



# The Federal Arbitration Act: Background and Recent Developments

**Jon O. Shimabukuro**  
Legislative Attorney

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## Summary

Enacted in 1925, the Federal Arbitration Act (“FAA”) seeks to ensure the validity and enforcement of arbitration agreements in any “maritime transaction or . . . contract evidencing a transaction involving commerce.” In general, the FAA evidences a national policy favoring arbitration. However, the application of the FAA to various types of arbitration agreements has been the subject of numerous lawsuits. As more employers and businesses use arbitration agreements as a way to avoid the judicial system for resolving disputes, Congress may become more involved by amending the FAA or by creating new legislation to address mandatory arbitration agreements.

This report provides a brief legislative history of the FAA, as well as a review of selected cases that have interpreted the FAA. The report also discusses bills introduced during the 108<sup>th</sup> Congress that would amend the FAA to address the use of arbitration to resolve employment and specific contract disputes.

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The use of arbitration agreements in employment and consumer contracts has grown steadily as employers and businesses have sought to avoid the judicial system for resolving disputes. It is believed that at least eight percent of American workers are now bound by arbitration agreements.<sup>1</sup> Since the early 1990s, an increasing number of credit card issuers have added arbitration clauses to their customer agreements.<sup>2</sup> Although arbitration is often perceived as a faster and less costly alternative to litigation, some consumer advocates contend that mandatory arbitration agreements are one-sided measures that force employees and consumers to give up certain advantages, including access to jury trials and the ability to maintain class actions lawsuits.<sup>3</sup>

Congress enacted the Federal Arbitration Act (“FAA”) to ensure the validity and enforcement of arbitration agreements in any “maritime transaction or . . . contract evidencing a transaction involving commerce.”<sup>4</sup> In general, the FAA evidences a national policy favoring arbitration.<sup>5</sup> However, the application of the FAA to various types of arbitration agreements has been the subject of numerous lawsuits. Since 2000, the U.S. Supreme Court has decided six cases involving the FAA.

This report provides a brief legislative history of the FAA, as well as a review of selected cases that have interpreted the FAA. The report also discusses bills introduced during the 108<sup>th</sup> Congress that would amend the FAA to address the use of arbitration to resolve employment and specific contract disputes.

## Background

Section 2 of the FAA provides that

[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.<sup>6</sup>

By enacting section 2, Congress sought to place arbitration agreements “upon the same footing as other contracts, where [they] belong.”<sup>7</sup> Prior to 1925, American courts viewed arbitration with judicial hostility.<sup>8</sup> It is believed that this hostility flowed from a similar hostility displayed by English courts.<sup>9</sup> Because English judges were paid fees based on the number of cases they

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<sup>1</sup> Lisa Girion, *Arbitration Agreements Stir Up a Growing Legal Battle*, L.A. Times, Apr. 1, 2001, at W1.

<sup>2</sup> See Catherine Gillespie, *On the Docket: Forced Arbitration*, Credit Card Mgmt., Sept. 1, 1999, at 93.

<sup>3</sup> *Id.*

<sup>4</sup> 9 U.S.C. § 2. The Federal Arbitration Act is codified at 9 U.S.C. §§ 1-16.

<sup>5</sup> See *Southland Corporation v. Keating*, 465 U.S. 1 (1984).

<sup>6</sup> 9 U.S.C. § 2.

<sup>7</sup> H.R. Rep. No. 96, 68<sup>th</sup> Cong., 1<sup>st</sup> Sess., 1 (1924).

<sup>8</sup> *Id.* at 2.

<sup>9</sup> See Preston Douglas Wigner, *The United States Supreme Court’s Expansive Approach to the Federal Arbitration Act: A Look at the Past, Present, and Future of Section 2*, 29 U. Rich. L. Rev. 1499 (1995).

decided, arbitration infringed on their livelihood.<sup>10</sup> English courts were also unwilling generally to surrender their jurisdiction over various disputes.<sup>11</sup>

As industrialization prompted an increased number of business disputes, the hostility toward arbitration subsided.<sup>12</sup> In 1924, the Court upheld a New York law that compelled arbitration in a dispute involving a maritime contract.<sup>13</sup> The Court's decision in *Red Cross Line v. Atlantic Fruit Company* opened the door for Congress to pass legislation that recognized the validity of arbitration agreements.<sup>14</sup>

President Coolidge signed the United States Arbitration Law (commonly referred to as the Federal Arbitration Act) on February 12, 1925. The enactment of the new law "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."<sup>15</sup> While Congress' primary motivation for drafting the FAA reflected its interest in recognizing arbitration agreements as being just as valid as other contract provisions, it also understood the potential benefits that would be provided by enactment of the FAA:

It is practically appropriate that the action should be taken at this time when there is so much agitation against the costliness and delays of litigation. These matters can be largely eliminated by agreements for arbitration, if arbitration agreements are made valid and enforceable.<sup>16</sup>

While section 2 of the FAA requires the enforcement of arbitration agreements in maritime transactions and contracts "evidencing a transaction involving commerce," the precise scope of this latter group of contracts has not been certain. Although Congress provided a definition for the term "commerce" in section 1 of the FAA, it did not identify the extent to which a contract must "evidenc[e] a transaction involving commerce" before the FAA will apply.<sup>17</sup> Prior to 1995, there was a split among courts interpreting this language. Some courts found that the FAA applied only to those contracts where the parties "contemplated" an interstate commerce connection.<sup>18</sup> In *Burke County Public Schools Board of Education v. Shaver Partnership*, a North Carolina court stated that where performance of the contract "necessarily involves, so that the parties to the agreement must have contemplated, substantial interstate activity the contract evidences a transaction involving commerce within the meaning of the Federal Arbitration Act."<sup>19</sup>

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<sup>10</sup> *Id.* at 1502.

<sup>11</sup> H.R. Rep. No. 96, *supra* note 7 at 1-2.

<sup>12</sup> Wigner at 1502.

<sup>13</sup> *Red Cross Line v. Atlantic Fruit Company*, 264 U.S. 109 (1924).

<sup>14</sup> Wigner at 1503.

<sup>15</sup> *Southland*, 465 U.S. at 10 (1984).

<sup>16</sup> H.R. Rep. No. 96, *supra* note 7 at 2.

<sup>17</sup> See 9 U.S.C. § 1 ("commerce" . . . means 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 . . .").

<sup>18</sup> See *Burke County Public Schools Board of Education v. Shaver Partnership*, 279 S.E.2d 816 (N.C. 1981); *R.J. Palmer Construction Co. v. Wichita Band Instrument Co.*, 642 P.2d 127 (Kan. 1982); *Lacheney v. Profitkey International, Inc.*, 818 F.Supp. 922 (E.D. Va. 1993).

<sup>19</sup> *Burke*, 279 S.E.2d at 822.

Other courts held that the section 2 language reached to the limits of Congress' power under the Commerce Clause.<sup>20</sup> In *Snyder v. Smith*, the U.S. Court of Appeals for the Seventh Circuit maintained that the courts should take into account Congress' broad power to regulate under the Commerce Clause when deciding which contracts involve commerce.<sup>21</sup> Because Congress may reach activities "affecting" interstate commerce under its Commerce Clause authority, the Seventh Circuit reasoned that it was logical to conclude that any contract affecting interstate commerce falls within section 2 of the FAA.<sup>22</sup>

In 1995, the Supreme Court determined that a broad interpretation of section 2's "involving commerce" language was appropriate. In *Allied-Bruce Terminix Companies, Inc. v. Dobson*, the Court held that the term "involving commerce" signaled the full exercise of Congress' power under the Commerce Clause.<sup>23</sup> The Court found that the FAA's legislative history "indicates an expansive congressional intent."<sup>24</sup> The House Report that accompanied the FAA stated that the Act's "control over interstate commerce reaches not only the actual physical interstate shipment of goods but also contracts relating to interstate commerce."<sup>25</sup> Remarks in the *Congressional Record* indicated further that the FAA "affects contracts relating to interstate subjects and contracts in admiralty."<sup>26</sup> The Court determined that the word "involve" should be read as the functional equivalent of the word "affect."<sup>27</sup> Because the phrase "affecting commerce" normally signals Congress' intent to exercise its Commerce Clause powers to the fullest extent, the Court reasoned that the use of the phrase "involving commerce" should be given a similar reading.

After concluding that section 2's "involving commerce" language should be interpreted broadly, the Court further determined that the FAA applies to all contracts that involve commerce and does not require the contemplation of an interstate commerce connection by the parties. The Court found that a "contemplation of the parties" requirement was inconsistent with the FAA's basic purpose. Such a requirement invited litigation about what was, or was not, contemplated by the parties. Any congressional recognition of an expedited dispute resolution system at the time the FAA was drafted would be undermined by this additional litigation.<sup>28</sup>

Other issues beyond those involving the scope of the FAA have also been addressed by the Supreme Court. For example, in *Southland Corporation v. Keating*, the Court concluded that the FAA preempts state law.<sup>29</sup> The Court maintained that Congress would not have wanted state and federal courts to reach different outcomes about the validity of arbitration in similar cases.<sup>30</sup> Allowing state courts to enforce state statutes that invalidate arbitration agreements would frustrate Congress' intent to place arbitration agreements on the same footing as other contracts.<sup>31</sup>

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<sup>20</sup> See *Foster v. Turley*, 808 F.2d 38 (10<sup>th</sup> Cir. 1986); *Snyder v. Smith*, 736 F.2d 409 (7<sup>th</sup> Cir. 1984).

<sup>21</sup> *Snyder*, 736 F.2d at 418.

<sup>22</sup> *Id.*

<sup>23</sup> 513 U.S. 265 (1995).

<sup>24</sup> *Id.* at 274.

<sup>25</sup> *Id.* (citing H.R. Rep. No 96, 68<sup>th</sup> Cong., 1<sup>st</sup> Sess., 1 (1924)).

<sup>26</sup> *Allied-Bruce*, 513 U.S. at 274 (citing 65 Cong. Rec. 1931 (1924) (remarks of Rep. Graham)).

<sup>27</sup> *Allied-Bruce*, 513 U.S. at 273-74.

<sup>28</sup> *Allied-Bruce*, 513 U.S. at 277.

<sup>29</sup> 465 U.S. 1 (1984).

<sup>30</sup> *Southland*, 465 U.S. at 15-16.

<sup>31</sup> *Id.*

In *Gilmer v. Interstate/Johnson Lane Corp.*, the Court found that a claim arising under the Age Discrimination in Employment Act could be resolved through arbitration.<sup>32</sup> The Court maintained that a statute will continue to serve both its remedial and deterrent functions so long as “the prospective litigant effectively may vindicate [his or her] statutory cause of action in the arbitral forum.”<sup>33</sup>

## Recent Developments

Since 2000, the Court has decided six cases involving the FAA. In *Green Tree Financial Corp. v. Randolph*, the Court concluded that the failure to identify the costs of arbitration in an arbitration agreement does not invalidate such an agreement.<sup>34</sup> The respondent, Larketta Randolph, financed the purchase of a mobile home through Green Tree Financial. Green Tree’s contract required that Randolph purchase insurance to protect the vendor or lienholder against the costs of repossession in the event of default. The contract also stipulated that all disputes, whether arising under case law or statutory law, would be resolved by binding arbitration.

Randolph sued Green Tree for violations of the Truth in Lending Act and the Equal Credit Opportunity Act. She argued that Green Tree failed to disclose the insurance requirement as a finance charge and impermissibly required her to arbitrate her statutory claims. Randolph contended that the arbitration agreement’s failure to disclose related costs and fees created a risk that she would have to bear prohibitive arbitration costs if she pursued her claims in an arbitral forum.<sup>35</sup> This risk forced her to forgo any claims she had against Green Tree and left her unable to vindicate her statutory rights in arbitration.<sup>36</sup>

The Court determined that the prohibitive costs identified by Randolph were too speculative to justify the invalidation of the arbitration agreement. The Court stated that where a party seeks to invalidate an arbitration agreement on the grounds that arbitration would be prohibitively expensive, she bears the burden of showing the likelihood of incurring such costs.<sup>37</sup> Randolph failed to meet this burden. The Court further noted that the party seeking to avoid arbitration must also establish that Congress intended to preclude arbitration of the statutory claims at issue.<sup>38</sup>

In *Circuit City Stores v. Adams*, the Court considered the FAA’s exemption clause in section 1.<sup>39</sup> Adams, a sales counselor at Circuit City, signed an employment application that included an arbitration provision. After filing a state employment discrimination claim against Circuit City, a federal district court found that the FAA compelled Adams to arbitrate his claim.<sup>40</sup> The Ninth Circuit reversed the decision of the district court on appeal. Relying on its decision in another

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<sup>32</sup> 500 U.S. 20 (1991).

<sup>33</sup> *Gilmer*, 500 U.S. at 28 (citing *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 637 (1985)). For additional discussion of *Gilmer*, see CRS Report RL30008, *Labor and Mandatory Arbitration Agreements: Background and Discussion*, by (name redacted) (2001).

<sup>34</sup> 531 U.S. 79 (2000).

<sup>35</sup> *Green Tree*, 531 U.S. at 90.

<sup>36</sup> *Id.*

<sup>37</sup> *Green Tree*, 531 U.S. at 92.

<sup>38</sup> *Id.*

<sup>39</sup> 532 U.S. 105 (2001).

<sup>40</sup> *Id.* at 110.

arbitration case, the Ninth Circuit held that the arbitration agreement was in a “contract of employment” within the exemption clause of section 1, and thus was not subject to the FAA.<sup>41</sup>

The Supreme Court concluded that if all contracts of employment were beyond the scope of the FAA’s coverage, the section 1 exemption for “contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign or interstate commerce” would be pointless.<sup>42</sup> The Court maintained that the section 1 exemption clause should be given a narrow construction. The Court interpreted the exemption to apply to contracts involving seamen, railroad employees, and other types of related transportation employees. A reading of the phrase “any other class of workers engaged in foreign or interstate commerce” to exclude all employment contracts would undermine the FAA’s enumeration of the specific “seamen” and “railroad employees” categories.<sup>43</sup> The Court stated: “there would be no need for Congress to use the phrases “seamen” and “railroad employees” if those same classes of workers were subsumed within the meaning of the ‘engaged in . . . commerce’ residual clause.”<sup>44</sup>

During its 2001-2002 term, the Court decided *EEOC v. Waffle House*, another case involving arbitration and the employment relationship. In *Waffle House*, the Court determined that an arbitration agreement between an employer and an employee did not bar the Equal Employment Opportunity Commission (“EEOC”) from seeking “victim-specific” relief on behalf of the employee.<sup>45</sup> In completing his application for employment with Waffle House, Eric Baker agreed to binding arbitration for any dispute or claim arising out of his employment. Baker suffered a seizure shortly after beginning work at Waffle House and was subsequently discharged. Baker did not initiate arbitration proceedings, but did file a charge of discrimination with the EEOC. Baker alleged that his discharge violated the ADA.

The Fourth Circuit concluded that the EEOC was authorized to bring suit, but could seek only injunctive relief. The court maintained that the federal policy favoring arbitration outweighs the EEOC’s authority to bring suit when it seeks victim-specific relief: “when an employee has signed a mandatory arbitration agreement, the EEOC’s remedies in an enforcement action are limited to injunctive relief.”<sup>46</sup>

The Supreme Court reversed the Fourth Circuit’s decision. The Court maintained that neither the ADA nor Title VII of the Civil Rights Act authorizes the courts to balance the competing policies of the ADA and the FAA.<sup>47</sup> Title VII does, however, authorize the EEOC to bring suit to pursue reinstatement, backpay, and compensatory or punitive damages.<sup>48</sup> Recognizing that the EEOC was not a party to the contract between Waffle House and Baker, the Court concluded that the

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<sup>41</sup> *Id.*

<sup>42</sup> *Circuit City*, 532 U.S. at 113.

<sup>43</sup> *Circuit City*, 532 U.S. at 114.

<sup>44</sup> *Circuit City*, 532 U.S. at 114-15 (“The wording of § 1 calls for the application of the maxim ejusdem generis, the statutory canon that “[w]here general words follow specific words in a statutory enumeration, the general words are construed to embrace only objects similar in nature to those objects enumerated by the preceding specific words.” (citing 2A N. Singer, *Sutherland on Statutes and Statutory Construction* § 47.17 (1991)).

<sup>45</sup> 534 U.S. 279 (2002). Victim-specific relief includes backpay, reinstatement, and damages.

<sup>46</sup> *Waffle House*, 534 U.S. at 285.

<sup>47</sup> *Waffle House*, 534 U.S. at 297. See 42 U.S.C. § 12117(a) (The EEOC shall exercise the same enforcement powers, remedies, and procedures that are set forth in Title VII when it is enforcing the ADA’s prohibitions against employment discrimination based on disability.).

<sup>48</sup> *Waffle House*, 534 U.S. at 287.



EEOC “has the authority to pursue victim-specific relief regardless of the forum that the employer and employee have chosen to resolve their disputes.”<sup>49</sup>

During its 2002-2003 term, the Court decided three cases involving the FAA. In *Howsam v. Dean Witter Reynolds*, the Court concluded that an arbitrator, not a court, should interpret and apply an arbitration rule of the National Association of Securities Dealers (“NASD”).<sup>50</sup> The NASD rule required an arbitration claim to be brought within six years of the occurrence or event that gave rise to the dispute.<sup>51</sup> Dean Witter asked a federal district court to declare that *Howsam*’s claim could not be arbitrated because it was more than six years old.

The Court maintained that procedural questions that arise from a dispute and that bear on its final disposition are to be decided by an arbitrator. In the absence of an agreement to the contrary, questions about time limits, notice, and other conditions precedent to arbitration are for an arbitrator to decide.<sup>52</sup> The Court observed the NASD arbitrators would be comparatively more knowledgeable about the meaning of their own rule, and would be better able to interpret and apply it.<sup>53</sup>

In *Citizens Bank v. Alafabco*, the Court considered whether a debt-restructuring agreement is a “contract evidencing a transaction involving commerce” within the meaning of the FAA.<sup>54</sup> Alafabco, a fabrication and construction company, executed two debt-restructuring agreements with Citizens Bank that required the parties to arbitrate all of their disputes, claims, or controversies. When Alafabco sued Citizens Bank, alleging breach of contract, fraud, and various other causes of action, Citizens Bank moved to compel arbitration in accordance with the agreements. The Alabama Supreme Court concluded that Alafabco’s claims did not have to be arbitrated because there was an insufficient nexus with interstate commerce to require arbitration pursuant to the FAA.<sup>55</sup>

The U.S. Supreme Court reversed the decision of the Alabama Supreme Court. Following its decision in *Allied-Bruce*, the Court maintained that the term “involving commerce” in the FAA should be interpreted broadly to apply to a wide range of transactions within the flow of interstate commerce. The Court articulated three reasons for finding the debt-restructuring agreements to involve commerce for purposes of the FAA. First, Alafabco engaged in business throughout the southeastern U.S. using substantial loans from Citizens Bank. These loans were renegotiated and redocumented in the debt-restructuring agreements. Second, the restructured debt was secured by Alafabco’s assets, including its inventory of goods assembled from out-of-state parts and raw materials. Finally, the Court noted that commercial lending has a broad impact on the national economy and interstate commerce.

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<sup>49</sup> *Waffle House*, 534 U.S. at 295.

<sup>50</sup> 123 S.Ct. 588 (2002).

<sup>51</sup> *Howsam*, 123 S.Ct. at 590.

<sup>52</sup> *Howsam*, 123 S.Ct. at 592.

<sup>53</sup> *Howsam*, 123 S.Ct. at 593.

<sup>54</sup> 123 S.Ct. 2037 (2003).

<sup>55</sup> *Alafabco*, 123 S.Ct. at 2039 (“Because there was no showing ‘that any portion of the restructured debt was actually attributable to interstate transactions; that the funds comprising that debt originated out-of-state; or that the restructured debt was inseparable from any out-of-state projects,’ . . . the court found an insufficient nexus with interstate commerce to establish FAA coverage of the parties’ dispute.”).

Finally, in *Green Tree Financial Corp. v. Bazzle*, the Court considered whether the arbitration clauses in lending contracts executed by Green Tree authorized the use of class arbitration.<sup>56</sup> Although the contracts provided for the arbitration of “[a]ll disputes, claims, or controversies arising from or relating to” the contracts, they were silent as to whether arbitration could proceed in the form of class arbitration.<sup>57</sup> The South Carolina Supreme Court found that when there is such silence, South Carolina law interprets the contracts as permitting class arbitration. The U.S. Supreme Court reviewed the case to determine whether that holding was consistent with the FAA.

The Court declined to automatically accept the South Carolina Supreme Court’s decision. The Court maintained that an arbitrator, rather than a court, should resolve the question of whether the contracts forbid class arbitration.<sup>58</sup> The Court characterized the question of class arbitration as a dispute relating to the contract and requiring contract interpretation by an arbitrator. Because the parties agreed to have an arbitrator resolve such a dispute, a judge should not decide the issue.

## Legislative Action

During the 108<sup>th</sup> Congress, two bills have been introduced to amend the FAA. S. 91, the Fair Contracts for Growers Act of 2003, was introduced by Senator Grassley on January 7, 2003. The Act would address the use of arbitration to resolve livestock or poultry contract disputes. Under the Act, if a livestock or poultry contract provides for the use of arbitration to resolve a dispute under the contract, arbitration could be used only if both parties consent in writing after the dispute arises.<sup>59</sup> The Act would also require the arbitrator to provide the parties with a written explanation of the factual and legal basis for the arbitration award.<sup>60</sup>

H.R. 540, to amend title 9 of the U.S. Code, was introduced on February 5, 2003 by Representative Andrews. H.R. 540 would add a new section to the FAA to allow arbitration related to an employment dispute only if arbitration is agreed to after the dispute arises. An employer could not require an employee to arbitrate a dispute as a condition of employment.

## Author Contact Information

(name redacted)  
Legislative Attorney  
[redacted]@crs.loc.gov , 7-....

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<sup>56</sup> 123 S.Ct. 2402 (2003).

<sup>57</sup> *Bazzle*, 123 S.Ct. at 2405.

<sup>58</sup> *Bazzle*, 123 S.Ct. at 2407.

<sup>59</sup> S. 91, 108<sup>th</sup> Cong. § 2(a) (2003).

<sup>60</sup> *Id.*

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