See Drahozal*, *supra* n. 6 at 398.

86. *See Volt Info. Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 477 (1989). It is possible to read FAA § 2 as an express preemption clause, *see* Caleb Nelson, *Preemption*, 86 Va. L. Rev. 225, 299 (2000), although the Supreme Court has never adopted this view. For a clear example of an express preemption clause, consider the following provision of the Employee Retirement Income Security Act, 29 U.S.C. § 1144(a): “Except as provided [elsewhere in] this section, the provisions of this subchapter . . . shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan.”

87. *Volt*, 489 U.S. at 477. *But see* Macneil et al., *supra* n. 20 § 10.8.2, at 10:76 (listing “strong arguments” that the FAA, if it applies, should preempt all of state arbitration law).

arbitration agreements and awards, not with minute regulation of the arbitration process itself, and many of the provisions are explicitly directed to federal, not state, courts.⁸⁸

To the extent the Supreme Court has articulated a coherent FAA preemption theory, it is one of implied conflict preemption.⁸⁹ Under this theory, state laws are preempted to the extent they “would undermine the [pro-arbitration] goals and policies of the FAA.”⁹⁰ This policy is manifested most clearly in FAA § 2. Because that section also contains the most significant limitation on the scope of FAA preemption, it merits extended discussion.

Under FAA § 2, state law “hostile” to arbitration is preempted; generally applicable state law is not.

FAA section 2 mandates that written arbitration agreements “shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.”⁹¹ Section 2 contains what might be termed the FAA’s preemptive “core,”⁹² establishing a national policy mandating enforcement of arbitration agreements notwithstanding state law to the contrary.

This pro-arbitration mandate, however, is tempered by section two’s “savings clause” which permits courts to invalidate arbitration agreements “upon such grounds as exist at law or in equity for the revocation of *any contract*.”⁹³ The savings clause permits courts to apply “*generally applicable*

88. *See, e.g.*, 9 U.S.C. §§ 3-4 (providing for stays of judicial proceedings pending arbitration and for orders compelling arbitration and referring to “courts of the United States” and “United States district court[s]”); 9 U.S.C. §§ 9-13 (establishing procedures and grounds for confirming, vacating, or modifying arbitral awards in federal courts; referring, for example, to “United States court[s]” and “United States district court[s]”); *see also* Hayford & Palmiter, *supra* n. 15 at 195, 200-01 (noting incomplete FAA coverage and arguing for a state role in regulating the process of arbitration).

89. *See Drahozal*, *supra* n. 6 at 407.

90. *Volt*, 489 U.S. at 478.

91. 9 U.S.C. § 2.

92. Hayford & Palmiter, *supra* n. 15 at 194-95; *see also* Drahozal, *supra* n. 6 at 407 (“[S]tate laws [are] preempted when they conflict with the dictate of § 2 that arbitration agreements be ‘valid, irrevocable, and enforceable.’”).

93. 9 U.S.C. § 2 (emphasis added).

contract defenses, such as fraud, duress, or unconscionability” to invalidate arbitration agreements.⁹⁴ Applying general contract law principles to arbitration agreements is consistent with the FAA’s goal of placing such agreements “upon the same footing as other contracts.”⁹⁵

“Courts may not, however, invalidate arbitration agreements under state laws applicable *only* to arbitration provisions.”⁹⁶ Nor may courts invalidate arbitration agreements under a “state-law principle that takes its meaning precisely from the fact that a contract to arbitrate is at issue.”⁹⁷ The Supreme Court has admonished that:

A court may not . . . in assessing the rights of litigants to enforce an arbitration agreement, construe that agreement in a manner different from that in which it otherwise construes nonarbitration agreements under state law. Nor may a court rely on the uniqueness of an agreement to arbitrate as a basis for a state-law holding that enforcement would be unconscionable.⁹⁸

Thus, the FAA requires courts to enforce arbitration agreements and preempts state law that would reach a contrary result, unless the relevant state law is a “generally applicable” defense to contract enforcement. The following section discusses how these preemption principles apply in particular cases.⁹⁹

Is state law hostile to arbitration?

The clearest case of FAA preemption involves state law that is hostile to arbitration. For example, the FAA indisputably preempts state laws that declare arbitration agreements invalid. The same is true of laws that single out arbitration agreements for special, unfavorable treatment, or that impose special limitations on the authority of arbitrators. These laws

94. *Doctor’s Assocs., Inc. v. Casarotto*, 517 U.S. 681, 687 (1996) (emphasis added).

95. *Gilmer*, 500 U.S. at 24; *Volt*, 489 U.S. at 474.

96. *Casarotto*, 517 U.S. at 687.

97. *Perry v. Thomas*, 482 U.S. 483, 492 n.9 (1987).

98. *Id.*

99. Readers should be aware that arbitrators, and not courts, must decide many challenges to the enforceability of contracts that contain arbitration clauses. This bulletin does not address whether courts or arbitrators should decide particular challenges. That topic will be addressed in a separate bulletin.

conflict with the FAA’s strong pro-arbitration mandate, and they are preempted.

Examples of state laws hostile to arbitration include:

- Laws forbidding courts to order specific performance of predispute arbitration agreements.¹⁰⁰
- Laws requiring a judicial forum for certain types of disputes, such as franchise disputes¹⁰¹ or wage collection actions.¹⁰²
- Laws allowing courts, but not arbitrators, to award punitive damages.¹⁰³
- Laws imposing on arbitration agreements special rules of contract formation – such as special “conspicuous notice” requirements – not applicable to other contracts.¹⁰⁴
- Laws prohibiting “nonnegotiable” arbitration clauses while permitting other types of “nonnegotiable” contract terms.¹⁰⁵

Is the challenged state law “generally applicable” contract law?

What about state laws that are not overtly hostile to arbitration but that nevertheless deny enforcement to an arbitration agreement? Under FAA section 2, such laws are not preempted if they constitute “grounds . . . for the revocation of any contract.” Thus, a court may invalidate an arbitration agreement, like any other contract, for lack of consideration, or because a party’s agreement to arbitrate was induced by fraud, or because a contract signatory lacked authority to bind a party to the contract.¹⁰⁶ Likewise, an arbitration agreement may

100. *See, e.g., Allied-Bruce*, 513 U.S. at 269.

101. *See Southland*, 465 U.S. at 5-6 & 16.

102. *See Perry*, 482 U.S. 483.

103. *See Mastrobuono v. Shearson/Lehman Hutton, Inc.*, 514 U.S. 52, 59 (1995) (unless the parties agreed otherwise, the FAA would preempt a state law rule forbidding arbitral awards of punitive damages).

104. *See Casarotto*, 517 U.S. at 683 (holding that the FAA preempted a Montana statute requiring arbitration clauses to be contained in a “Notice of Arbitration” typed in underlined capital letters on the front of the contract).

105. *See Saturn Distribution Corp. v. Williams*, 905 F.2d 719, 725-26 (4th Cir. 1990).

106. *See, e.g., Martin v. Vance*, 133 N.C. App. 116, 122, 514 S.E.2d 306, 310 (1999) (considering whether arbitration agreement was supported by consideration); *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S.

be invalidated under the doctrine of unconscionability.¹⁰⁷ The FAA does not preempt such “generally applicable” state law.

The Supreme Court, however, has made clear that courts may not apply state law principles that take their meaning “precisely from the fact that a contract to arbitrate is at issue.”¹⁰⁸ So, for example, the FAA would preempt a judicially-crafted state law invalidating as unconscionable all consumer arbitration agreements.¹⁰⁹ The FAA would also preempt even “generally applicable” state law if applied in a manner hostile to arbitration. For example, a court could not invalidate an arbitration agreement under a duress or fraud in the inducement theory, when the same contract, without the arbitration clause, would be enforced.¹¹⁰ The guiding

395 (1967) (court, rather than arbitrator, decides whether arbitration agreement was fraudulently induced); *Sphere Drake Ins. Ltd. v. All American Ins. Co.*, 256 F.3d 587, 592 (7th Cir. 2001) (remanding for decision as to whether contract signatory was authorized to bind party).

107. Unconscionability is a state law “policing doctrine” used by courts to limit the enforceability of contracts perceived to be unfair. The doctrine is recognized in North Carolina. See G.S. 25-2-302; *Brenner v. Little Red School House, Ltd.*, 302 N.C. 207, 213-14, 274 S.E.2d 206, 210-11 (1981); *Sidden v. Mailman*, 137 N.C. App. 669, 675, 529 S.E.2d 266, 271(2000). For detailed discussion of the use of unconscionability doctrine in policing arbitration agreements, see Jeffrey W. Stempel, *Arbitration, Unconscionability, and Equilibrium: The Return of Unconscionability Analysis as a Counterweight to Arbitration Formalism*, 19 Ohio St. J. Disp. Resol. 757 (2004).

Note that there may be some circumstances under which arbitrators, and not courts, must decide whether an arbitration clause is unconscionable. Compare *Hawkins v. Aid Ass'n for Lutherans*, 338 F.3d 801, 807 (7th Cir. 2003) (arbitrator, not court, must decide whether contract provisions barring punitive damages and classwide arbitration were unconscionable) with *Ingle v. Circuit City Stores, Inc.*, 328 F.3d 1165, 1170-73, 1175-76 (9th Cir. 2003) (addressing whether waiver of right to proceed as class rendered arbitration provision unconscionable). Whether courts or arbitrators must decide particular issues will be covered in more detail in a separate bulletin.

108. *Perry*, 482 U.S. at 492 n.9.

109. See *id.* (“Nor may a court rely on the uniqueness of an agreement to arbitrate as a basis for a state-law holding that enforcement would be unconscionable.”).

110. See *Allied-Bruce*, 513 U.S. at 281 (“What States may not do is decide that a contract is fair enough to

principle is one of neutrality: both the substantive law and the court’s application of that law must be consistent with the FAA’s requirement that arbitration agreements be placed “upon the same footing as other contracts.”¹¹¹

Laws that are not “generally applicable”

A final category consists of laws that are not “generally applicable” but that also are not overtly hostile to arbitration. As an example, consider laws regulating or facilitating the arbitration process – say, by establishing procedures governing pre-hearing discovery. Are such laws preempted?

The case law provides relatively little guidance as to how courts should address such preemption issues.¹¹² Recall, however, that the Supreme Court’s preemption theory is one of implied obstacle preemption: state laws are preempted if they “undermine the goals and policies of the FAA.”¹¹³ The FAA’s principal purpose is to ensure that arbitration agreements are enforced according to their terms.¹¹⁴ State laws that regulate the arbitration process are likely consistent with this purpose, unless they invalidate the parties’ agreement, nullify its terms, or otherwise operate in a manner “hostile” to arbitration.¹¹⁵

For example, the Revised Uniform Arbitration Act (RUAA), enacted with limited changes in North Carolina, regulates numerous aspects of the arbitration process not explicitly addressed by the FAA.¹¹⁶ The RUAA addresses, among other topics, disclosure of information by arbitrators, arbitral discovery and hearing procedures, and arbitrator immunity.¹¹⁷ While this bulletin does not attempt to

enforce all its basic terms (price, service, credit), but not fair enough to enforce its arbitration clause.”).

111. *Gilmer*, 500 U.S. at 24.

112. For a summary of possible approaches, see Drahozal, *supra* n. 6 at 416-20.

113. *Volt*, 489 U.S. at 478.

114. See *id.*

115. For a contrary view arguing that the FAA preempts all state arbitration law when it applies, see MacNeil et al., *supra* n. 20 § 10.8.2.2, at 10:76.

116. See G.S. § 1-569.1 *et seq.*; 7 U.L.A. 1 *et seq.* [herein RUAA § ____]. The RUAA applies to agreements to arbitrate made after January 1, 2004, and to prior agreements if the parties so agree “in a record.” G.S. § 1-569.3.

117. See G.S. § 1-569.1 *et seq.* The RUAA also addresses issues covered more directly by the FAA, including the enforceability of arbitration agreements, the

evaluate each RUAA provision for compatibility with the FAA, most RUAA provisions are likely to survive an obstacle preemption analysis.¹¹⁸ Courts faced with preemption challenges to state law that is not “generally applicable” must determine whether the law is consistent with the FAA or, rather, whether it undermines the FAA’s pro-arbitration mandate.

Specific North Carolina preemption issues

A number of cases have addressed FAA preemption of North Carolina law. The following section discusses these cases and identifies other aspects of North Carolina law that may raise preemption issues.

Judicial review of arbitral awards: In *WMS, Inc. v. Weaver*,¹¹⁹ the North Carolina Court of Appeals stated that the FAA preempts “state law addressing the role of courts in reviewing arbitration awards.”¹²⁰ In deciding whether to confirm or vacate an arbitral award, the Court of Appeals therefore looked to the standards governing vacatur in 9 U.S.C. § 10, rather than those now contained in G.S. § 1-569.23.¹²¹

By its express terms, FAA section 10 is directed to federal, not state, courts: the statute governs vacatur of arbitral awards by “the United States court” in the district where the arbitral award was made.¹²² Arguably, states retain the freedom to establish their own standards for vacatur of arbitral awards, subject to the usual qualification that state law must not “undermine the goals and policies of the FAA.”¹²³ Concerns about preemption, however, apparently led the drafters of the RUAA to adhere closely to the vacatur standards specified in the FAA.¹²⁴ As a result, had the Court of Appeals in *Weaver* looked to state law to determine the relevant

arbitrability of disputes, and the processes for confirming, modifying, and vacating arbitral awards. On these matters, the RUAA adheres closely to the FAA, recognizing that they fall within the “core” areas of FAA preemption. See Hayford & Palmiter, *supra* n. 15 at 213-226.

118. For thorough treatment of whether the FAA preempts state law that, like the RUAA, regulates the arbitration process itself, see Hayford & Palmiter, *supra* n. 15, and Drahozal, *supra* n. 6.

119. 602 S.E.2d 706 (N.C. App. 2004).

120. *Id.* at 710.

121. *See id.*

122. *See* 9 U.S.C. § 10(a).

123. *Volt*, 489 U.S. at 478.

124. *See* Hayford & Palmiter, *supra* n. 15 at 219.

vacatur standards, it would have found little difference from those set out in the FAA.¹²⁵

Laws forbidding out-of-state forum selection clauses: G.S. § 22B-3 invalidates forum selection clauses, in contracts entered into in North Carolina, requiring contract parties to litigate or arbitrate their disputes outside of North Carolina.¹²⁶ Although the statute invalidates out-of-state forum selection clauses regardless whether the contract at issue requires arbitration, and therefore does not apply “only to arbitration provisions,”¹²⁷ the North Carolina Court of Appeals has held that it is preempted.¹²⁸ A number of other courts have reached similar conclusions with respect to other statutes.¹²⁹

To understand these cases, return to the language of the FAA section 2 savings clause: arbitration agreements must be enforced “save upon such grounds as exist at law or in equity for the revocation of any contract.”¹³⁰ The relevant preemption cases involve statutes that invalidate out-of-state forum selection clauses in franchise agreements, but not in other contracts.¹³¹ Because such statutes apply only

125. *Compare* G.S. §§ 1-569.22-25 (current N.C. arbitration statute) with 9 U.S.C. §§ 9-11. *See also* Hayford & Palmiter, *supra* n. 15 at 218-19.

126. G.S. § 22B-3 provides: “Except as otherwise provided in this section, any provision in a contract entered into in North Carolina that requires the prosecution of any action or the arbitration of any dispute that arises from the contract to be instituted or heard in another state is against public policy and is void and unenforceable. This prohibition shall not apply to non-consumer loan transactions or to any action or arbitration of a dispute that is commenced in another state pursuant to a forum selection provision with the consent of all parties to the contract at the time that the dispute arises.”

127. *Casarotto*, 517 U.S. at 687.

128. *Boynton*, 152 N.C. App. at 109, 566 S.E.2d at 734.

129. *See Bradley v. Harris Research, Inc.*, 275 F.3d 884 (9th Cir. 2001) (similar statute applicable to franchise agreements); *KKW Enters, Inc. v. Gloria Jean's Gourmet Coffees Franchising Corp.*, 184 F.3d 42 (1st Cir. 1999) (same); *Doctor's Assocs., Inc. v. Hamilton*, 150 F.3d 157 (2d Cir. 1998) (same); *see also* See Drahozal, *supra* n. 6 at 409-410 (arguing that *Southland* supports preemption of such statutes). *But see Keystone, Inc. v. Triad Sys. Corp.*, 971 P.2d 1240, 1244 (Mont. 1998) (holding that FAA did not preempt Montana statute invalidating contract terms requiring state residents to resolve disputes out of state).

130. 9 U.S.C. § 2 (emphasis added).

131. *See Bradley*, 275 F.3d 884; *KKW Enters*, 184 F.3d 42; *Hamilton*, 150 F.3d 157.

to a limited subset of contracts, rather than to “contracts generally,”¹³² courts have found them preempted.¹³³

G.S. § 22B-3 presents a closer call. Unlike a state franchise act, § 22B-3 does not single out a particular type of contract for regulation. But neither does it apply to *any* contract; there are narrow exceptions. The principal exception is for non-consumer loan transactions.¹³⁴ Moreover, G.S. § 22B-3 invalidates only the out-of-state forum selection clause, potentially allowing the court to enforce the remainder of the arbitration agreement.¹³⁵ Nevertheless, the Court of Appeals has determined that the FAA preempts § 22B-3.¹³⁶

Laws requiring the parties specifically to authorize arbitral awards of punitive damages: One area in which North Carolina arbitration law departs from the model RUAA relates to arbitrators’ authority to award punitive damages or “other exemplary relief.” G.S. § 1-569.21 allows such awards if (1) the arbitration agreement “provides for an award of punitive damages or exemplary relief”; (2) an award of such relief is authorized by law in a civil action involving the same claim, and (3) the evidence

132. *Perry*, 482 U.S. at 492 n.9.

133. See *Bradley*, 275 F.3d at 889-90; *KKW Enters*, 184 F.3d at 51; *Hamilton*, 150 F.3d at 163.

134. Other exceptions are for contracts entered into in other states (though this exception is of little practical consequence, as North Carolina law typically would not apply to such contracts, see *Walden v. Vaughn*, 157 N.C. App. 507, 510, 579 S.E.2d 475, 477 (2003)) and for post-dispute agreements to arbitrate. See G.S. § 22B-3.

135. Cf. *Triad Sys. Corp.*, 971 P.2d at 1245-46 (Montana statutes invalidating out-of-state forum clauses did not “nullif[y] either party’s obligation to arbitrate”). Note, however, that state law invalidating particular arbitration-related terms, while otherwise allowing arbitration to go forward, might still be preempted under the theory that the FAA requires enforcement of arbitration agreements “according to their terms.” Cf. *Green Tree Fin. Corp. v. Bazzle*, 539 U.S. 444 (2003) (Rehnquist, O’Connor, Kennedy, JJ., dissenting) (advancing this argument with respect to arbitration agreement that, in dissent’s view, unambiguously barred classwide arbitration proceedings).

136. See *Boynton*, 152 N.C. App. at 109, 566 S.E.2d at 734; see also *Szymczyk*, 606 S.E.2d at 732. Even if the FAA preempts statutes like G.S. § 22B-3, courts may be willing to consider the effect of a forum selection clause when analyzing an arbitration agreement under unconscionability doctrine. See, e.g., *Patterson v. ITT Consumer Fin. Corp.*, 18 Cal. Rptr. 2d 563, 565-67 (Cal. Ct. App. 1st Dist. 1993).

produced at the hearing justifies the award under the legal standards otherwise applicable to the claim. The model RUAA does not contain the first of these three requirements.¹³⁷

G.S. § 1-569.21 may be vulnerable to a preemption challenge. In *Mastrobuono v. Shearson/Lehman Hutton, Inc.*,¹³⁸ discussed in more detail in the following section, the U.S. Supreme Court indicated that the FAA preempts state law allowing courts, but not arbitrators, to award punitive damages.¹³⁹ Thus, “state law cannot prohibit the arbitrability of a claim for punitive damages.”¹⁴⁰ This limitation on state law is unsurprising, given the FAA’s goal of eliminating state law hostile to arbitration.¹⁴¹

Unlike the state-law rule in *Mastrobuono*, G.S. § 1-569.21 does permit arbitral awards of punitive damages if “provide[d] for” in the parties’ agreement. What does this mean? Conceivably, G.S. § 1-569.21 might be interpreted to allow punitive damages whenever such awards are *consistent with* the parties’ agreement. Because courts interpreting agreements subject to the FAA must resolve “any doubts concerning the scope of arbitral issues . . . in favor of arbitration,”¹⁴² and because “arbitrators presumptively enjoy the power to award punitive damages,”¹⁴³ G.S. § 1-569.21 might permit such awards unless “the arbitration contract *unequivocally excludes* punitive damages claims.”¹⁴⁴ Such an interpretation would pose no preemption issue, as parties are free to arbitrate whatever issues they wish (though state law may limit the ability to waive the right to recover punitive damages altogether).

But interpreting the phrase “provides for” to mean “does not expressly exclude” arguably strips the phrase of its meaning. Instead, G.S. § 1-569.21 might be interpreted, more plausibly, to bar arbitral awards of punitive damages unless the parties specifically grant the arbitrators that authority. So interpreted, G.S. § 1-569.21 would presumptively

137. See RUAA § 21(a).

138. 514 U.S. 52 (1995).

139. See *id.* at 59 (unless the parties intended to exclude punitive damages claims from arbitration, the FAA would preempt state law forbidding arbitral awards of punitive damages).

140. *Hayford & Palmiter*, *supra* n. 15 at 214.

141. See *Gilmer*, 500 U.S. at 24.

142. *Moses H. Cone*, 460 U.S. at 24-25.

143. *Weaver*, 602 S.E.2d at 711 (quotation omitted).

144. *Id.* (discussing *Mastrobuono* in a case governed by N.C. law before enactment of G.S. § 1-569.21)

exclude some claims from arbitration¹⁴⁵ and withhold from arbitrators a remedial power routinely exercised by courts. Such presumptions would be difficult to square with *Mastrobuono*.¹⁴⁶

State law governing whether courts or arbitrators decide particular questions: Parties to arbitration agreements often disagree on a fundamental procedural question: whether the court or the arbitrator should decide an issue. For example, assume that Party A wants to rescind a contract (say, a consulting agreement) containing an arbitration clause, claiming that Party B obtained A's agreement by falsely representing B's ability to perform the required consulting services. Party A wants a court to decide the rescission issue, arguing that A cannot be compelled to arbitrate anything if the entire contract is unenforceable. Unfortunately for A, its argument will almost certainly fail. As a matter of federal arbitration law, the arbitrator must decide whether A may rescind the contract, unless the parties' agreement says otherwise.¹⁴⁷

This procedural question – *who decides* a particular issue – will be discussed in a separate bulletin. An extensive (if confused) body of FAA law has developed on this topic. For purposes of this bulletin, however, readers should be aware that “[i]f the FAA requires that a particular question be determined by the arbitrators, while state law would allow a court to address the issue, the FAA controls.”¹⁴⁸

145. For example, assume the parties validly agreed to arbitrate “any and all claims arising out of or related to” their contract, but said nothing about punitive damages, and that one party thereafter filed a lawsuit alleging breach of contract and fraud claims. Cf. *Eddings*, 605 S.E.2d at 682. The defendant would clearly be entitled to have the breach of contract claim referred to arbitration, but G.S. § 1-569.21 might preserve a judicial forum for the fraud claim (or, more likely, for punitive damages issues related to that claim).

146. “Under *Mastrobuono*, an arbitrator does not exceed his powers if (1) state law allows the remedy for the specified cause of action, and (2) the arbitration contract does not unequivocally preclude it.” *Weaver*, 602 S.E.2d at 711.

147. See *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*, 388 U.S. 395 (1967) (unless the parties agree otherwise, arbitrator decides claim that entire contract was induced by fraud, court decides claim that arbitration clause itself was induced by fraud).

148. *Weaver*, 602 S.E.2d at 710.

State law requiring “independent negotiation” of arbitration clauses: Some North Carolina cases state that arbitration agreements, “if contained in a contract covering other topics, must be independently negotiated.”¹⁴⁹ Sometimes these statements appear in cases clearly governed by the FAA,¹⁵⁰ and at least one case purports to trace this “independent negotiation” requirement to the U.S. Supreme Court’s decision in *Southland*.¹⁵¹

Nothing in *Southland*, however, requires “independent negotiation” of arbitration clauses, and Supreme Court cases since *Southland* have consistently enforced arbitration agreements in circumstances where there was clearly no independent negotiation.¹⁵² Moreover, it is difficult to see how an “independent negotiation” requirement can be squared with the rule that state law may not impose more stringent contract formation requirements on arbitration agreements than on other types of contracts.¹⁵³ If the FAA applies, a court may not condition enforcement of the arbitration agreement on proof that the agreement was “independently negotiated,” at least where state law does not require independent negotiation of *all* contract terms.¹⁵⁴

149. *Routh v. Snap-On Tools Corp.*, 108 N.C. App. 268, 272, 423 S.E.2d 791, 794 (1992); see also *Blow v. Shaughnessy*, 68 N.C. App. 1, 16-17, 313 S.E.2d 868, 876-77 (1984); *Sciolino v. TD Waterhouse Investor Servs., Inc.*, 149 N.C. App. 642, 645, 562 S.E.2d 64, 66 (2002) (noting cases suggesting such a requirement).

150. See, e.g., *Blow*, 68 N.C. App. 1, 313 S.E.2d 868.

151. See *id.* at 16-17, 313 S.E.2d at 876-77.

152. See, e.g., *Circuit City Stores*, 532 U.S. 105 (FAA compelled arbitration of employee’s discrimination claims pursuant to clause in employment application form used by national retailer); *Allied-Bruce*, 513 U.S. 265 (FAA preempted state law invalidating pre-dispute arbitration clause in consumer transaction involving termite control services); *Gilmer*, 500 U.S. 20 (FAA compelled arbitration of federal age discrimination claims brought by registered securities representative; such persons are required to agree to arbitration as a condition of registration with the relevant stock exchange).

153. See, e.g., *Casarotto*, 517 U.S. at 687; see also *Perry*, 482 U.S. at 492 n.9.

154. See *Saturn Distrib. Corp.*, 905 F.2d at 725-26 (FAA preempts state law forbidding “nonnegotiable” arbitration clauses but not other “nonnegotiable” terms).

Have the parties chosen to apply state arbitration law?

Previously, this bulletin noted that contract parties may agree to apply state arbitration law to their disputes.¹⁵⁵ That they may do so reflects the contractual nature of arbitration.¹⁵⁶ Like other contracts, “parties are generally free to structure their arbitration agreements as they see fit.”¹⁵⁷ Thus, parties to arbitration agreements may exclude particular issues from arbitration, establish procedures to govern their arbitration, or agree to apply state arbitration law to their dispute. Whatever their agreement, the FAA requires courts to enforce it, subject, of course, to “generally applicable” state law governing all contracts.

If an arbitration agreement otherwise subject to the FAA *expressly* incorporates state arbitration law, the result is simple: state arbitration law applies without any concerns about FAA preemption. More commonly, however, a contract will contain a generic choice of law clause such as the following: “This agreement shall be governed and construed in accordance with the law of the State of North Carolina, irrespective of its choice of law rules.” Does a generic choice of law clause *implicitly* incorporate state arbitration law, even though the FAA would otherwise preempt that law? For example, would a generic choice of law clause implicitly incorporate G.S. § 1-569.21, which bars arbitral awards of punitive damages unless the agreement “provides for” such awards, even though the FAA might otherwise preempt this aspect of North Carolina law?

Two U.S. Supreme Court cases are relevant to this question. The first is *Volt Information Sciences, Inc. v. Board of Trustees of the Leland Stanford Junior University*.¹⁵⁸ *Volt* involved a contract between a California university and a construction contractor. The contract contained an arbitration clause and also provided that the “law of the place where the Project is located” would govern any disputes.¹⁵⁹ The university sued the contractor in California state court, joining two additional

defendants who were involved in the construction project but who had not agreed to arbitrate. The contractor petitioned the trial court to compel arbitration.

Although the FAA arguably would have required the trial court to stay litigation and compel arbitration,¹⁶⁰ the trial court instead stayed the arbitration pursuant to a California statute authorizing such stays pending litigation between third parties and a party to the arbitration agreement. The court reached this result by interpreting the choice of law clause to incorporate California substantive law *and* California arbitration law, and the state appellate courts upheld this ruling.¹⁶¹

The U.S. Supreme Court affirmed. According to the Court, while the FAA preempts state law requiring a judicial forum for claims the parties have agreed to arbitrate, “it does not follow that the FAA prevents the enforcement of agreements to arbitrate under different rules than those set forth in the [FAA] itself.”¹⁶² Deferring to the state courts’ contract interpretation, the Court explained that the parties had “agreed to arbitrate in accordance with California law,”¹⁶³ including “state rules of arbitration.”¹⁶⁴ The Court then asked whether applying California law to stay arbitration “in accordance with the terms of the arbitration agreement itself, would undermine the goals and policies of the FAA.”¹⁶⁵ It concluded that enforcing the parties’ agreement “is fully consistent with the goals of the FAA even if the result is that

160. *See id.* at 476-77 & n.6; *Moses H. Cone Mem’l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 26-27 & n. 34-35 (1983).

161. *Volt*, 489 U.S. at 471-73.

162. *Id.* at 478-79.

163. *Id.* at 477.

164. *Id.* at 479. Somewhat oddly, the majority opinion in *Volt* construed the California arbitration rules to “generally foster the federal policy favoring arbitration” by addressing “special practical problems that arise in multiparty contractual disputes,” a topic not addressed by the FAA. *Id.* at 476 n.5. This seems rather dubious, as the effect of the relevant state law was to prevent, or at least delay, arbitration where it would otherwise have gone forward. Moreover, the Court’s preemption analysis makes little sense unless one presumes that the FAA would have preempted the state law at issue but for the choice of law clause. *See Drahozal, supra* n. 6 at 406. *But see* Hayford & Palmiter, *supra* n. 15 at 197 (*Volt* is consistent with Court’s general approach “not to invalidate state law merely because it may offend some general and abstractly-framed federal purpose, such as to promote arbitration”).

165. *Volt*, 489 U.S. at 477-78.

155. *See supra* p. 9.

156. *See, e.g., United Steelworkers v. Warrior & Gulf Nav. Co.*, 363 U.S. 574, 582 (1960) (“For arbitration is a matter of contract, and a party cannot be required to submit to arbitration any dispute which he has not agreed so to submit.”).

157. *Volt*, 489 U.S. at 479.

158. 489 U.S. 468.

159. *Id.* at 470.

arbitration is stayed where the [FAA] would otherwise permit it to go forward.”¹⁶⁶

Volt raised a prospect at odds with the Court’s otherwise expansive FAA preemption jurisprudence: that courts could interpret generic choice of law provisions broadly to incorporate state arbitration law, thus saving from preemption a host of state laws hostile to arbitration.¹⁶⁷ But the Court subsequently limited this aspect of *Volt* in *Mastrobuono v. Shearson/Lehman Hutton, Inc.*¹⁶⁸

In *Mastrobuono*, the Court held that a panel of arbitrators had properly awarded punitive damages even though New York law, which governed the parties’ dispute pursuant to a generic choice of law provision, allowed courts but not arbitrators to award such damages. The Court first made clear that, unless the parties intended to exclude punitive damages claims from arbitration, the FAA would preempt New York law forbidding an arbitral award of punitive damages.¹⁶⁹ Examining their agreement for evidence of such an intent, the Court reasoned that the choice of law clause was ambiguous: “the provision might include only New York’s substantive rights and obligations, and not the State’s allocation of power between” courts and arbitrators.¹⁷⁰

The Court resolved this ambiguity by construing the agreement to permit an arbitral award of punitive damages, emphasizing that, when interpreting a contract subject to the FAA, “due regard must be given to the federal policy favoring arbitration, and ambiguities as to the scope of the arbitration clause itself resolved in favor of arbitration.”¹⁷¹ Although the generic choice of law clause at issue in *Volt* had been similarly ambiguous, the Court distinguished *Volt* as a case in which it had deferred to a state court’s construction of an arbitration agreement under state law.¹⁷²

At a minimum, *Mastrobuono* cautions courts against interpreting generic choice of law provisions to incorporate state law hostile to arbitration. According to the North Carolina Court of Appeals,

166. *Id.* at 479.

167. *See Drahozal, supra* n. 6 at 406.

168. 514 U.S. 52 (1995).

169. *See id.* at 59.

170. *Id.* at 60.

171. *Id.* at 62 (quoting *Volt*, 489 U.S. at 476). The Court also invoked the rule that ambiguous contract terms are construed against their drafter (in *Mastrobuono*, the party trying to overturn the arbitral award). *See id.* at 62-3.

172. *See id.* at 60 n.4. By contrast, *Mastrobuono* involved a motion to vacate the arbitral award filed in federal court.

after *Mastrobuono* “a state choice of law clause in an arbitration agreement should not be construed to limit the authority of arbitrators.”¹⁷³

In summary, contract parties may choose to apply whatever law they wish to their arbitration agreement, even if the FAA might otherwise preempt the chosen law. Where the contract expressly chooses state arbitration law, courts should have little trouble enforcing it. But ambiguous contract language should not be interpreted to incorporate state law that is hostile to arbitration.¹⁷⁴

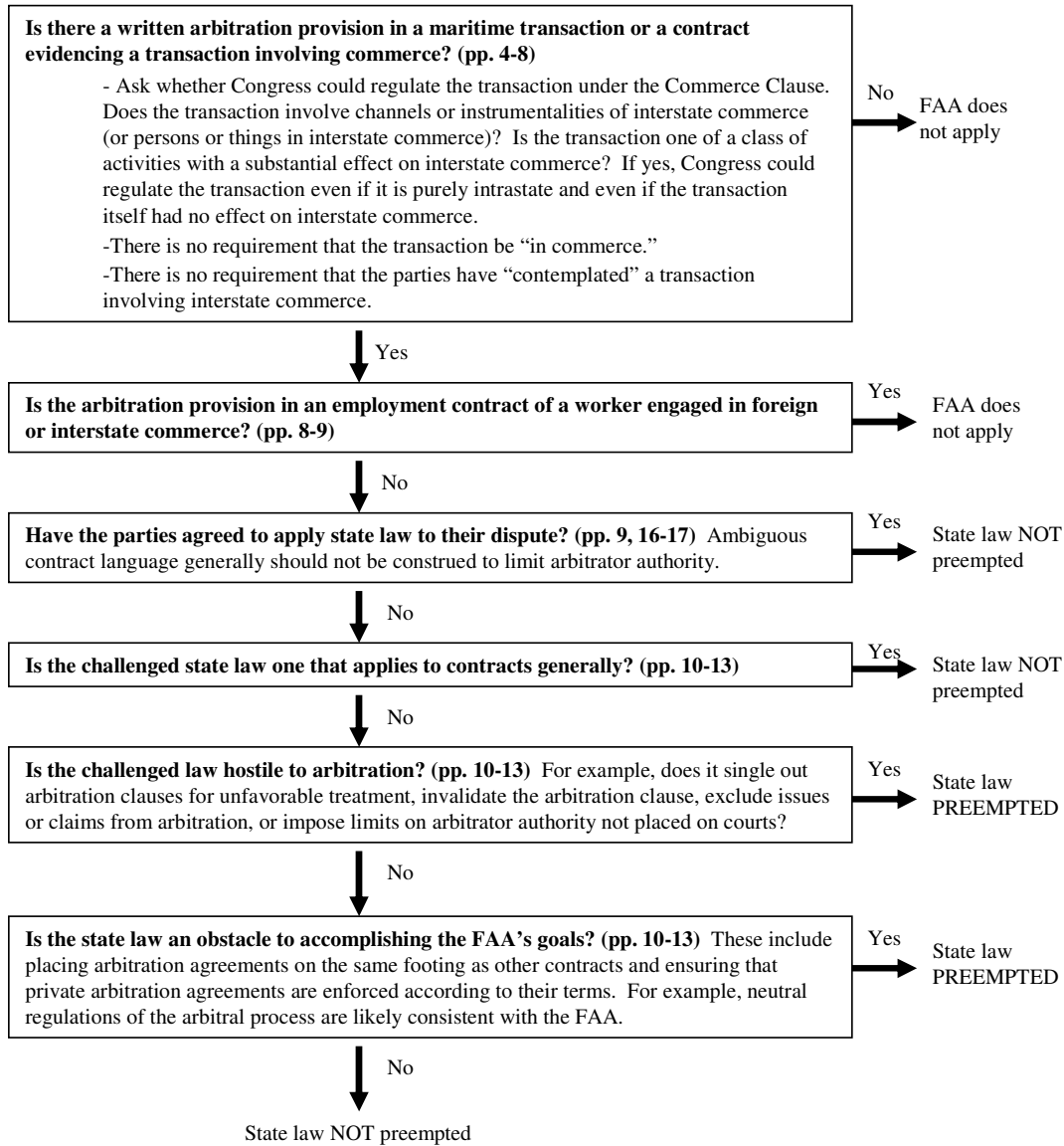
Conclusion

Arbitration is fundamentally a matter of contract, and the FAA’s primary goal is to ensure that arbitration agreements are treated as any other contract. But determining when the FAA applies, and whether it preempts particular state laws, is not always a simple inquiry. This bulletin has attempted to identify the analytical steps courts should take in addressing issues of FAA preemption. The following page contains a diagram of these steps, along with references to the relevant sections of the bulletin.

173. *Lorelli*, 607 S.E.2d at 677 (N.C. App. 2005).

174. *See Ferro Corp. v. Garrison Indus., Inc.*, 142 F.3d 926, 937 (6th Cir. 1998) (asking whether state law is “consistent with the primary purpose of the FAA, i.e., to ensure that the agreement to arbitrate . . . is enforced according to its terms”).

Preemption analysis



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