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## Punitive Damages Under the Federal Arbitration Act: Have Arbitrators' Remedial Powers Been Circumscribed by State Law?

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# PUNITIVE DAMAGES UNDER THE FEDERAL ARBITRATION ACT: HAVE ARBITRATORS' REMEDIAL POWERS BEEN CIRCUMSCRIBED BY STATE LAW?

Congress enacted the Federal Arbitration Act<sup>1</sup> ("FAA") in 1925 to ensure that arbitration agreements would be given the same legal effect as other contracts.<sup>2</sup> The FAA was designed to overcome the great reluctance on the part of the courts to enforce these agreements, and to promote arbitration.<sup>3</sup> To advance

<sup>1</sup> 9 U.S.C. §§ 1-14 (1988). Section 2 of the FAA makes arbitration agreements as enforceable as other contractual provisions:

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 . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

*Id.* § 2. Section 3 provides for a stay of court proceedings pending arbitration, and Section 4 allows a court to issue an order compelling arbitration. *Id.* §§ 3, 4: see *infra* note 9 (discussing sections 3 and 4 of FAA). Section 10 of the FAA provides specific instances where an arbitrator's award may be vacated by a district court. 9 U.S.C. § 10; *infra* note 10 (quoting section 10 of FAA).

<sup>2</sup> See *Gilmer v. Interstate/Johnson Lane Corp.*, 111 S. Ct. 1647, 1651 (1991) (FAA enacted to put arbitration agreements "upon the same footing" as other legal contracts); *Volt Information Sciences, Inc. v. Board of Trustees of the Leland Stanford Junior Univ.*, 489 U.S. 468, 474 (1989) (FAA created "'to overrule the judiciary's longstanding refusal to enforce agreements to arbitrate'" (quoting *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 219-20 (1985)) and to "'place such agreements upon the same footing as other contracts'" (quoting *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 511 (1974) (quoting H.R. REP. NO. 96, 68th Cong., 1st Sess. 1, 2 (1924))); *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 404 n.12 (1967) (same); see also MARTINE DOMKE, *COMMERCIAL ARBITRATION* § 4:03 (1990) (FAA provides that arbitration agreements shall be enforceable to same extent as other contracts); Barbara Ann Atwood, *Issues in Federal-State Relations Under the Federal Arbitration Act*, 37 U. FLA. L. REV. 61, 66 (1985) (same).

<sup>3</sup> See *Southland Corp. v. Keating*, 465 U.S. 1, 13 (1984). Congress faced two problems when enacting the FAA: the hostility of courts toward arbitration and the failure of state legislatures to mandate enforcement of arbitration agreements. *Id.*; *Gilmer*, 111 S. Ct. at 1651. The purpose of the FAA was to reverse the longstanding trend of judicial hostility that the American courts adopted from the English common law. See S. REP. NO. 536, 68th Cong., 1st Sess. 2-3 (1924) [hereinafter SENATE REPORT]; H.R. REP. NO. 96, 68th Cong., 1st Sess. 1-2 (1924) [hereinafter HOUSE REPORT]; *Joint Hearings on S.1005 and H.R. 646 Before the Subcomm. of the Committees on the Judiciary*, 68th Cong., 1st Sess. 14-15 (1924) [hereinafter *Joint Hearings*] (remarks of Julius Cohen). The Senate Report cited as a reason for the hostility to arbitration enforcement, "[t]he courts' jealousy of their rights as courts, coupled with the fear that if arbitration agreements were to prevail and be enforced, the courts would be ousted of much of their jurisdiction." SENATE REPORT, *supra*, at 2-3; see also DOMKE, *supra* note 2, § 3:01 (stating reason for courts' reluctance to enforce arbitration agreements); Douglas M. Fox, *Preemption Under the Federal Arbitration Act*, 15 U. BALT.

these goals courts have restricted judicial review of arbitration awards.<sup>4</sup> Because the FAA was not endowed with an independent basis of jurisdiction, parties who want to compel arbitration under the FAA in federal court must rely upon diversity of citizenship.<sup>5</sup> When diversity jurisdiction is invoked, courts must generally apply state substantive law.<sup>6</sup> However, courts have interpreted the FAA as creating a body of federal substantive law which may therefore preempt conflicting state law.<sup>7</sup> Recently, a split in the circuits has developed concerning the preemptability of state law provisions which prohibit an arbitrator's award of punitive damages.<sup>8</sup>

L. REV. 129, 130 (1985-86) (majority of courts at common law refused to enforce arbitration agreements because of jealousy and quest for prestige); Linda R. Hirshman, *The Second Arbitration Trilogy: The Federalization of Arbitration Law*, 71 VA. L. REV. 1305, 1310 (1985) (courts refused to recognize arbitration agreements as legally binding obligations).

<sup>4</sup> See *infra* text accompanying notes 19-28 (Supreme Court's broad interpretation of FAA).

<sup>5</sup> See *infra* note 13 and accompanying text (FAA's basis of jurisdiction).

<sup>6</sup> See *infra* notes 10-12 and accompanying text (narrow review of arbitration awards).

<sup>7</sup> See discussion *infra* part II (discussing preemption of state procedural and substantive law).

<sup>8</sup> See discussion *infra* parts II, III (discussing relevant circuit court decisions on issue of preemption of state substantive law which prohibited awards of punitive damages).

For the first notable use of punitive damages in America, see *Coryell v. Colbaugh*, 1 N.J. 77, 79 (1791) (awarding punitive damages for breach of promise to marry "for examples sake"). Since the first application of punitive damages by American courts, the guidelines under which such damages have been imposed vary from jurisdiction to jurisdiction. See, e.g., *Northwestern Nat'l Casualty Co. v. McNulty*, 307 F.2d 432, 443 (5th Cir. 1962) (Gewin, J., concurring). "The term [punitive damages] is too loose, vague, indefinite, and uncertain; and its meaning often varies from state to state, court to court, and jury to jury. It is a chameleon of the law—changing its hue to the color of the situation on which it may be used." *Id.*: see also John D. Long, *Punitive Damages: An Unsettled Doctrine*, 25 DRAKE L. REV. 870, 879, 881 (1976) (giving examples of various states' conduct requirements ranging from "oppression, fraud, or malice" to "mere caprice").

Subsequent case history in the United States has delineated four basic motives in granting such an award. The first motive is to deter the wrongdoer and to punish outrageous conduct. See *City of Newport v. Fact Concerts, Inc.*, 453 U.S. 247, 266 (1981) (goal is to punish tortfeasor and deter others from similar conduct); *International Bhd. of Elec. Workers v. Foust*, 442 U.S. 42, 48 (1979) (same); *Gertz v. Robert Welch, Inc.*, 418 U.S. 323, 350 (1974) (punitive damages "are private fines levied by civil juries to punish reprehensible conduct and to deter its future occurrence"); see also RESTATEMENT (SECOND) OF TORTS § 908 (1) (1965). "Punitive damages are damages, other than compensatory or nominal damages, awarded against a person to punish him for his outrageous conduct and to deter him and others like him from similar conduct in the future." *Id.*

Other courts cite public justice as a motive. See Philip H. Corboy, *Should Punitive Damages Be Abolished? A Statement for the Negative*, A.B.A. SEC. ON INS. NEG. & COMP. LAW 292, 294 (1965):

Oftentimes an aggrieved person cannot be adequately recompensed unless the outrage of the wrongdoer's action and the embarrassment or mental anguish or loss of face to the plaintiff are the foremost measures of damages. Without the prospect of

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Part One of this Note will review the historical background, jurisdiction, and scope of the FAA. Part Two will examine the Supreme Court's approach in evaluating the applicability of a state procedural provision in arbitration. It will then analyze two recent decisions which addressed the preemptability of a state substantive provision with regard to an arbitrator's ability to award punitive damages, and suggest that they fail to provide any certainty in making such a determination. Finally, this Note will propose an approach that courts may find useful when interpreting whether an arbitration agreement permits an award of punitive damages.

### I. SCOPE OF THE FAA

#### A. Background

The FAA was enacted to give arbitration agreements the same legal effect as other contractual provisions.<sup>9</sup> When an award is

an award of damages measured in other than actual monetary loss or special damage, there is small incentive for a plaintiff to invoke the law or force the wrongdoer to make formal reparation in civil damages for his actions.

*Id.*: see also Melvin M. Belli, *Punitive Damages: Their History, Their Use, and Their Worth in Present-Day Society*, 49 UMKC L. REV. 1, 5-6 (1980) (punitive damages may serve public justice).

A third motive cited by courts is compensation. See, e.g., *Gagne v. Town of Enfield*, 734 F.2d 902, 905 (2d Cir. 1984) (considering victim's attorney's fees element of punitive damages award). See generally Long, *supra*, at 870 (compensatory rationale for punitive damages).

Finally, some courts have cited revenge as a motive. See, e.g., *Roginsky v. Richardson-Morrell, Inc.*, 378 F.2d 832, 838 (2d Cir. 1967) (diverting plaintiff's desire for revenge into peaceful channels was one of several rationales underlying punitive damages award).

Most American courts have demanded the necessary state of mind and actual or compensatory damages as prerequisites to any award of punitive damages. *Kendall Yacht Corp. v. United Cal. Bank*, 50 Cal. App. 3d 949, 958 (1975) (punitive damages available where defendant has acted with oppression, fraud, or malice—express or implied); *Collens v. New Canaan Water Co.*, 234 A.2d 825, 832 (Conn. 1967) (conscious disregard for safety of others was necessary for punitive damages award); *Engman v. Southwestern Bell Tel. Co.*, 591 S.W.2d 78, 82 (Mo. Ct. App. 1979) (punitive damages available when defendant knowingly committed wrongful act without just cause or excuse); *Borkowski v. Borkowski*, 39 N.Y.2d 982, 983, 355 N.E.2d 287, 287, 387 N.Y.S.2d 233, 233 (1976) (prerequisite for punitive damage award was gross, wanton, or willful fraud or other morally culpable conduct to degree sufficient to justify such award).

<sup>9</sup> See 9 U.S.C. § 2 (1988). Section 2 of the FAA provides that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity from the revocation of any contract." *Id.* The 'savings clause' of Section 2 indicates that "the purpose of Congress in 1925 was to make arbitration agreements as enforceable as other contracts, but not more so." *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 404 n.12 (1967): see also *Perry v. Thomas*, 482 U.S. 483, 489 (1987) (FAA re-

granted by an arbitrator, a court may not set it aside unless it can be shown that the award involved fraud, corruption, undue means, or that the arbitrator exceeded his power under the arbitration agreement.<sup>10</sup> Courts have construed these factors nar-

quires arbitration if agreement to arbitrate is part of contract evidencing interstate commerce, or if agreement is revocable upon such grounds as exist at law or equity for revocation of any contract); *Southland Corp. v. Keating*, 465 U.S. 1, 2 (1984) (Congress declared national policy favoring arbitration and withdrew power of states to resolve arbitration agreements by making arbitration agreements valid and irrevocable); *Seymour v. Gloria Jean's Coffee Bean Franchising Corp.*, 732 F. Supp. 988, 991-92 (D. Minn. 1990) (FAA intended to address traditional hostility of courts at common law towards arbitration as well as remedy failure of state arbitration statutes to mandate enforcement of arbitration agreements); *supra* notes 1 & 3 and accompanying text (discussing courts' hostility toward arbitration agreements and Congress's response via FAA).

A party may challenge or seek enforcement of an arbitration award by a motion in district court to stay litigation pending arbitration or to compel arbitration pursuant to sections 3 and 4 respectively. 9 U.S.C. §§ 3, 4; see *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 22 (1983) ("The Act provides two parallel devices for enforcing an arbitration agreement: a stay of litigation in any case raising a dispute referable to arbitration, . . . and an affirmative order to engage in arbitration." (citations omitted)); see also *Campeau Corp. v. May Dep't. Stores Co.*, 723 F. Supp. 224, 226-27 (S.D.N.Y. 1989) (under FAA, stay pending arbitration is mandatory if it is shown that suit was commenced on issue referable to arbitration under written agreement); *Merrill Lynch, Inc. v. Melamed*, 405 So. 2d 790, 793 (Fla. Dist. Ct. App. 1981) (state courts required to stay judicial proceedings upon showing that disputes are subject to valid and enforceable arbitration agreements). See generally *Zhaodong Jaing, Federal Arbitration Law and State Court Proceedings*, 23 *Loy. L.A. L. Rev.* 473, 502-18 (1991) (discussing sections 3 and 4 of Act); *Arthur S. Feldman, Note, Volt Info. Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.: Confusing Federalism with Federal Policy Under the FAA*, 69 *Tex. L. Rev.* 691, 694 (1990) (same).

For sources discussing section 4 of the FAA, see *Moses*, 460 U.S. at 22 n.27 (explaining section 4 of FAA); *Avant Petroleum, Inc. v. Pecten Arabian Ltd.*, 696 F. Supp. 42, 44 (S.D.N.Y. 1988) (to compel arbitration, court must determine whether controversy is covered by written arbitration agreement and petitioner is aggrieved by respondent's failure, neglect, or refusal to arbitrate). See generally 9 U.S.C. § 4; *Jaing, supra*, at 502-18 (discussing section 4 of FAA); *Feldman, supra*, at 694 (same).

<sup>10</sup> See 9 U.S.C. § 10(d). Section 10 of the FAA provides that judicial review of an arbitration award is limited to four possible situations:

- (a) Where the award was procured by corruption, fraud, or undue means.
- (b) Where there was evident partiality or corruption in the arbitrators, or either of them.
- (c) Where the arbitrators were guilty of misconduct . . . by which the rights of any party have been prejudiced.
- (d) Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.
- (e) Where an award is vacated and the time within which the agreement required the award to be made has not expired the court may, in its discretion, direct a rehearing by the arbitrators.

*Id.*

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rowly,<sup>11</sup> and have required a showing that the arbitration award was procured with a “manifest disregard for the law.”<sup>12</sup>

### *B. Jurisdictional Basis*

Since Congress did not foresee the need to create an independent basis of federal jurisdiction within the FAA, actions to enforce arbitration agreements rely upon diversity of citizenship for jurisdiction.<sup>13</sup> The landmark case of *Erie Railroad v. Tompkins*<sup>14</sup>

<sup>11</sup> See *Van Waters & Rogers Inc. v. International Bhd. of Teamsters, Local Union 70*, 913 F.2d 736, 739 (9th Cir. 1990). A reviewing court may not overturn an arbitrator's decision merely because it disagrees with the arbitrator's factual findings, contract interpretation, or choice of remedies. *Id.* As long as the arbitrator is acting within the scope of his authority, the award must be upheld. *Id.*; see also *Office of Supply, Gov't of Republic of Korea v. New York Navigation Co.*, 469 F.2d 377, 379-80 (2d Cir. 1972) (review of arbitrator's award restricted in order to promote prompt and inexpensive resolution of disputes); *Saxis S.S. Co. v. Multifacs Int'l Traders, Inc.*, 375 F.2d 577, 581-82 (2d Cir. 1967) (role of courts limited to ascertaining whether there are specific grounds for vacation of award as provided in section 10 of FAA); *Zeigler Coal Co. v. District 12, United Mine Workers of America*, 484 F. Supp. 445, 446-47 (C.D. Ill. 1980) (power to vacate arbitrator's award severely restricted by FAA and by policy favoring resolution of grievances through arbitration where parties have agreed to arbitrate); *Shahmoon Indus., Inc. v. United Steelworkers of America*, 263 F. Supp. 10, 13-14 (D.N.J. 1966) (only where arbitrator clearly goes beyond scope of grievance submitted will courts interfere); *Local Union 560, I.B.T. v. Fazor Exp. Inc.*, 230 A.2d 521, 525 (N.J. Super. Ct. 1967) (review of arbitration awards extremely narrow).

<sup>12</sup> See *Carte Blanche Int'l, Ltd.*, 888 F.2d 260, 262 (2d Cir. 1989) (“manifest disregard of the law” by arbitrators is judicially created ground for vacating arbitration awards, implying that arbitrator appreciates existence of clearly governing legal principle but decides to ignore or pay no attention to it); *Dundas Shipping & Trading Co. v. Stravelakis Bros., Ltd.*, 508 F. Supp. 1000, 1003-04 (S.D.N.Y. 1981) (court's power to vacate arbitrators' awards is confined to grounds specified in FAA, and when award is in manifest disregard of law); *Marshall v. Coach House Restaurant, Inc.*, 457 F. Supp. 946, 952-52 (S.D.N.Y. 1978) (may vacate an award based on manifest disregard).

<sup>13</sup> See *Huffco Petroleum Corp. v. Transcontinental Gas Pipe Line Corp.*, 681 F. Supp. 400, 401 (S.D. Tex. 1988) (no independent source of federal question subject matter jurisdiction under FAA); *Hamilton Life Ins. Co. of N.Y. v. Republican Nat'l Life Ins. Co.*, 291 F. Supp. 225, 232-33 (S.D.N.Y. 1968) (FAA does not create independent basis for federal jurisdiction: diversity of citizenship or federal question is required for federal jurisdiction), *aff'd*, 408 F.2d 606 (2d Cir. 1969); *Local 1416, Int'l Ass'n of Machinists v. Jostens, Inc.*, 250 F. Supp. 496, 499 (D. Minn. 1966) (FAA does not furnish independent basis for federal jurisdiction).

At the time of its enactment, the FAA was considered to govern in federal cases based on the view that Congress could create a “general federal common law.” *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 405 n.13 (1967); see *Feldman, supra* note 9, at 693-94. In *Swift v. Tyson*, the Supreme Court ruled that the “laws of the several states” did not include state judicial decisions, thus allowing federal courts to create general federal common law for issues not governed by state statutes. 41 U.S. 1, 1 (1842), *overruled by Erie Railroad v. Tompkins*, 304 U.S. 64 (1938), *reh'g denied*, 305 U.S. 673 (1938).

held that state substantive law must be applied in federal diversity actions.<sup>15</sup> Subsequently, in *Bernhardt v. Polygraphic Co. of America*,<sup>16</sup> the Court held that enforcement of arbitration agreements was a matter of substantive law.<sup>17</sup> Thus, the FAA's enforcement provisions were seriously jeopardized.<sup>18</sup>

<sup>14</sup> 304 U.S. 64 (1938).

<sup>15</sup> *Id.* at 73, 78-80. The Court based its decision on its finding that federal courts under *Swift v. Tyson* had unconstitutionally usurped rights belonging to the states. *Id.*: see *Joint Hearings, supra* note 1, at 27. The FAA temporarily avoided the *Erie* challenge since, at the time of its adoption, the FAA was viewed as procedural in nature. *Id.*: Committee on Commerce, Trade and Commercial Law, *The United States Arbitration Law and its Application*, A.B.A. J., March 1925, at 153, 156. A month after the FAA's enactment the A.B.A. drafters wrote: "The statute establishes a procedure in the Federal Courts for the enforcement of arbitration agreements . . . . A Federal statute providing for the enforcement of arbitration agreements does relate solely to procedure in the Federal courts." *Id.*: see also *Southland Corp. v. Keating*, 465 U.S. 1, 25-28 (1984) (O'Connor, J., dissenting) (legislative history clearly shows Congress in 1925 viewed FAA as procedural); Julius Henry Cohen & Kenneth Dayton, *The New Federal Arbitration Law*, 12 VA. L. REV. 265, 275-276 (1926). The *Erie* Court held that federal courts in diversity cases had to apply the substantive law of the forum state, but federal procedural law should be used as long as it did not significantly effect the outcome of the litigation. *Id.*

<sup>16</sup> 350 U.S. 198 (1956).

<sup>17</sup> *Id.* at 203.

<sup>18</sup> See, e.g., *Prima Paint Corp. v. Flood & Conklin*, 388 U.S. 395, 403 (1967). "[W]ith respect to a matter within the jurisdiction of the federal courts save for the existence of an arbitration clause, the federal court is instructed to order arbitration to proceed once it is satisfied 'that the making of the agreement for arbitration or the failure to comply [with the arbitration agreement] is not in issue.'" *Id.* Since Congress enacted the FAA under the view that it could create "general federal common law," it did not specify whether it was acting under the authority to devise procedures for federal courts or to regulate interstate commerce and the admiralty field. See *infra* note 21 and accompanying text (discussing these two bases of authority in FAA). The power to regulate interstate and foreign commerce and to legislate in the admiralty and maritime fields is suggested in section 2 of the FAA, which provides that a "written provision in any *maritime* transaction or contract . . . involving commerce . . . shall be valid, irrevocable and enforceable." 9 U.S.C. § 2 (1988) (emphasis added). Commerce power is granted under Article I, Section 8, of the Constitution. U.S. CONST. art. I, § 8, cl. 3. Article III grants the courts federal jurisdiction over admiralty and maritime cases. U.S. CONST. art. III, § 2.

The power to establish procedures for lower federal courts is suggested in section 4 of the FAA. Section 4, authorizing the issuance of an order to compel arbitration, applies by its terms only to "any United States district court." 9 U.S.C. § 4 (1988). Congress's power over federal court procedure derives from the power to establish the lower federal courts. U.S. CONST. art. I, § 8, art. III, § 1.

The *Bernhardt* decision eventually forced the Court to decide which basis of authority it was acting under when it adopted the FAA. See *infra* notes 20-26 and accompanying text (discussing how FAA is product of congressional intent to regulate maritime and interstate commerce). Ten years after *Bernhardt*, the Court stated that Congress's reliance on the "'oft challenged' . . . [power to create] 'general law,' . . . was only supplementary to the admiralty and commerce powers, which formed the principal bases of the legislation." *Prima Paint*, 388 U.S. at 405 n.13 (quoting *Erie*, 304 U.S. at 69).

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In *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*,<sup>19</sup> the Supreme Court once again examined the jurisdiction of the FAA. After careful review of the legislative history of the FAA,<sup>20</sup> the Court determined that the FAA was a product of Congress's power to regulate maritime and interstate commerce,<sup>21</sup> and upheld the FAA's substantive role in federal diversity actions involving arbitration.<sup>22</sup> Fueled by the injection of Commerce Clause

<sup>19</sup> 388 U.S. 395 (1967).

<sup>20</sup> *Id.* at 405 n.13. The Court noted that one of the bill's sponsors in the House told his colleagues that it "only affects contracts relating to interstate subjects and contracts in admiralty." *Id.* (quoting 65 CONG. REC. 1931 (1924)). The Senate Report on this legislation similarly indicated that "the bill [related] to maritime transactions and to contracts in interstate and foreign commerce." *Id.* (quoting SENATE REPORT, *supra* note 3, at 3).

<sup>21</sup> *Prima Paint*, 388 U.S. at 405. The Supreme Court stated that the question was not whether Congress could create federal substantive rules to govern in diversity cases, but "whether Congress [could] prescribe how federal courts are to conduct themselves with respect to subject matter over which Congress plainly has power to legislate". *Id.* The Court then stated that "it 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.'" *Id.* (quoting HOUSE REPORT, *supra* note 3, at 1). Thus, the FAA was not merely a procedural device for the lower courts. *Id.* at 405; see *supra* note 15 (discussing FAA as procedural mechanism).

<sup>22</sup> See *Prima Paint*, 388 U.S. at 406. The Court noted that "[f]ederal courts [were] bound to apply rules enacted by Congress with respect to matters—here, a contract involving commerce—over which it has legislative power." *Id.* However, once the Supreme Court gave the FAA its national scope in *Prima Paint*, many states attempted to evade its ever-broadening scope by limiting arbitration to particular types of claims while reserving others for judicial resolution. See, e.g., *Collins Radio Co. v. Ex-Cell-O Corp.*, 467 F.2d 995, 997, 999 (8th Cir. 1972) (refusing to enforce Texas law which required advice and signature of lawyer before agreement to arbitrate was valid); *Wydel Assocs. v. Thermasol, Ltd.*, 452 F. Supp. 739, 741-42 (W.D. Tex. 1978) (FAA applied and preempted state law which stated that arbitration agreements were effective only when all members of partnership agreed).

Some state laws were hostile to arbitration agreements. For instance, a recently repealed Texas arbitration statute rendered any contract voidable at will if it failed to feature the arbitration agreement itself in capital letters. See Act of June 13, 1979, 66th Leg., R.S., ch. 704, § 2, 1979 TEX. GEN. LAWS 1708, *repealed by* Act of June 18, 1987, 70th Leg., R.S., ch. 817, 1987 TEX. GEN. LAWS 2828 (effective Aug. 31, 1987).

Some state courts devised common-law doctrines making enforcement difficult, creating rules which required judicial resolution of all charges of fraud. See, e.g., *George Engine Co. v. Southern Shipbuilding Corp.*, 350 So. 2d 881, 884 (La. 1977) ("The arbitration law and arbitration clauses in contracts do not vest in arbitrators the historic jurisdiction of the courts to determine fraud . . ."); *West Fargo Pub. Sch. Dist. No. 6 v. West Fargo Educ. Ass'n*, 259 N.W.2d 612, 616 (N.D. 1977) (absent fraud or deception, agreement to submit certain disputes to binding arbitration is valid).

More specifically, some states exempt claims for punitive damages from arbitration. *Garity v. Lyle Stuart, Inc.*, 40 N.Y.2d 354, 356, 353 N.E.2d 793, 795, 386 N.Y.S.2d 831, 833 (1976) (state law prohibits arbitrators from awarding punitive damages). For other examples of states that exempt certain claims from arbitration or place limits on arbitration, see e.g., *Litton RCS, Inc. v. Pennsylvania Turnpike Comm'n*, 376 F. Supp. 579, 588 (E.D. Pa. 1974) (limiting state's authority to prohibit public instrumentality from entering into arbi-



power into the FAA, the Court decided *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*,<sup>23</sup> which provided a rule of construction: any doubt as to whether parties to a contract intended to include or exclude matters that were potentially arbitrable was to be resolved in favor of arbitration.<sup>24</sup>

The broad scope of the FAA was confirmed in *Southland Corp. v. Keating*,<sup>25</sup> where the Supreme Court held that the FAA was a body of federal substantive law which must be applied in both state and federal courts.<sup>26</sup> After *Southland* it was clear that state

tration agreement).

In federal causes of action, the Supreme Court has deemed most claims arbitrable under the FAA as a response to the many attempts by litigants to avoid arbitration. *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 485 (1989) (alleged violations of both the Securities Act of 1933 and Securities Exchange Act of 1934 were arbitrable under FAA); *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 234, 242 (1987) (claims under RICO and Securities Exchange Act of 1934 were arbitrable under FAA). In addition, the Supreme Court considers the FAA to "mandate[ ] enforcement of agreements to arbitrate statutory claims" absent an explicit federal prohibition against the claim at issue. *McMahon*, 482 U.S. at 226.

<sup>23</sup> 460 U.S. 1 (1983).

<sup>24</sup> *Id.* at 24. The Court cited the "liberal federal policy favoring arbitration agreements." *Id.* Many appellate courts, prior to *Moses H. Cone*, had already begun to base their decisions on the broad policy favoring arbitration expressed in the *Prima Paint* decision. *Id.*: see, e.g., *Wick v. Atlantic Marine*, 605 F.2d 166, 168 & n.4 (5th Cir. 1979) (noting that court should stay proceedings for arbitrable claims); *Hanes Corp. v. Millard*, 531 F.2d 585, 598 (D.C. Cir. 1976) (favoring arbitration of disputes on failure of amicable settlements); *Controlled Sanitation Corp. v. District 128 of Int'l Ass'n of Machinists & Aerospace Workers*, 524 F.2d 1324, 1328 (3d Cir. 1975) (ruling damage claim susceptible to arbitration), *cert. denied*, 424 U.S. 915 (1976); *Avecedo Maldonado v. PPG Indus.*, 514 F.2d 614, 616 (1st Cir. 1975) (describing coverage of broad arbitration language in contract); *Hirshman*, *supra* note 3, at 1331 & n.149 (citing *Dickinson v. Heinhold Sec., Inc.*, 661 F.2d 638, 643 (7th Cir. 1981)).

The *Moses H. Cone* Court noted several issues it viewed as arbitrable: "construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability." 460 U.S. at 25.

<sup>25</sup> 465 U.S. 1 (1984).

<sup>26</sup> *Id.* at 12. Arbitration is a question of substantive federal law applicable in state and federal courts. *Id.* The *Southland* Court relied largely upon legislative history to support its conclusion that Congress intended the FAA to apply to both state and federal courts. *Id.* at 13-14. The Court specifically quoted H.R. Rep. No. 96, which suggested that "[t]he purpose of this bill is to make valid and enforceable [sic] agreements for arbitration contained in contracts involving interstate commerce or within the jurisdiction or [sic] admiralty, or which may be the subject of litigation in the Federal courts." *Id.* at 12, 13 (quoting HOUSE REPORT, *supra* note 3, at 1); see also *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 219 (1985) (legislative history established that purpose behind FAA was to ensure enforcement of agreements to arbitrate). Thus, the *Southland* Court held that the FAA was "based upon . . . the incontestable federal foundations of 'control over interstate commerce and over admiralty.'" *Southland*, 465 U.S. at 11 (quoting *Prima Paint*, 388 U.S. at 405 (quoting HOUSE REPORT, *supra* note 3, at 1)).

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laws which conflicted with the FAA would be preempted.<sup>27</sup>

### II. PREEMPTION

#### A. *Preemption of State Procedural Provisions: Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University*

Although it recognized the broad preemptive power accorded the FAA, the Supreme Court seemed to refine its scope in *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University*.<sup>28</sup> *Volt Information Sciences, Inc.* (“Volt”) and Stan-

The *Southland* Court also stated that Congress, in enacting the FAA, wanted to overcome the reluctance of state courts to enforce arbitration agreements. *Southland*, 465 U.S. at 13; see *supra* notes 2 & 3 (discussing judicial hostility towards arbitration and Congress's purpose in enacting FAA). The Court further concluded that “[i]n creating a substantive rule applicable in state as well as federal courts, Congress intended to foreclose state legislative attempts to undercut the enforceability of arbitration agreements.” *Southland*, 465 U.S. at 16 (footnotes omitted).

In her dissent, Justice O’ Connor stated that *Southland* was the first case in which the Court had the opportunity to determine whether the FAA applied to state court proceedings. *Id.* at 24. She maintained that the statement in *Moses H. Cone*, which said the FAA was applicable in state courts, was merely dicta since the case involved a federal, not state, proceeding. *Id.*

<sup>27</sup> See *Perry v. Thomas*, 482 U.S. 483, 489-90 (1987). The preemptive scope accorded the FAA in *Southland* was reinforced by the Supreme Court’s decision in *Perry*, which quoted *Southland* extensively in supporting its determination. *Id.* at 489-90. The Court added to the *Southland* decision by outlining the proper approach to normative state law under the FAA. *Id.* at 492 n.9. It noted that “state law, whether of legislative or judicial origin, is applicable if that law arose to govern issues concerning the validity, revocability, and enforceability of contracts generally.” *Id.* However, the Court stated that “[a] state-law principle that takes its meaning precisely from the fact that a contract to arbitrate is at issue does not comport with [the Savings Clause] requirement of section 2.” *Id.* The Court further explained that “[a] court may not construe an arbitration agreement in a manner different from that in which it otherwise construes nonarbitration agreements under state law.” *Id.* But see Barbara Ann Atwood, *Issues in Federal-State Relations Under the Federal Arbitration Act*, 37 U. FLA. L. REV. 61, 83-89 (1985) (criticizing *Southland*’s approach to issue of preemption).

<sup>28</sup> 489 U.S. 468 (1989). Prior to *Volt*, a number of cases involving an arbitrator’s award of punitive damages echoed the “substantive” effect the FAA had in preventing state law from quashing such an award. See, e.g., *Willis v. Shearson/American Express, Inc.*, 569 F. Supp. 821, 824-25 (M.D.N.C. 1983). The United States District Court for the Middle District of North Carolina granted a brokerage firm’s motion to stay court proceedings pending arbitration of a customer’s claims of fraud and breach of fiduciary duty. *Id.* at 825. The court held that since the parties’ contract evidenced a transaction in interstate commerce, section 3 of the FAA compelled a stay of the court action. *Id.* at 823. Additionally, the court discounted the customer’s claim that the contract’s New York choice-of-law provision would negate the chances of recovering punitive damages if the contract were subject to arbitration: “If an issue is arbitrable under federal law, it remains so despite contrary state

ford Junior University ("Stanford") entered into a contract which provided that all disputes arising out of, or relating to, the contract or its breach would be arbitrated.<sup>29</sup> The parties also agreed to a choice-of-law provision which stated that the contract would be "governed by the law of the place where the project is located."<sup>30</sup>

After a dispute arose during the performance of the contract, Volt made a demand for arbitration.<sup>31</sup> Stanford sought indemnity from third parties,<sup>32</sup> and made a motion to stay arbitration pursuant to Section 1281.2(c) of California's Code of Civil Procedure.<sup>33</sup> According to the California rule, a court could stay arbitration pending resolution of a dispute between a party to an arbitration agreement and a third party, if there were "a possibility of con-

law." *Id.* at 824. The court further noted that "[t]he broad arbitration provision includes claims for punitive damages. Hence, the parties by their contract have authorized any arbitrator who may hear this matter to award punitive damages." *Id.* Under New York state substantive law, an arbitrator is not permitted to award punitive damages. *Garrity v. Lyle Stuart*, 40 N.Y.2d 354, 355, 353 N.E.2d 793, 794, 386 N.Y.S.2d 831, 832 (1976).

The Eleventh Circuit reiterated the *Willis* court's expansive application of the FAA, and extended it to permit an arbitrator's award of punitive damages where the contract itself had not expressly included such an award. *Willoughby v. Kajima Int'l*, 776 F.2d 269, 270 (11th Cir. 1985). The lower court had stated: "When the extremely broad arbitration clause is read in light of the equally broad grant of remedial power in Rule 43 [of the AAA], it is clear that the parties by the contract have authorized the arbitrators to award punitive damages." *Willoughby*, 598 F. Supp. 353, 357 (N.D. Ala. 1984). Where the arbitration clause incorporated provisions of the American Arbitration Association ("AAA"), which permits an arbitrator to grant any remedy that is just and equitable, strong federal policy authorized an award of punitive damages. *Id.* at 355; see AMERICAN ARBITRATION ASSOC. R. 43 (providing for arbitration panel's award of "any remedy or relief which is just and equitable and within terms of the agreements of the parties.").

The decision in *Willoughby* was later affirmed by the Eleventh Circuit in *Bonar v. Dean Witter Reynolds*, which held that a choice-of-law provision in a contract governed by the FAA merely designated the substantive law which arbitrators must apply in deciding whether the conduct in issue merited an award of punitive damages; it did not deprive the arbitrators of their authority to award punitive damages. 835 F.2d 1378, 1387 (11th Cir. 1988). As such, a New York choice-of-law provision which raised the specter of the *Garrity* rule did not deprive the arbitrators of their power to award punitive damages. *Id.*

The United States District Court for the Southern District of Florida similarly held that the FAA evinced a desire to create a national policy favoring arbitration of punitive damages claims, regardless of a New York choice-of-law provision. *Singer v. E.F. Hutton & Co.*, 699 F. Supp. 276, 279 (S.D. Fla. 1988).

<sup>29</sup> *Volt*, 489 U.S. at 470.

<sup>30</sup> *Id.*

<sup>31</sup> *Id.* at 471.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

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flicting rulings on a common rule of law or fact.”<sup>34</sup>

The Superior Court denied Volt’s motion to compel arbitration.<sup>35</sup> On appeal, the California Court of Appeals affirmed,<sup>36</sup> noting that although the FAA governed the parties’ contract, it did not contain a provision similar to the California provision.<sup>37</sup> The court held that the provision which stated that arbitration would be governed by “the place where the project is located” was intended by the parties to incorporate local arbitration rules. In construing this provision, the court rejected any arguments of preemption by the FAA.<sup>38</sup> Although the California Supreme Court denied Volt’s petition for discretionary review,<sup>39</sup> the United States Supreme Court granted certiorari to resolve the issue pursuant to its appellate jurisdiction.<sup>40</sup>

Writing for the majority, Chief Justice Rehnquist held that the FAA did not preempt the California procedural law.<sup>41</sup> The Court recognized that in applying state-law principles of contract interpretation to an arbitration agreement, due regard must be given to the federal policy favoring arbitration.<sup>42</sup> Nonetheless, the Court held that the FAA did not seek to enforce arbitration under all circumstances.<sup>43</sup> Noting additionally that the FAA did not contain an express preemptive provision nor did it indicate any congressional intent to occupy the entire field,<sup>44</sup> the Court upheld application of the California procedural rule stating, “we give effect to the contractual rights and expectations of the parties

<sup>34</sup> *Volt*, 498 U.S. at 471 n.3 (quoting CAL. CIV. PROC. CODE § 1281.2(c) (West 1982)).

<sup>35</sup> *Id.* at 471.

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

<sup>37</sup> *Id.* at 471-72.

<sup>38</sup> *Id.* at 472.

<sup>39</sup> *Volt*, 489 U.S. at 473.

<sup>40</sup> *Id.* at 472.

<sup>41</sup> *Id.* at 477-78. Under 28 U.S.C. § 1257(2), the Court had appellate jurisdiction to review a final judgment rendered by the highest court of a state in which a decision could be had “[w]hen . . . the validity of a statute of any state [is drawn into question] on the ground of its being repugnant to the Constitution, treaties or laws of the United States, and the decision is in favor of its validity.” *Id.*

<sup>42</sup> *Id.* at 478. The Supreme Court noted that the purpose of the FAA was to overrule the judiciary’s longstanding refusal to enforce arbitration agreements. *Id.* at 478; *see supra* notes 1 & 3 (discussing hostility of courts towards arbitration).

<sup>43</sup> *Volt*, 489 U.S. at 477-78.

<sup>44</sup> *Id.* at 477.

without doing violence to the FAA policies.”<sup>46</sup>

### *B. Preemption of State Substantive Provisions*

Although *Volt* set forth a definitive approach in evaluating the preemptability of state procedural provisions in arbitration, no such clarity exists regarding a state substantive provision.<sup>46</sup> This lack of guidance has resulted in a split among the circuits in the area of punitive damages awards.

#### *1. Fahnestock & Co. v. Waltman—Punitive Damages Award Vacated*

In *Fahnestock & Co. v. Waltman*,<sup>47</sup> the Second Circuit examined the validity of an arbitrator's award of punitive damages under the FAA.<sup>48</sup> *Fahnestock & Co.* (“*Fahnestock*”) was a brokerage firm which challenged the validity of an arbitration award of punitive damages pursuant to a New York Stock Exchange (“*NYSE*”) proceeding.<sup>49</sup> The district court vacated the punitive damages portion of the award, and stated that arbitrators were prohibited from awarding punitive damages under state law.<sup>50</sup> On appeal, the Second Circuit held that the award of punitive damages was properly vacated pursuant to New York's rule in *Garrity v. Lyle Stuart, Inc.*<sup>51</sup> In *Garrity*, the New York Court of Appeals held that “[a]n arbitrator has no power to award punitive damages, even if agreed upon by the parties.”<sup>52</sup> Noting that state law may be preempted in federal diversity cases “to the extent that it *actually*

<sup>46</sup> *Id.* at 479.

<sup>46</sup> See discussion *infra* parts II.B, III (relevant circuit court cases illustrating uncertainty with respect to preemption of state substantive law).

<sup>47</sup> 935 F.2d 512 (2d Cir.), *cert. denied*, 112 S. Ct. 380 (1991).

<sup>48</sup> *Id.* at 514.

<sup>49</sup> *Id.* at 515.

<sup>50</sup> *Id.*

<sup>51</sup> 40 N.Y.2d 354, 353 N.E.2d 793, 386 N.Y.S.2d 831 (1976). See generally G. Richard Shell, *The Power to Punish: Authority of Arbitrators to Award Multiple Damages and Attorneys' Fees*, 72 MASS. L. REV. 26, 33-35 (1987) (discussing *Garrity* rule); Note, *Arbitration: The Award of Punitive Damages as a Public Policy Question*, 43 BROOK. L. REV. 546, 550 (1976) (same). But see *Belco v. Avx Corp.*, 251 Cal. Rptr. 557, 566-67 (Cal. Ct. App. 1988) (awarding punitive damages where expressly provided for in arbitration agreement).

<sup>52</sup> *Garrity*, 40 N.Y.2d at 356, 353 N.E.2d at 794, 386 N.Y.S.2d at 832.

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conflicts with federal law,"<sup>63</sup> and that the FAA neither contained an express, preemptive provision nor a congressional intent to pervasively occupy the field of arbitration, the Second Circuit upheld the *Garrity* rule.<sup>64</sup>

Judge Miner, writing for the majority, noted that the agreement between the parties did not expressly give the arbitrator power to award punitive damages.<sup>65</sup> The court stated that had such a provision been included, the FAA might have required confirmation of the award since it provides for arbitration agreements to be enforced according to their terms.<sup>66</sup> The court further added that a similar result would have occurred if the provision had incorporated the American Arbitration Association's ("AAA") Commercial Arbitration Rules which provide that "[a]n arbitrator may grant any remedy or relief which the [a]rbitrator deems just and equitable within the scope of the agreement of the parties."<sup>67</sup> This language, observed Judge Miner, would probably be broad enough to allow such an award, although the issue was not specifically before them.<sup>68</sup> Turning to the parties' agreement which incorporated the governing arbitration provisions of the NYSE Constitution, the court stated that since the NYSE rules were silent as to the ability of an arbitrator to award punitive damages, the *Garrity* rule did not conflict with the agreement of the parties, and therefore the FAA did not preempt the NYSE

<sup>63</sup> *Fahnestock*, 935 F.2d at 517 (emphasis added); see *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941) (preemption is found in cases where state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress"); see also *Flight Sys. v. Paul A. Laurence Co.*, 715 F. Supp. 1125, 1127 (D.D.C. 1989) (interpreting *Volt* to mean all choice-of-law provisions enforceable as long as consistent with FAA); *Batton v. Green*, 801 S.W.2d 923, 927 (Tex. 1990) (state law only preempted to extent it conflicts with objectives of Congress); cf. *Saturn Distribution Corp. v. Williams*, 905 F.2d 719, 722 n.2 (4th Cir. 1990) (interpreting *Volt* as holding that state law will not be preempted if it addresses concerns that FAA does not). See generally *Jiang*, *supra* note 9, at 473 (discussing choice-of-law provision impact on applicability of FAA).

<sup>64</sup> *Fahnestock*, 935 F.2d at 518-19; see *infra* note 79 and accompanying text (detailing applicable NYSE arbitration rules).

<sup>65</sup> *Fahnestock*, 935 F.2d at 517.

<sup>66</sup> *Id.*

<sup>67</sup> *Id.* at 519 (citing *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1386 (11th Cir. 1988)); see *Raytheon Co. v. Automated Business Sys., Inc.*, 882 F.2d 6, 9 (1st Cir. 1989) (upholding AAA award of punitive damages).

<sup>68</sup> *Fahnestock*, 935 F.2d at 519.

rules.<sup>59</sup>

## 2. *Cunard Line, Ltd. v. Todd Shipyards, Inc.*—Punitive Damages Award Confirmed

In a decision rendered contemporaneously with *Fahnestock*, the Ninth Circuit addressed the validity of an arbitrator's award of punitive damages in *Cunard Line, Ltd. v. Todd Shipyards, Inc.*<sup>60</sup> In *Cunard*, a dispute arose between a contractor and a cruise line in the course of performance of their contract, after which the contractor filed a demand for arbitration.<sup>61</sup> The contract between the parties, which incorporated the AAA Rules and contained a New York choice-of-law provision, provided that any dispute would be referred to arbitration.<sup>62</sup> Ultimately, the contractor was awarded one million dollars in punitive damages.<sup>63</sup>

On appeal, the Ninth Circuit held that the arbitration panel properly awarded punitive damages based on the broad view of the power of arbitrators to settle disputes,<sup>64</sup> coupled with the incorporation of the AAA's Commercial Arbitration Rules.<sup>65</sup> Adopting the Supreme Court's view that the FAA governs arbitration matters in state and federal courts,<sup>66</sup> the court rejected the argument that where parties incorporate a choice-of-law provision, state law would necessarily apply in every instance.<sup>67</sup> Disagreeing with the *Fahnestock* decision, the *Cunard* court instead held that despite the choice-of-law provision in the Todd-Cunard contract, New York's *Garrity* rule was preempted by federal law.<sup>68</sup>

<sup>59</sup> *Id.* at 517.

<sup>60</sup> 943 F.2d 1056 (9th Cir. 1991).

<sup>61</sup> *Id.* at 1059.

<sup>62</sup> *Id.* Section 21 of the contract stated, "[a]ny and every dispute, difference or question between the parties hereto which shall at anytime arise after the execution of this Agreement . . . relating to this Agreement, shall be referred to arbitration." *Id.* at 1060.

<sup>63</sup> *Id.* at 1061. The award was later confirmed by the district court. *Id.*

<sup>64</sup> *Id.* at 1063.

<sup>65</sup> *Cunard*, 943 F.2d at 1063. The court relied on the fact that two other federal courts had permitted arbitrators to award punitive damages where application of this rule was coupled with a broad arbitration agreement. *Id.*

<sup>66</sup> *Id.*

<sup>67</sup> *Id.* at 1062.

<sup>68</sup> *Id.* at 1063.

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### III. PROPOSAL: A CLOSER EXAMINATION OF THE PARTIES' INTENT

It is submitted that although *Volt* is clear as to the applicability of state arbitration procedural provisions which do not conflict with the FAA, no such edict has been issued with regard to similar substantive state provisions. In the wake of this uncertainty, courts have taken divergent paths in assessing the weight to be accorded such provisions, which is apparent in the foregoing decisions of the Second<sup>69</sup> and Ninth<sup>70</sup> Circuits with respect to the application of the *Garrity* rule.

Despite the contradictory results reached by these circuits, one thing is clear from *Volt*: the parties' intent is the pivotal factor in resolving this issue. As such, the ensuing portion of this Note will suggest an approach to determine whether the FAA preempts a state substantive provision.

#### A. Express Agreement

Arbitration under the FAA is truly consensual in nature.<sup>71</sup> Since parties are generally free to structure their agreements as they see fit,<sup>72</sup> it is suggested that courts should closely examine the

<sup>69</sup> See *supra* notes 46-59 and accompanying text (detailing vacatur of punitive damages award in *Fahnestock* pursuant to state substantive ban on power of arbitrators to make such awards).

In *Barbier v. Shearson Lehman Hutton, Inc.*, the lower court upheld an arbitration panel's award of punitive damages despite the presence of a New York choice-of-law provision: "[A] choice-of-law provision in a contract governed by the [Federal] Arbitration Act merely designates the substantive law that the arbitrators must apply in determining whether the conduct of the parties warrants an award of punitive damages; it does not deprive the arbitrators of their authority to award punitive damages." 752 F. Supp. 151, 154 (S.D.N.Y. 1990). However, the Second Circuit reversed, relying on their opinion in *Fahnestock*, and held that the parties' inclusion of a New York choice-of-law provision evidenced an intent to be bound by the *Garrity* rule. *Barbier*, 948 F.2d 117, 121-23 (2d Cir. 1991).

<sup>70</sup> See *supra* notes 60-68 and accompanying text (punitive damages award upheld in *Cunard* despite presence of New York choice-of-law provision).

<sup>71</sup> See *supra* notes 1 & 2 and accompanying text (reviewing FAA and its formative history as founded upon enforcement of privately negotiated arbitration agreements).

<sup>72</sup> See *Fahnestock & Co. v. Waltman*, 935 F.2d 512, 518 (2d Cir.), *cert. denied*, 112 S. Ct. 380 (1991). "If the parties had agreed to permit the arbitrators to make such an award, federal arbitration law might require confirmation, for 'parties are generally free to structure their arbitration agreements as they see fit,' and the FAA provides for the enforcement of the terms of such privately negotiated agreements." *Id.* (quoting *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 478-79 (1989)); see also *Complete Interiors, Inc. v. Behan*, 558 So. 2d 48, 51 (Fla. 1990) (punitive



intent of the parties as the primary means of effectuating their agreement. If the parties in *Fahnestock* and *Cunard* had expressly agreed in their contracts to award or preclude an award of punitive damages upon arbitration of a dispute, most courts would agree that the award should be upheld.<sup>73</sup> A contrary ruling would be inimical to the FAA's mandate that courts enforce such agreements in accordance with their terms.<sup>74</sup> Furthermore, it is asserted that even where the parties' choice-of-law provision, e.g., New York, may foreclose an award of punitive damages by virtue of state law, e.g., the *Garrity* rule, the express agreement would clearly outweigh any contrary inference drawn from incorporation of state law.

### B. Extrinsic Evidence

In the absence of an express provision, courts should then focus on extrinsic evidence to determine the intent of the parties when deciding whether to incorporate a substantive state provision into their agreement.<sup>75</sup> For instance, if an arbitration agreement utilized broad or indefinite language in describing the powers of an arbitrator, an award of punitive damages by an arbitrator would

damages should not be awarded absent express provision authorizing such relief in arbitration agreement); cf. C. Evan Stewart, *Punitive Damages Arbitration: Fish or Cut Bait*, N.Y.L.J., Feb. 21, 1991, at 5, col. 1. To secure protection from an arbitrator's award of punitive damages pending clarification of the law, Mr. Stewart suggests that arbitration agreements be drafted so as to: (1) state specifically that New York substantive and procedural law are to govern the proceeding; and (2) state that the application of New York law will be to the exclusion of any other state's law and federal law, except where federal law is in direct conflict. *Id.* See generally Douglas R. Davis, *Overextension of Arbitral Authority: Punitive Damages and Issues of Arbitrability—Raytheon Co. v. Automated Business Systems, Inc.*, 882 F.2d 6 (1st Cir. 1989), 65 WASH. L. REV. 695, 712 (1990) (nontraditional contractual remedy should not be allowed in arbitration absent express provision).

<sup>73</sup> See *Fahnestock*, 935 F.2d at 518 ("If the parties had agreed to permit the arbitrators to make such an award, federal arbitration law might require confirmation."); *Cunard Line, Ltd., v. Todd Shipyards Inc.*, 943 F.2d 1056, 1061 (9th Cir. 1991) (arbitrators may award punitive damages when given authority which may arise impliedly via extrinsic evidence).

<sup>74</sup> See *Volt*, 489 U.S. at 472 (goal of FAA is to enforce terms of privately negotiated agreements).

<sup>75</sup> See *Schering Corp. v. Home Ins. Co.*, 712 F.2d 4, 9 (2d Cir. 1983). Where the contract language is not entirely unambiguous, parties have a right to present extrinsic evidence of their intent at the time of contracting. *Id.* But see *Burger King Corp. v. Horn & Hardart Co.*, 893 F.2d 525, 527 (2d Cir. 1990) (if unambiguous, court must enforce provision as clearly written); *American Home Prod. Corp. v. Liberty Mutual Ins. Co.*, 748 F.2d 760, 765 (2d Cir. 1984) (same).

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be in harmony with the federal policy favoring arbitration, and would ensure that any doubts concerning the scope of arbitrable issues be resolved in favor of arbitration.<sup>76</sup>

Where the parties have expressly incorporated the Commercial Rules of the AAA, which broadly provide for “any remedy or relief which the arbitrator deems just and equitable within the scope of the agreement of the parties,” courts should evaluate it as compelling evidence of the parties’ intent not to foreclose any remedial measure—including punitive damages.<sup>77</sup> This was part of the *Cunard* court’s rationale in upholding the arbitration panel’s authority to award punitive damages.<sup>78</sup>

Similarly, when arbitration involves a dispute pursuant to the rules of the NYSE,<sup>79</sup> the fact that the award form includes a space marked “punitive damages” could be considered strong extrinsic evidence of the parties’ intent, and warrant an award of punitive damages.<sup>80</sup> It should be noted, however, that the majority in *Fah-*

<sup>76</sup> See *supra* note 28 and accompanying text (federal policy in favor of broad view of arbitrability supports arbitrator’s power to award punitive damages); see also *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 626 (1985) (pursuant to FAA, “as with any other contract, the parties’ intentions control, but those intentions are generously construed as to issues of arbitrability”).

<sup>77</sup> See *Raytheon Co. v. Automated Business Sys., Inc.*, 882 F.2d 6, 11 n.5 (1st Cir. 1989); *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1387-88 (11th Cir. 1988); *Willoughby Roofing & Supply Co. v. Kajima Int’l*, 598 F. Supp. 353, 357 (N.D. Ala. 1984), *aff’d*, 776 F.2d 269 (11th Cir. 1985). But see generally *Davis*, *supra* note 72, at 704-12 (criticizing *Raytheon* decision as overextending arbitral authority).

<sup>78</sup> See *Cunard Line, Ltd. v. Todd Shipyards, Inc.*, 943 F.2d 1056, 1063 (9th Cir. 1991).

<sup>79</sup> See 2 N.Y.S.E. Guide (CCH) ¶ 2347. Rule 347 provides that:

Any controversy between a registered representative and any member or member organization arising out of the employment or termination of employment of such registered representative by and with such member or member organization shall be settled by arbitration, at the instance of any such party, in accordance with the arbitration procedure prescribed elsewhere in these rules.

*Id.* Rule 600(a) states that “[a]ny dispute, claim or controversy between . . . a member . . . and/or associated person arising in connection with the business of such member . . . and/or associated person in connection with his activities as an associated person shall be arbitrated under the Constitution and Rules of the New York Stock Exchange . . .” *Id.* ¶ 2600.

<sup>80</sup> See *Fahnestock & Co. v. Waltman*, 935 F.2d 512, 521 (2d Cir.), *cert. denied*, 112 S. Ct. 380 (1991) (Mahoney, J., concurring in part and dissenting in part). Judge Mahoney indicated that such evidence could have been more helpful if the district court had given it proper consideration. *Id.*; *Barbier v. Shearson Lehman Hutton, Inc.*, 752 F. Supp. 151, 160 (S.D.N.Y. 1990), *aff’d in part, rev’d in part*, 948 F.2d 117 (1991). In *Barbier*, the court stated that “[a]lthough the NYSE rules do not address the issue of punitive awards, the NYSE award form utilized by the exchange explicitly provides for awards of punitive damages. This suggests that the arbitration body chosen by the parties contemplates punitive

*nestock* stated that such award forms were not part of the arbitration agreement and had no bearing on the issue of an arbitrator's power to award punitive damages.<sup>81</sup>

Ultimately, it is suggested that the use of extrinsic evidence by courts to determine the intent of the parties where there is no express agreement as to an award of punitive damages becomes a weighing process. It is further suggested that this process becomes more difficult when there is a choice-of-law provision effectively incorporating a conflicting state provision such as the *Garrity* rule. The outcome in such an instance is clearly dependent on the strength of the extrinsic evidence contradicting its incorporation, and, it is asserted that an AAA agreement is the strongest of such evidence.<sup>82</sup>

### C. Absence of Express Agreement or Extrinsic Evidence

In those instances where there is neither an express agreement nor extrinsic evidence indicating the parties' intent to permit an award of punitive damages, one court has suggested that "in light of the federal policy, any doubts concerning the scope of the arbitral issues should be resolved in favor of arbitration."<sup>83</sup> In that decision, an award of punitive damages was upheld despite the *Garrity* rule.<sup>84</sup> It is submitted this holding was flawed by its simple invocation of pre-*Volt* authority.<sup>85</sup>

Instead, it is suggested that at such an impasse, courts should preliminarily recognize the state substantive provision, i.e., *Garrity* rule, as a "gap-filler"<sup>86</sup> in the parties' agreement—and use it to fill

awards where warranted by applicable law." *Id.*

<sup>81</sup> See *Fahnestock*, 935 F.2d at 519 ("We cannot conclude that award forms are part of the arbitration agreement.").

<sup>82</sup> See *supra* note 74 (choice-of-law provision is nondeterminative on question of punitive damages). But see *Henry v. Alcove Investment*, 284 Cal. Rptr. 255, 259 (1991) (choice-of-law provision makes contract arbitrable under state law rather than FAA); *Albright v. Edward D. Jones & Co.*, 571 N.E.2d 1329, 1332-33 (Ind. 1991) (citing *Volt* as holding that where parties agreed state law would govern, FAA would not preempt).

<sup>83</sup> *Barbier*, 752 F. Supp. at 157 (quoting *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1983)).

<sup>84</sup> *Id.* at 160.

<sup>85</sup> See *supra* note 28 (discussing pre-*Volt* cases dealing with effects of choice-of-law provision on punitive damages award).

<sup>86</sup> See *Feldman, supra* note 9, at 695 (author labels as "gap filling" those areas where states can provide procedures to enforce arbitration agreements when FAA does not).

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a gap or area, i.e., punitive damages, not dealt with specifically by the parties' agreement or the FAA.<sup>87</sup> It is asserted that despite a designation of New York's *Garrity* rule as a "gap-filler," further inquiry must be made to ensure its consistency with the underlying goals and policies of the FAA. Only then should the state substantive provision be incorporated into the parties' agreement.<sup>88</sup>

In *Garrity*, the New York Court of Appeals asserted that a prohibition on punitive damages awards in arbitration was necessary for several reasons.<sup>89</sup> Most importantly, the court noted that such awards displaced the state "as the engine for imposing a social sanction," and therefore warranted judicial interference.<sup>90</sup> Ironically, the court's rationale was almost identical to those espoused by "hostile" courts unwilling to enforce arbitration agreements, which in part prompted the enactment of the FAA in 1925.<sup>91</sup> It is submitted that the *Garrity* rationale is inconsistent with the FAA policies, and therefore should be preempted.

Similarly, although it was unnecessary for the *Cunard* court to proceed to the final portion of this analysis, since it held that the available extrinsic evidence evinced a willingness by the parties to include punitive damages in their agreement, it is asserted that such a determination effectively highlights the incorrect result reached by the *Fahnestock* court. Although the *Fahnestock* court proceeded correctly in incorporating the gap-filler in the absence of an express agreement or credible extrinsic evidence to the contrary, it failed to take the analysis one step further and evaluate

<sup>87</sup> *Id.*

<sup>88</sup> See *Volt Information Sciences, Inc. v. Board of Trustees of the Leland Stanford Junior Univ.*, 489 U.S. 468, 477 (1989) (quoting in part, *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)). "But even when Congress has not completely displaced state regulation in an area, state law may nonetheless be preempted to the extent that it 'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'" *Id.*

<sup>89</sup> *Garrity v. Lyle Stuart, Inc.*, 40 N.Y.2d 354, 358-60, 353 N.E.2d 793, 795-96, 386 N.Y.S.2d 831, 833-35 (1976). The New York Court of Appeals believed such an intrusion into arbitration proceedings was well supported for several reasons: (1) punitive damages are generally not available for mere breach of contract; (2) such an award displaces the State "as the engine for imposing a social sanction," thus warranting judicial interference on a policy matter of such significance; and finally, (3) awards of punitive damages undermine the ultimate usefulness of arbitration. *Id.*

<sup>90</sup> *Id.* at 358, 353 N.E.2d at 796, 386 N.Y.S.2d at 833.

<sup>91</sup> See *supra* notes 1 & 3 and accompanying text (explaining judicial hostility to arbitration agreements).

the substantive state provision in light of the goals and policies of the FAA.

#### CONCLUSION

The FAA mandates that state and federal courts enforce arbitration agreements in accordance with their terms in an effort to make such agreements as enforceable as other contracts. Meanwhile, states have taken the liberty to create procedural as well as substantive provisions in the absence of any clear designation of the FAA's preemptive scope. Although the Supreme Court has since defined such boundaries with regard to procedural matters, the effect to be accorded substantive provisions remains unsettled. Until Congress or the Supreme Court definitively resolves this dilemma, parties should draft their contracts carefully. They should bear in mind the foregoing analysis when contemplating an arbitration agreement and draft it accordingly. In doing so, parties will be secure in the knowledge that their intent alone governs the interpretation of their agreement, while insuring that the FAA remains true to its original purpose.

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