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ARBITRATION

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'Public Policy' Limits on Punitive Damage Clauses

Parties often agree to arbitration in hopes of resolving their disputes in a faster, less-expensive, more-effective and less-formal manner than may be available in ordinary court proceedings.

Arbitration agreements and arbitration clauses in contracts may limit the issues to be arbitrated and may specify the rules under which the arbitration will be conducted.[1]

State laws vary, however, as to whether and by what means arbitrators can be given or denied the power to award punitive damages. In some states, arbitration clauses that proscribe punitive damage awards may be unenforceable.

By contrast, New York's highest court has held that the power to award punitive damages is reserved to judicial tribunals and may not be exercised by arbitrators.[2]

This article discusses potential state public policy limitations on the ability of parties to grant or deny power to arbitrators to award punitive damages in the arbitration of contract disputes, and suggests some drafting solutions to such limitations.[3]

The 'Garrity' Rule

In *Garrity v. Lyle Stuart, Inc.*, decided in 1976, the New York Court of Appeals held that an arbitrator's award that imposed punitive damages would violate public policy, even if the parties had agreed to grant the arbitrator the power to issue such an award.[4] The court held that such an award would violate "strong" public policy, both because punitive sanctions are "reserved to the State," through judicial power, and because issuance of punitive damages awards through arbitration would be "uncontrolled" by judicial review.[5]

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The *Garrity* rule, as a potential limitation on the enforceability of an arbitration agreement, arguably is preempted by the Federal Arbitration Act (FAA) in circumstances where the agreement at issue addresses "a transaction involving commerce."[6] The Supreme Court has made clear that, applying the FAA, "[c]ourts may not ...invalidate arbitration agreements under state law applicable only to arbitration provisions,"[7] and thus states cannot create a special rule governing punitive damages applicable only in arbitration proceedings. It is also clear that the FAA, which applies in state court proceedings so long as the commerce requirement is met,[8] does not require arbitration on any particular terms. Where parties have expressly consented, as part of their arbitration agreement, to the application of a particular state's law to the arbitration, such an agreement generally must be enforced.[9] A tension thus appears between the FAA's no-discrimination-against-arbitration policy and its direction that contractual choice-of-law provisions be honored.

The Supreme Court, in *Mastrobuono v. Shearson Lehman Hutton, Inc.*, addressed this potential conflict. In *Mastrobuono*, the parties adopted a clause stating that their agreement would be "governed by the laws of the State of New York," arguably including the *Garrity* rule. However, the agreement also provided that any controversy arising out of the transaction would be settled by arbitration in accordance with the rules of the National Association of Securities Dealers (NASD). Under NASD rules, the Court noted, arbitrators could consider punitive damages as a remedy.[10]

In the absence of a specific clause in the agreement addressing punitive damages, the *Mastrobuono* Court read the conflicting NASD rules and the New York choice-of-law provisions of the agreement together, and determined that the arbitration agreement did not preclude punitive damage arbitration awards. The Court emphasized that any ambiguity on this issue would be construed against the drafter (respondents, who sought to disallow punitive damages), and that such a resolution was particularly appropriate because it did not appear that plaintiffs were "actually aware" of New York's approach to punitive damages, or aware that by signing the agreement they might be giving up the "important substantive right"[11] to potential recovery of punitive damages.

Subsequent lower court decisions have made clear that, although the *Garrity* rule may remain alive in New York law, courts will strictly construe arbitration agreements, to ensure that unintended limitations on the award of punitive damages are not created by casual reference to New York law.[12] Similar issues may arise in reference to the law of other states. Restrictions on punitive damage arbitration awards vary by state, and include requirements for contractual[13] or statutory authorization for punitive damages,[14] tortious conduct,[15] and willfulness.[16]

Limits on Punitive Damage Proscriptions

In the opposite direction, one might ask whether the general ability of parties to arrange their arbitration proceedings as they see fit permits parties to include an express proscription of punitive damage relief in their

agreements. Recent cases illustrate potential state public policy limits on that principle. In *Cavalier Mfg., Inc. v. Jackson*, a manufacturing defects case, the Supreme Court of Alabama remanded, for consideration by the trial court, the question whether an arbitration clause that prohibited the arbitrator from awarding punitive damages was valid as a matter of Alabama public policy.[17] A rather vigorous dissent in the case suggested that the court should have "draw[n] the line" to prohibit such a restriction, "[b]ecause a person should not be able to avoid punishment for injuring another by bargaining with the targeted victim."[18] Further, in *Dunlap v. Berger*, an action under state consumer protection laws, the Supreme Court of West Virginia held that a prohibition on (among other things) punitive damages in arbitration was an "unconscionable" limitation on consumer remedies.[19]

These potential public policy limitations on the ability of parties to arrange their arbitration agreements as they see fit can be avoided in some instances, as the *Garrity* rule has been avoided, through strict interpretation of an arbitration agreement. Thus, for example, in *Stark v. Sandberg, Phoenix & Von Gontard, P.C.*, a U.S. Court of Appeals for the Eighth Circuit case applying Missouri law, the parties agreed to arbitrate within the framework of the FAA and American Arbitration Association (AAA) rules. The agreement also provided that "borrower and lender expressly waive any right to claim [punitive damages] to the fullest extent permitted by law."[20]

The state law in this case, however, provided that "one may never exonerate oneself from future liability for intentional torts or for gross negligence, or for activities involving the public interest."[21] The Eighth Circuit, while recognizing that "had the parties to this agreement intended its interpretation to be governed solely by the FAA, the punitive damages waiver might have barred such an award," nevertheless held that "[t]he plain language of the agreement…makes it clear that Missouri law applies to this issue" and that the arbitrator's award of punitive damages was consistent with Missouri law, and therefore permissible under the agreement.[22]

Crafting a Provision

When choosing the law and procedure that will apply to an agreement to arbitrate, parties should expressly decide whether punitive damages will be allowed in arbitration, and which state's law best serves their choice on that matter. Due to the wide variety of potential state law restrictions on punitive damage awards, parties should avoid unintentional limitations, by taking care in choosing the substantive law that will govern their agreement.[23] Parties must also pay attention to the choice of arbitration rules, to ensure that nothing in the chosen rules conflicts with their choice on whether to grant or withhold power from the arbitrator to award punitive damage relief.

Further, parties must take care that their intention (to permit or prohibit punitive awards) is clearly expressed. As the case of *Stark v. Sandberg* demonstrates, even adding seemingly innocent phrases such as "to the fullest extent permitted by law" may actually have significant legal effect.

Finally, drafters should be aware of the types of awards that are encompassed by the phrase "punitive damages." For example, the U.S. Court of Appeals for the Fifth Circuit has held that treble antitrust damages are compensatory, not punitive, and may be awarded even when the parties have expressly and unambiguously agreed to proscribe "punitive" damage awards.[24] Parties thus should consider the possibility that statutory damages may remain available, despite an enforceable limitation on extra-statutory punitive damages, when deciding whether to select arbitration as the forum to resolve their disputes.

When choosing the law that will apply to an agreement to arbitrate, parties should express whether punitive damages will be allowed in arbitration and which state's law serves their choice. Due to the variety of state restrictions on punitive damages, parties should avoid unintentional limitations, by taking care in choosing the law that will govern their agreement.

1. See *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 57 (1995) ("[P]arties are generally free to structure their arbitration agreements as they see fit.").

2. See *Garrity v. Lyle Stuart, Inc.*, 40 N.Y.2d 354, 386 N.Y.S.2d 831, 353 N.E.2d 793 (N.Y. 1976) ("Since enforcement of an award of punitive damages as a purely private remedy would violate strong public policy, an arbitrator's award which imposes punitive damages should be vacated.").

3. We do not deal here with the special issues that may arise with arbitration of statutory claims, where the laws involved may require that an arbitrator retain the power to assess punitive damages in an appropriate case. See *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 32 (1991) (arbitrators generally "have the power to fashion equitable relief"); id. at n.4 (noting that courts have review power to "ensure that arbitrators comply with the requirements of the statute at issue") (quotation omitted).

4. The agreement in *Garrity* was broad, providing: "Any controversy or claim arising out of this agreement or the breach or interpretation thereof shall be determined by arbitration[.]" *Garrity*, 40 N.Y.2d at 361. The court vacated a punitive damages award even though the defendant arguably had waived objections to such an award, by failing to object, at the outset, to a demand for punitive damages. See id. at 360.

5. See id. at 358-359. The court rejected the dissenting view that "irrational" or "unjust" punitive damage arbitration awards could be vacated, noting that this approach would involve the courts in supervision of awards for "justness," which is "contrary to the sound development of arbitration law." Id. at 359.

6. 9 U.S.C. §1 et seq. The term "involving commerce" encompasses a wider range of activity than activity "in commerce." See *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265 (1995); see also *Citizens Bank v. Alafabco, Inc.*, 539 U.S. 52 (2003).

7. *Doctor's Assocs., Inc. v. Casarotto*, 517 U.S. 681, 687 (1996) (invalidating Montana law requiring special notice of arbitration provision).

8. See *Southland Corp. v. Keating*, 465 U.S. 1 (1984).

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

10. See *Mastrobuono*, 514 U.S. at 60 (arbitrators may award "damages and other relief") (quoting NASD Code of Arbitration Procedure ¶3741(e) (1993)). The Court noted that the general NASD Code was "broad enough" at least to contemplate a punitive damages remedy. Moreover, the Court referred to a manual for arbitrators, which expressly stated that NASD arbitrators "can consider punitive damages as a remedy." See id. (quotation omitted).

11. *Mastrobuono*, 514 U.S. at 63

12. See, e.g., *Americorp Sec., Inc. v. Sager*, 656 N.Y.S.2d 762, 764 (1st Dept. 1997) (reference to New York law did not amount to "unequivocal exclusion" of punitive damages relief); *R.C. Layne Constr., Inc. v. Stratton Oakmont, Inc.*, 651 N.Y.S.2d 973 (1st Dept. 1996) (same).

13. See *Ryan v. Kontrick*, 304 Ill. App. 3d 852 (Ill. App. Ct. 1999). Under Illinois law, punitive damages may be awarded by an arbitrator only where there is an express provision authorizing such relief in the arbitration agreement. A general agreement incorporating FAA or NASD arbitration rules may not suffice.

14. *Kennewick Education Ass'n v. Kennewick School Dist. No. 17*, 35 Wash. App. 280, 282 (Wash. Ct. App. 1983) ("It has long been established that recovery of punitive damages is contrary to the public policy of the State and will not be allowed unless expressly authorized by statute.") (citing authorities).

15. See *Gateway Technologies, Inc. v. MCI Telecommunications Corp.*, 64 F.3d 993 (5th Cir. 1995) (under Virginia law, punitive damages must be predicated on tort liability and must be supported by an award of compensatory tort damages).

16. *Faiyaz v. Dicus*, 245 Ga. App. 55, 58 (Ga. Ct. App. 2000) ("Punitive damages [ ] may be obtained when tortious conduct displays willful misconduct, malice, fraud, or wantonness as proven by clear and convincing evidence.").

17. 823 So. 2d 1237, 1243 (Ala. 2001).

18. Id. at 1244 (dissent).

19. 567 S.E.2d 265, 280 (W. Va. 2002).

20. 381 F.3d 793, 800 (8th Cir. 2004) (quoting agreement).

21. Id. (quoting *Alack v. Vic Tanny Int'l of Mo., Inc.*, 923 S.W.2d 330, 337 (Mo. 1996) (citations omitted)).

22. Id. at 800-801.

23. See generally Michael D. Nolan & Andrew M. Leblanc, "The Punitive Damages Remedy: Lessons for Drafters of Arbitration Agreements," 60-JAN Disp. Resol. J. 50 (2006).

24. See *Investment Partners, L.P. v. Glamour Shots Licensing, Inc.*, 298 F.3d 314 (5th Cir. 2002) ("[T]he prohibition in the parties' arbitration agreement against awarding 'punitive damages' does not extend to statutory treble damages").

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