

FORDHAM LAW REVIEW



PUNITIVE DAMAGES IN ARBITRATION: CONTRACTING OUT OF GOVERNMENT'S ROLE IN PUNISHMENT AND FEDERAL PREEMPTION OF STATE LAW

STEPHEN J. WARE

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FORDHAM LAW REVIEW
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STEPHEN J. WARE*

INTRODUCTION

THERE has been a fierce debate among courts and commentators about when arbitrators may award punitive damages.¹ The resolution of this debate will have great practical consequences and will turn on answers to fundamental questions of political philosophy and constitutional theory. The practical importance of the debate over punitive damages in arbitration has rapidly increased as punitive damages awards have grown in size and frequency,² and courts have expanded the authority of arbitrators to hear claims for which punitive damages are often available.³ There is, quite bluntly, a lot of

* Assistant Professor of Law, Cumberland School of Law, Samford University. B.A., 1987, University of Pennsylvania; J.D., 1990, University of Chicago. Thanks to Randy Barnett, Bruce Hay, Tom Stipanowich, Andy Morriss, Carrie Menkel-Meadow, Kenneth Redden, Lisa Bernstein, George Wright, Larry Kramer, Henry Strickland, Tom Berg, Andy Klein, Trisha Olson, Mike DeBow, Mike Floyd, Albert Brewer, David Langum, Tom Gallanis and the Institute for Humane Studies. This Article was written with support from a summer research grant provided by the Cumberland School of Law, Samford University.

1. Ian R. Macneil et al., *Federal Arbitration Law* § 36.3.1 (1994). This recently published treatise by Ian R. Macneil, Richard E. Speidel, and Thomas J. Stipanowich, with contributions by G. Richard Shell, is an invaluable resource for anyone interested in arbitration law.

2. The extent of this growth is hotly debated. Compare James B. Sales & Kenneth B. Cole, Jr., *Punitive Damages: A Relic That Has Outlived Its Origins*, 37 Vand. L. Rev. 1117, 1154 (1984) ("The amount of punitive damages awarded in recent years . . . has escalated to astronomical figures that boggle the mind.") and Mark A. Peterson et al., *Punitive Damages—Empirical Findings* (1987) (finding that the incidence of punitive damages and the amount of money awarded for punitive damages have increased substantially over the years) with Stephen Daniels & Joanne Martin, *Myth and Reality in Punitive Damages*, 75 Minn. L. Rev. 1, 63 (1990) (challenging "widespread beliefs that punitive damages are awarded routinely, and in large amounts, [and] that the frequency and size of these awards are rapidly increasing").

3. Macneil et al., *supra* note 1, § 36.3.1. For examples of the controversy this expansion of arbitral authority has generated, see Margaret A. Jacobs, *Woman Claims Arbiters of Bias are Biased, Too*, Wall St. J., Sept. 19, 1994, at B1 (discussing arbitration of sex, race and age discrimination claims); Margaret A. Jacobs, *Men's Club: Riding Crop and Slurs: How Wall Street Dealt With a Sex-Bias Case*, Wall St. J., June 9, 1994, at A1 (same). In August 1994, bills were introduced in both houses of Congress to render unenforceable predispute arbitration agreements with respect to various discrimination claims. See S. 2405, 103rd Cong., 2d Sess. (1994); H.R. 4981, 103rd Cong., 2d Sess. (1994).

money riding on the eventual shape of the law governing punitive damages in arbitration.⁴

These crass practical concerns are inextricably linked to at least three venerable theoretical questions. The most basic question of political philosophy—"What is the proper role of government?"—is raised by the award of punitive damages in arbitration. Courts are an arm of government. Arbitration, to the extent it resolves disputes that would otherwise be resolved by courts, reduces government's role. Punitive damages are generally viewed as an expression of society's outrage against particularly heinous conduct.⁵ They are quasi-criminal.⁶ Allowing arbitrators to award punitive damages privatizes a function many feel is quintessentially public.⁷ In contrast, this Article contends that allowing parties to privatize that function, as a matter of freedom of contract, is both good policy and compelled by current arbitration law.

The second theoretical question raised by the award of punitive damages in arbitration is a basic problem of federalism—how to deal with conflicting federal and state law. Here too, an appealing answer is freedom of contract, allowing parties to choose whether to be gov-

4. See, e.g., *Punitive Award Survey*, Sec. Arb. Commentator, May 1993, at 1, 7.

5. In most jurisdictions, the court will award punitive damages because of the positive public policy to punish the defendant and to serve as a warning or example to others who may commit similar outrageous acts in the future. These public policy grounds are also found to be in the interest of society and for the public benefit.

Linda L. Schlueter & Kenneth R. Redden, *Punitive Damages* § 2.1(C) (2d ed. 1989) (citation omitted).

6. *Id.* § 2.2(A)(1) ("In modern law, the concept of punishment is embraced by criminal law for the protection of society. In contrast, civil law is designed to indemnify the plaintiff so as to make him whole. It is because of these distinctions that punitive damages often cross a fine line.")

7. "The problem arises because an arbitrator resolves disputes that are basically private in nature, whereas punitive damages are awarded to punish and deter misconduct for the public benefit." *Id.* § 4.5(C) (citing Timothy E. Travers, Annotation, *Arbitrator's Power To Award Punitive Damages*, 83 A.L.R.3d 1037 (1978)). See, e.g., *Garrity v. Lyle Stuart, Inc.*, 353 N.E.2d 793, 794 (N.Y. 1976). In *Garrity*, the court declared:

Punitive damages is a sanction reserved to the State, a public policy of such magnitude as to call for judicial intrusion to prevent its contravention. 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.

Id.

Privatizing the decision to award punitive damages will undoubtedly seem like another step down the wrong path to those who "assert that quality solutions are more likely to emerge when the dispute resolution process is not privatized and individualized." Carrie Menkel-Meadow, *For and Against Settlement: Uses and Abuses of the Mandatory Settlement Conference*, 33 UCLA L. Rev. 485, 487 (1985) (citing Richard L. Abel, *The Contradictions of Informal Justice*, in *The Politics of Informal Justice* 267 (R. Abel ed., 1982); Owen M. Fiss, *Against Settlement*, 93 Yale L. J. 1073, 1075 (1984) (discussing the potential role of alternate dispute resolution centers); Judith Resnik, *Managerial Judges*, 96 Harv. L. Rev. 374 (1982)).

erned by state or federal law. And current positive law allows them to do just that with respect to federal and state arbitration law.⁸ This unusual form of federal preemption may have great untapped potential for arbitration and other areas of the law.

The third theoretical question raised by the award of punitive damages in arbitration goes to the nature of the due process protections guaranteed by the Fifth and Fourteenth Amendments to the United States Constitution. The Due Process Clauses restrict government, not private, action.⁹ Is there sufficient government action in court enforcement of an arbitrator's punitive damages award to implicate the Due Process Clauses? This Article suggests that, under present state action doctrine, there is not. If, on the other hand, there *is* sufficient state action to trigger due process protections, have these protections been waived by one who enters into an otherwise enforceable arbitration agreement? In other words, do arbitration agreements contract out of due process requirements? Yes, this Article suggests, they do. The conclusion that there are no due process constraints on arbitral punitive damages awards, however, should not be disturbing because arbitration law and contract law provide courts with the tools necessary to prevent enforcement of outlandish arbitral awards.¹⁰

Part I of this Article emphasizes that the Federal Arbitration Act ("FAA"),¹¹ by its terms and as interpreted by the Supreme Court, requires the enforcement of arbitration agreements¹² unless there is a defense to the enforcement of any contract, such as fraud or duress. Therefore, in the absence of such a defense, whether an arbitrator of a given dispute has the power to award punitive damages depends on the agreement by which the parties submitted the dispute to arbitration. If the arbitration agreement expressly confers on the arbitrator the power to award punitive damages, courts must enforce that agreement. Likewise, if the arbitration agreement expressly denies the arbitrator the power to award punitive damages, courts must enforce that agreement. If the arbitration agreement does not expressly address punitive damages, then, in accordance with the usual methods of contractual interpretation, other terms in the agreement must be examined to determine whether the arbitrator has the power to award them. In other words, the language of the arbitration agreement might *impliedly* address punitive damages. If, however, there is nothing at all in the language of the arbitration agreement that can plausibly be construed as addressing the arbitrator's power to award

8. See *infra* notes 97-120 and accompanying text.

9. See *infra* notes 134-35 and accompanying text.

10. See *infra* notes 197-201 and accompanying text.

11. 9 U.S.C. §§ 1-16 (1988).

12. The term "arbitration agreement" is used herein to encompass, not just the particular contract term pertaining to arbitration, but all the terms of the parties' contract. In other words, "arbitration agreement" refers to the container contract as well as the arbitration clause it contains.

punitive damages, then a default rule must be supplied by the courts. The federal policy favoring arbitration supports a default rule allowing arbitrators to award punitive damages.

Part II of this Article addresses state arbitration law. The FAA's command that arbitration agreements be enforced leads to noteworthy conclusions about the relationship between federal and state arbitration law. The FAA rests on the authority of Congress to enact substantive law under the Constitution's Commerce Clause¹³ and applies if the pertinent arbitration agreement evidences a transaction involving interstate commerce.¹⁴ Because the FAA requires enforcement of arbitration agreements, any state law purporting to limit freedom of contract with respect to the arbitrability of punitive damages conflicts with the FAA and is preempted by it. But if the parties choose in their agreement to be governed by state law on the arbitrability of punitive damages, courts must apply that state law even though the agreement involves interstate commerce. In such a situation, state law would ultimately govern the punitive damages question even though, as an initial matter, federal law is controlling. This is so because federal law incorporates the parties' agreement which, in turn, incorporates state law. Federal preemption of state law is unusual in the arbitration context because FAA preemption of state arbitration law is a default rule rather than a mandatory rule.¹⁵ In other words, the parties to an arbitration agreement can choose whether to be governed by federal or state arbitration law.

This Article's third and final part addresses constitutional challenges to the award of punitive damages in arbitration. These challenges have been based on the Due Process Clauses of the Fifth and Fourteenth Amendments. This Article suggests that these challenges fail for at least two reasons: first, because there is no state action in the arbitral award of punitive damages, and, second, because due process rights are waived by entering into an otherwise enforceable arbitration agreement.

I. THE FEDERAL ARBITRATION ACT AND PUNITIVE DAMAGES

A. *The FAA: Freedom of Contract for Arbitration Agreements*

Whether an arbitrator has the power to award punitive damages becomes an issue if an arbitrator awards punitive damages and the

13. U.S. Const. art. I, § 8, cl. 3.

14. See *infra* notes 18-23 and accompanying text.

15. Some scholars use the term "immutable rule" rather than "mandatory rule." See, e.g., Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L.J. 87, 87 (1989) ("[D]efault rules fill the gaps in incomplete contracts; they govern unless the parties contract around them. Immutable rules cannot be contracted around; they govern even if the parties attempt to contract around them.").

party ordered to pay does not do so.¹⁶ If this occurs, the issue can come before a court if the party who prevailed in arbitration applies to the court for an order confirming the arbitral award,¹⁷ or if the party ordered to pay seeks an order vacating or correcting the award.¹⁸

16. An arbitrator's power to award damages can also become an issue prior to arbitration. This will be the case, for example, if a party contends that a dispute should be litigated, rather than arbitrated, because the dispute involves claims for punitive damages and contends that arbitrators are not, or should not be, permitted to hear such claims. *See, e.g., DiCrisci v. Lyndon Guar. Bank*, 807 F. Supp. 947, 953 (W.D.N.Y. 1992) (finding that employee's Title VII claim was arbitrable but that punitive damages claim had to be severed).

17. Confirmation is the usual procedure by which final arbitral awards are converted into court judgments. Macneil et al., *supra* note 1, § 38.1.1. Section 9 of the FAA provides, in pertinent part:

If the parties in their agreement have agreed that a judgment of the court shall be entered upon the award made pursuant to the arbitration, and shall specify the court, then at any time within one year after the award is made any party to the arbitration may apply to the court so specified for an order confirming the award, and thereupon the court must grant such an order unless the award is vacated, modified, or corrected as prescribed in sections 10 and 11 of this title. If no court is specified in the agreement of the parties, then such application may be made to the United States court in and for the district within which such award was made.

9 U.S.C. § 9 (1988). The FAA governs only arbitration arising out of agreements evidencing a transaction involving interstate commerce. *See infra* notes 20-24 and accompanying text. Whether Section 9 governs state courts is not clear, but, even if it does not, state courts still have the power, derived from state arbitration law, to confirm awards arising out of agreements involving interstate commerce. Macneil et al., *supra* note 1, § 38.1.8.

18. Section 10 of the FAA provides, in pertinent part:

In either of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration—

(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 in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior 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.

9 U.S.C. § 10 (1988). With respect to awards arising out of arbitration agreements evidencing transactions involving interstate commerce, "the FAA preempts any state grounds for vacation unless the parties have clearly agreed to be bound by them." Macneil et al., *supra* note 1, § 40.1. Section 11 of the FAA allows courts to correct arbitral awards "[w]here the arbitrators have awarded upon a matter not submitted to them" and for other reasons not relevant to this discussion. 9 U.S.C. § 11 (1988).

The primary substantive provision of the FAA is Section 2.¹⁹ It 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.²⁰

Because "commerce" is defined as interstate commerce²¹ and excludes certain employment contracts,²² Section 2 provides that arbitration agreements (other than excluded employment contracts) evidencing a transaction involving interstate commerce²³ are "enforceable, save upon such grounds as exist . . . for the revocation of any contract."²⁴

19. *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983). *Accord* Macneil et al., *supra* note 1, § 5.3.1.

20. 9 U.S.C. § 2 (1988).

21. "[C]ommerce", as herein defined, 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, but nothing herein contained shall apply to contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign or interstate commerce.

9 U.S.C. § 1 (1988). With respect to international arbitration, see 9 U.S.C. §§ 201-08 (1988) (adopting Convention on the Recognition and Enforcement of Foreign arbitral Awards of June 9, 1958) and 9 U.S.C. §§ 301-07 (1992) (adopting Inter-American Convention on International Commercial Arbitration).

22. The final clause in 9 U.S.C. § 1 is the labor exemption to the FAA. See Macneil et al., *supra* note 1, § 11.2.1. Agreements to arbitrate in certain employment contracts—generally collective bargaining agreements—are enforceable, not under the FAA, but under Section 301 of the Labor Management Relations Act ("LMRA"). 29 U.S.C. §§ 152(2), 185 (1988). This Article does not discuss punitive damages in arbitration arising out of agreements governed by the LMRA. For a discussion of punitive damages in labor arbitration, see Linda L. Schlueter & Kenneth R. Redden, *Punitive Damages* § 4.5(D)(2) (2d ed. 1989). There are federal statutes, other than the FAA and LMRA, relating to arbitration, but they do not affect the issues addressed in this Article. See Macneil et al., *supra* note 1, § 12.

23. For a thorough analysis of the FAA's interstate commerce requirement, see Henry C. Strickland, *The Federal Arbitration Act's Interstate Commerce Requirement: What's Left For State Arbitration Law?*, 21 Hofstra L. Rev. 385, 411-12 (1992). See also Macneil et al., *supra* note 1, §§ 9.5.3-.5.4 (addressing the Supreme Court's expansive interpretation of "transaction involving commerce"); Zhaodong Jiang, *Federal Arbitration Law and State Court Proceedings*, 23 Loy. L.A. L. Rev. 473, 482-88 (1990) (analyzing the reach of Section 2). The Supreme Court has granted certiorari in a case involving the FAA's interstate commerce requirement. See *Allied-Bruce Terminix Cos., Inc. v. Dobson*, 628 So. 2d 354 (Ala. 1993), *cert. granted*, 114 S. Ct. 1292 (1994).

24. 9 U.S.C. § 2 (1988).

The significance of Section 2 is apparent in light of the historical reluctance of courts to enforce arbitration agreements, particularly agreements to arbitrate future disputes.²⁵ The judicial hostility to arbitration agreements has been generally understood as a product of government courts' desire to weaken private sector competition for the dispute-resolution business.²⁶ Courts did often enforce arbitral awards where the parties had completed arbitration, and nineteenth century arbitration statutes somewhat increased the enforceability of executory arbitration agreements.²⁷ "But until the New York Arbitration Act of 1920 and the United States Arbitration Act (FAA), enacted by Congress in 1925, agreements to arbitrate future disputes were almost always unenforceable in the United States."²⁸

In light of this history, the FAA's core is freedom of contract with respect to arbitration agreements in order to prevent government courts from weakening their private sector competitors by refusing to enforce arbitration agreements.

The FAA was designed "to overrule the judiciary's long-standing refusal to enforce agreements to arbitrate" . . . and to place such agreements "upon the same footing as other contracts. . . ." While Congress was no doubt aware that the Act would encourage the expeditious resolution of disputes, its passage "was motivated, first and foremost, by a congressional desire to enforce agreements into which parties had entered."²⁹

The Supreme Court has repeatedly emphasized that the FAA "simply requires courts to enforce privately negotiated agreements to arbitrate, like other contracts, in accordance with their terms."³⁰ Thus, the FAA requires courts to enforce arbitration agreements that pro-

25. Macneil et al., *supra* note 1, § 4.1.2. See generally Ian R. Macneil, *American Arbitration Law: Reformation, Nationalization, Internationalization* ch. 2 (1992) [hereinafter Macneil, *American Arbitration law*].

26. Judicial hostility to executory agreements to arbitrate was due to the "desire of the judges, at a time when their salaries came largely from fees, to avoid loss of income." *Kulukundis Shipping Co. v. Amtorg Trading Corp.*, 126 F.2d 978, 983 (2d Cir. 1942) (Frank, J.). See Macneil et al., *supra* note 1, § 4.2.2.1 n.17; Clinton W. Francis, *The Structure of Judicial Administration and the Development of Contract Law in Seventeenth-Century England*, 83 Colum. L. Rev. 35, 134 (1983).

27. Macneil et al., *supra* note 1, § 4.1.2.

28. *Id.*

29. *Volt Info. Sciences, Inc. v. Board of Trustees of the Leland Stanford Junior Univ.*, 489 U.S. 468, 478 (1989) (citations omitted). "Arbitration agreements are purely matters of contract, and the effect of the bill is simply to make the contracting party live up to his agreement. . . . An arbitration agreement is placed upon the same footing as other contracts, where it belongs." H.R. Rep. No. 96, 68th Cong., 1st Sess. 1 (1924).

30. *Volt*, 489 U.S. at 478. See also *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 221 (1985) ("The preeminent concern of Congress in passing the [FAA] was to enforce private agreements into which parties had entered, and that concern requires that we rigorously enforce agreements to arbitrate."); *Southland Corp. v. Keating*, 465 U.S. 1, 10 (1984) (finding that Section 2 thus "mandated the enforcement of arbitration agreements").

vide an arbitrator with the power to award punitive damages. Likewise, the FAA requires courts to enforce arbitration agreements that withhold an arbitrator's power to award punitive damages. In short, whether an arbitrator has the power to award punitive damages depends on the pertinent arbitration agreement.³¹

B. Application to Various Agreements

1. Express Terms

It is quite simple for a court to determine whether an arbitral award of punitive damages should be confirmed or vacated if the arbitration agreement expressly states whether or not the arbitrator is empowered to award punitive damages. If an arbitration agreement expressly states that the arbitrator has that power, then a court must confirm the punitive damages award. Likewise, if an arbitration agreement expressly states that the arbitrator does *not* have that power, then a court must vacate the punitive damages award.³² Many arbitration agreements, however, do not expressly address the question of whether punitive damages may be awarded.³³

31. *Cf. Volt*, 489 U.S. at 476 ("There is no federal policy favoring arbitration under a certain set of procedural rules; the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate.").

32. "If the arbitration clause plainly states that the arbitrators have no power to award punitive damages, that ends the matter," E. Allan Farnsworth, *Punitive Damages in Arbitration*, 20 Stetson L. Rev. 395, 408 (1991), unless one of the parties is a member of a national securities exchange, in which case exchange rules may prohibit such an agreement. See Marilyn B. Cane, *Punitive Damages in Securities Arbitration: The Interplay of State and Federal Law (or a Smaller Bite of the Big Apple)*, 1993 J. Disp. Resol. 153, 167-68 (1993) (arguing that terms denying arbitrator power to award punitive damages should not be enforced in securities broker-customer context); Stephen H. Kupperman & George C. Freeman III, *Selected Topics in Securities Arbitration*, 65 Tul. L. Rev. 1547, 1597, 1602 (1991). For instance, the New York Stock Exchange rules provide that "[n]o agreement shall contain any condition which limits . . . the ability . . . of the arbitrators to make any award." NYSE Rule 636(d), 2 N.Y.S.E. Guide (CCH) ¶ 2636, at 4328 (Nov. 1992). See also NASD Rules of Fair Practice art. III, § 21 (f)(4), NASD Manual (CCH) ¶ 2171, at 2095-4 (Jan. 1993). The Securities and Exchange Commission interprets these rules as prohibiting waivers of punitive damages. Adoption of Rule Changes to Securities Arbitration Rules, Exchange Act Release No. 26,805, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,414, at 80,113 (May 10, 1989) ("If punitive damages . . . would be available under applicable law, then the agreement cannot limit . . . arbitrators' rights to award them.").

33. Farnsworth, *supra* note 32, at 410 (citing Stephen Bond, *How to Draft an Arbitration Clause*, J. Int'l Arb., June 1989, at 65). Arbitration agreement terms expressly addressing punitive damages may be becoming more common. See, e.g., James W. Durham, et al., *ADR More Than a Means of Resolving Disputes*, Corp. Legal Times, May 1994, at 1 (reporting that corporate counsel revise arbitration agreements "as the issues of punitive damages have come up"). For an example of an arbitration agreement term expressly addressing punitive damages, see John F. Dolan, Uniform Commercial Code: Terms and Transactions in Commercial Law 81 (1991).

2. Implied Terms

If the arbitration agreement does not expressly address the arbitrability of punitive damages, then, in accordance with the usual methods of contractual interpretation, other terms in the agreement must be examined to determine whether the arbitrator has the power to award punitive damages. An agreement may *impliedly* address punitive damages. For instance, many arbitration agreements incorporate the Commercial Rules of the American Arbitration Association. One of those rules, Rule 43, is entitled "Scope of Award" and provides that "[t]he arbitrator may grant any remedy or relief that the Arbitrator deems just and equitable and within the scope of the agreement of the parties including but not limited to, specific performance of the contract."³⁴ Courts have sensibly relied on the incorporation of this rule (or earlier versions of it) in arbitration agreements to conclude that those agreements impliedly empower arbitrators to award punitive damages.³⁵

An example of language impliedly denying an arbitrator the power to award punitive damages is: "The arbitrator may grant no remedy other than compensatory damages." This hypothetical language does not expressly address punitive damages, but it impliedly waives them along with other remedies like reformation, rescission or specific performance.

Some courts refuse to find that parties have impliedly given their arbitrator the power to award punitive damages; these courts insist that arbitrators may award punitive damages only if the arbitration agreement expressly authorizes punitive damages.³⁶ These courts

34. Macneil et al., *supra* note 1, § 36.3.2.3.

35. See *Todd Shipyards Corp. v. Cunard Line*, 943 F.2d 1056, 1063 n.6 (9th Cir. 1991); *Raytheon Co. v. Automated Business Sys., Inc.*, 882 F.2d 6, 9-10 (1st Cir. 1989); *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378 (11th Cir. 1988); *Willoughby Roofing & Supply Co., v. Kajima Int'l, Inc.*, 598 F. Supp 353, 358 (N.D. Ala. 1984), *aff'd*, 776 F.2d 269 (11th Cir. 1985).

36. See, e.g., *Complete Interiors, Inc. v. Behan*, 558 So. 2d 48, 51 (Fla. Dist. Ct. App. 1990) (holding that arbitrator exceeded his power by awarding punitive damages in absence of express agreement between the parties); see also *Bonar*, 835 F.2d at 1388-89 (Tjoflat, J., concurring) ("I have difficulty, however, understanding how punitive damages can ever be considered 'within the scope of the agreement of the parties' absent some express provision in the contract."); *Edward Elec. Co. v. Automation, Inc.*, 593 N.E.2d 833, 842-43 (Ill. App. Ct. 1992) (finding that arbitrators may award punitive damages only where expressly authorized by the arbitration agreement); Douglas R. Davis, Note, *Overextension of Arbitral Authority: Punitive Damages and Issues of Arbitrability*, 65 Wash. L. Rev. 695 (1990) (asserting that arbitrators should interpret broadly-drafted arbitration clauses to encompass only traditional contract remedies).

James Hadden puts *State Farm Mut. Ins. Co. v. Blevins*, 551 N.E.2d 955 (Ohio 1990), in the category of cases prohibiting arbitral awards of punitive damages in the absence of an express term authorizing them. See James Hadden, Note, *The Authority of Arbitrators to Award Punitive Damages*, 7 Ohio St. J. on Disp. Resol. 337, 344-45 (1992). Hadden's interpretation of *Blevins* may be somewhat misleading. *Blevins* involved an insurance policy providing coverage for "damages for bodily injury an

generally begin with the misunderstanding that the parties have submitted to arbitration only breach of contract claims. Because punitive damages are not normally available for such claims,³⁷ these courts will not find that the parties have agreed to punitive damages unless there is express language to that effect in the arbitration agreement.³⁸ Once one realizes that non-contract claims (for which punitive damages would be available in court) also have been submitted to arbitration, there is no reason to presume that the parties have chosen to deny the arbitrator the power to award punitive damages.

3. Default Rules

When there is no term expressly addressing the arbitrability of punitive damages, courts properly look for terms impliedly addressing it. Suppose, however, there is nothing at all in the language of the arbi-

insured is legally entitled to collect from the owner or driver of an uninsured motor vehicle." 551 N.E.2d at 956. After an auto accident, the insureds demanded arbitration against the insurer. The arbitration panel concluded that the insureds were legally entitled to compensatory and punitive damages from the uninsured motorist and, therefore, were entitled to that amount of damages from the insurer. The Supreme Court of Ohio subsequently affirmed a lower court ruling that vacated the arbitral "punitive damages" award. The Supreme Court of Ohio did so because "in the absence of specific contractual language, coverage for punitive or exemplary damages will not be presumed under a provision for uninsured motorist coverage." *Id.* at 959. This is not a holding that arbitrators may only award punitive damages when the arbitration agreement expressly authorizes them to do so. It is a holding that the insurance policy should not be interpreted (by either a court or an arbitrator) to include coverage for punitive damages. While *Blevins* did "hold that the arbitrators exceeded their power when they made an award for punitive damages," *id.*, the Supreme Court of Ohio's reasoning would lead to the conclusion that a court awarding punitive damages under the same agreement had exceeded *its* powers. In short, *Blevins* is a case about the interpretation of an insurance policy, not about the scope of arbitrators' remedial power.

37. *Schlueter & Redden*, *supra* note 22, § 7.0 ("It is well established that punitive damages cannot be recovered for a mere breach of contract."). As Judge Richard Posner said in affirming the confirmation of an arbitral punitive damages award,

Occasional statements that punitive damages are disfavored in arbitration . . . must be read in context. Most arbitrations concern contract interpretation, and it is untraditional and still infrequent to award punitive damages for breach of contract. . . . Here we have the unusual case of tort arbitration, and punitive damages are commonly awarded for certain torts.

Baravati v. Josephthal, Lyon & Ross, Inc., 28 F.3d 704, 710 (7th Cir. 1994).

38. See *Farnsworth* *supra* note 32, at 401-04. *Complete Interiors, Inc. v. Behan* suggests that only express language can support an arbitral punitive damages award. However, to support this assertion, the court cites cases that are inapposite because they are labor arbitration cases decided under the LMRA, not the FAA. 558 So. 2d at 51. Only labor cases are cited by *Schlueter & Redden* for the proposition that "some courts have held that an arbitrator can award punitive damages, but only when the express language of the contract so permits." *Schlueter & Redden*, *supra* note 22, § 4.5(C) n.15. See also Michael L. Collyer, Note, *Punitive Damages in Arbitration: The Second Circuit on a Collision Course With the U.S. Supreme Court*, 8 Ohio St. J. on Disp. Resol. 385, 395 (1993) ("The trend in the arbitration of labor law cases has been to allow arbitration of punitive damages issues only when the contract explicitly authorizes such power.").

tration agreement that can plausibly be construed as addressing the arbitrator's power to award punitive damages. What is the default rule to fill the gap in the agreement? The Supreme Court has consistently stated "that questions of arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration,"³⁹ and "ambiguities as to the scope of the arbitration clause itself [are] resolved in favor of arbitration."⁴⁰ This "federal policy favoring arbitration" constitutes a default rule to fill the gap in an arbitration agreement, which does not in any way indicate whether the arbitrator is empowered to award punitive damages.⁴¹ Courts have properly held "that federal policy in favor of a broad view of arbitrability supports the power of arbitrators to award punitive damages."⁴² But too much should not be read into the federal policy favoring arbitration. It is merely a "tie-breaker," an answer to the question posed by an arbitration agreement that is silent on the issue at hand, whether that issue is the arbitrability of punitive damages or anything else. The federal policy favoring arbitration does not come into play when the express or implied terms of the arbitration agreement speak to the issue.⁴³

39. *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983). See also *Volt Info. Sciences v. Board of Trustees of Leland Stanford Junior Univ.* 489 U.S. 468, 475-76 (1989).

40. *Volt*, 489 U.S. at 476.

41. This default rule can be justified on efficiency grounds even if the alternative default rule (prohibiting punitive damages in arbitration) is preferred by most parties whose contracts are silent on the issue. Ayres and Gertner coined the term "penalty default" to describe a default rule purposely set contrary to what most parties would want. Ayres & Gertner, *supra* note 15, at 91. "Penalty defaults are designed to give at least one party to the contract an incentive to contract around the default rule . . ." *Id.* The benefit of providing this incentive to contract around the default rule is that it encourages the production of information. *Id.* at 97-98.

Consider, for instance, the arbitration agreements between a securities brokerage firm and its customers. Assume that the brokerage firm will prefer a rule against arbitral awards of punitive damages because arbitrators order brokerage firms to pay punitive damages to customers more often than vice-versa. As a "repeat player" using the same form contract with each of its customers, the brokerage firm is more likely than its customer to know the default rule on punitive damages in arbitration. An efficiency argument can be made for application of the default rule against the brokerage firm on the ground that this will give the more informed party an incentive to contract around the rule. This, in turn, will generate information for the relatively uninformed customer. *Id.* at 98. In other words, the contract terms will reveal to the customer whether or not the brokerage firm proposes to deny the arbitrator the power to award punitive damages.

42. *Todd Shipyards Corp. v. Cunard Line*, 943 F.2d 1056, 1063 (9th Cir. 1991) (citing *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1387 (11th Cir. 1988)). See *Barbier v. Shearson Lehman Hutton, Inc.*, 752 F. Supp. 151, 163 (S.D.N.Y. 1990), *aff'd in part and rev'd in part*, 948 F.2d 117 (2d Cir. 1991); *Singer v. E.F. Hutton & Co.*, 699 F. Supp. 276, 278-79 (S.D. Fla. 1988); *Ehrich v. A.G. Edwards & Sons, Inc.*, 675 F. Supp. 559, 565 (D.S.D. 1987); *Willis v. Shearson/American Express, Inc.*, 569 F. Supp. 821, 824 (M.D.N.C. 1983).

43. Use of the federal policy favoring arbitration as a default rule that supports the arbitrability of punitive damages has been both defended, see Michael L. Collyer, Note, *Punitive Damages in Arbitration: The Second Circuit on a Collision Course with*

C. Resistance to Freedom of Contract

If an arbitration agreement—by express terms, implied terms, or the default rule—empowers an arbitrator to award punitive damages, the issue has been resolved as far as (non-constitutional) federal law is concerned.⁴⁴ But if an arbitration agreement—by express or implied terms—denies an arbitrator the power to award punitive damages, an additional issue arises: may a court award punitive damages on the claim or has the right to recover them been waived altogether?

The best answer is “waived altogether.”⁴⁵ In agreeing to arbitrate, parties waive their rights to court-ordered relief (except confirmation of arbitral awards) and create a right to arbitrator-ordered relief. Then, in denying the arbitrator the power to award punitive damages, the parties waive a portion of the newly created right to arbitrator-ordered relief. This second waiver (of some arbitrator-ordered relief) cannot plausibly be interpreted as reversing the first waiver (of all court-ordered relief).

Ian Macneil et al. disagree and assert that an arbitration agreement denying the arbitrator the power to award punitive damages does not preclude a court from awarding them. According to Macneil et al., there is “no justification for interpreting an ordinary arbitration clause as a waiver of substantive rights—it is a waiver of the right to normal judicial processes, and that is all.”⁴⁶ It is true that there is no justification for interpreting an “ordinary arbitration clause” as foreclosing the possibility of punitive damages if the term “ordinary arbitration

the U.S. Supreme Court, 8 Ohio St. J. on Disp. Resol. 385 (1993), and criticized. See Joseph P. Lakatos & Thomas G. Stenson, Note, *Punitive Damages Under the Federal Arbitration Act: Have Arbitrators' Remedial Powers Been Circumscribed By State Law?*, 7 St. John's J. Legal Comment. 661 (1992).

Lakatos and Stenson agree that the arbitrability of punitive damages is a matter of contract so express terms in the contract govern and, if there are no relevant express terms, other contract terms may provide an answer by implication. *Id.* at 675-78. Furthermore, they agree that a default rule is necessary if the terms of the arbitration agreement do not address punitive damages, even by implication. *Id.* at 678-79. But, they have an unusual proposal for the default rule.

Lakatos and Stenson contend that “courts should preliminarily recognize” state law on the arbitrability of punitive damages as the default rule. *Id.* at 678. But then “further inquiry must be made to ensure [the state law's] consistency with the underlying goals and policies of the FAA.” *Id.* at 679. For example, state law prohibiting arbitral punitive damages awards is inconsistent with the FAA and “should be preempted.” *Id.* As part II of this Article explains, use of state law on the arbitrability of punitive damages as a default rule (or otherwise) in arbitration arising out of transactions in interstate commerce is unwarranted.

44. Part II will address state law and part III will address constitutional requirements of due process.

45. For cases treating agreements to arbitrate as waivers of the right to recover punitive damages in any forum, see *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 812 F. Supp. 845, 846-47 (N.D. Ill. 1993) (citing cases), *aff'd*, 20 F.3d 713 (7th Cir.), *cert. granted*, 63 U.S.L.W. 3064 (U.S. Oct. 7, 1994); *Waltman v. Fahnestock & Co.*, 792 F. Supp. 31, 33-34 (E.D. Pa. 1992), *aff'd*, 989 F.2d 490 (3d Cir. 1993).

46. Macneil et al., *supra* note 1, § 36.3.2.2

clause" refers to a clause that does not (expressly or impliedly) deny the arbitrator the power to award punitive damages. Such a clause transfers from courts to arbitrators the power to decide whether to award punitive damages. If, however, an arbitration agreement denies the arbitrator the power to award punitive damages, then the parties have waived their rights both to judicial resolution of their claims and to the award of punitive damages.⁴⁷ Section 2 of the FAA requires courts to enforce this waiver of the right to recover punitive damages just as it requires courts to enforce arbitration agreements in other respects, that is, "save upon such grounds as exist at law or in equity for the revocation of any contract."⁴⁸

Macneil et al.'s assertion that agreeing to arbitrate is a waiver of normal judicial processes, but not a waiver of substantive rights, sets up a false dichotomy. A waiver of the right to normal judicial processes necessarily entails a waiver of substantive rights unless courts vacate arbitral awards when arbitrators make errors of law. That courts confirm arbitral awards even when arbitrators make errors of law⁴⁹ shows that arbitration agreements constitute waivers of

47. An arbitration agreement could conceivably deny the arbitrator the power to award punitive damages, but preserve the right to recover them in court. This would require arbitration of liability and nonpunitive damages issues followed by judicial resolution of claims for punitive damages. This bifurcation has been considered by commentators, *see* Commercial and Federal Litigation Section of the New York State Bar Association, Report on Punitive Damages in Commercial Arbitration 24 (1990), and has occurred in New York. *See* DiCrisci v. Lyndon Guar. Bank, 807 F. Supp. 947, 953 (W.D.N.Y. 1992) (severing claim for punitive damages pending completion of arbitration); *see also* Mulder v. Donaldson, Lufkin & Jenrette, 611 N.Y.S. 2d 1019, 1021 (Sup. Ct. 1994) (plaintiff's "appropriate recourse was to wait for a favorable award from the arbitrators, and then bring a plenary action in this court for punitive damages"); *Singer v. Salomon Bros. Inc.*, 593 N.Y.S.2d 927, 930 (Sup. Ct. 1992) ("At the conclusion of the arbitration, this court may award punitive damages, if proper."). This bifurcation, however, is "entirely unsatisfactory. Given the nature of arbitration proceedings and the likely absence of a record, findings of fact, and conclusions of law, the court would typically have little alternative but to try the entire case all over again, but for the sole purpose of deciding about punitive damages." Macneil et al., *supra* note 1, § 36.3.2.2. Because bifurcation "would make arbitration where punitive damages may be in issue extremely inefficient," it is "unlikely to be chosen by the knowledgeable." *Id.* If, however, this bifurcation is chosen by the parties, that choice must be enforced. "The preeminent concern of Congress in passing the [FAA] was to enforce private agreements into which parties had entered, and that concern requires that we rigorously enforce agreements to arbitrate, even if the result is 'piecemeal' litigation, at least absent a countervailing policy manifested in another federal statute." *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 221 (1985).

48. 9 U.S.C. § 2 (1988).

49. Macneil et al., *supra* note 1, §§ 40.5.2.4, 40.7. Courts do reserve the power to vacate an arbitral award when the arbitrators "manifestly disregard" the law. *Id.* § 40.7.1. But "manifest disregard" is much more than an error of law; it occurs when "the arbitrator understood and correctly stated the law but proceeded to ignore it." *Siegel v. Titan Indus. Corp.*, 779 F.2d 891, 893 (2d Cir. 1985) (quoting *Bell Aerospace Co. v. Local 516*, 356 F. Supp. 354, 356 (W.D.N.Y. 1973)). "It is nearly impossible to find FAA arbitration decisions where application of the [manifest disregard] doctrine

substantive rights.⁵⁰ An uncorrected error of law, by definition, deprives a party of the substantive right that would have been vindicated by a correct application of the law. Courts do not correct errors of law, that is, deprivations of substantive rights, by arbitrators, because courts treat an agreement to arbitrate as a waiver of those substantive rights.

Assume, for example, that A and B have agreed to arbitrate all disputes arising out of their contract, which evidences a transaction involving interstate commerce. Assume further that A has been defrauded by B and that, under a proper application of the law of fraud, B would be liable to A for both compensatory and punitive damages. If the arbitrator hearing A's fraud claim misapplies the law of fraud and concludes that B is not liable to A at all, then the arbitrator's decision will be confirmed by the courts. Courts will confirm what would otherwise be a complete deprivation of A's substantive right to recover for fraud because A waived that right when A agreed to arbitrate.

Now assume the same situation except that the arbitrator correctly applies the law of fraud to find B liable to A but incorrectly concludes that, on the facts of this dispute, B is liable only for compensatory, not punitive, damages. Rather than a complete deprivation of A's substantive rights—as occurred in the first hypothetical—we have only a partial deprivation of A's substantive rights. Just as the complete deprivation of substantive rights is enforced because A waived those rights in agreeing to arbitrate, so the partial deprivation of substantive rights should be enforced because of A's waiver. A contrary ruling enforcing a waiver of the whole but refusing to enforce a waiver of a part of that whole is illogical. More specifically, enforcing arbitration agreements as waivers of complete substantive rights—which is routine—but refusing to enforce them as waivers of part of those rights (the punitive damages part) is illogical.⁵¹

has resulted in the upsetting of an [arbitral] award." Macneil et al., *supra* note 1, § 40.7.1.

50. In agreeing to arbitrate, parties trade their substantive rights for the arbitrator's decision as constrained by the agreement and the limited judicial review of arbitral awards. Courts do vacate arbitral awards based on errors of law when the arbitration agreement requires the arbitrator "to apply particular law and do it correctly." Macneil et al., *supra* note 1, §§ 40.5.2.3, 40.7.1. This is because the parties to such an agreement have contractually reinstated their substantive rights, which otherwise would have been contractually waived by agreeing to arbitrate.

51. Macneil et al. recognize that "[i]n accordance with the general principles of consensual arbitration law, the parties may, of course, explicitly limit the authority of the arbitrators to rescind or reform their contract." *Id.* § 36.5.4. Is this a waiver of rescission or reformation in any forum? If so, then how can the remedy of punitive damages be distinguished from the remedies of rescission or reformation? If it is not a waiver of rescission or reformation in any forum, then there is the unfortunate possibility that an arbitrator, unable to rescind or reform the contract, could order "second best" relief followed by a court granting rescission or reformation over and above the arbitrator's remedy.

Numerous commentators have worried that enforcing arbitration agreement terms waiving the right to recover punitive damages would permit securities brokerage firms and other parties using form contracts to insulate themselves from punitive damages claims by including such terms in the fine-print of their form contracts.⁵² This worry is misplaced to the extent that contract law declines to enforce onerous terms in form contracts generally because the FAA allows courts to treat form arbitration agreements like other form contracts.⁵³ The FAA, however, forbids courts from being more resistant to enforcing

52. *Id.* § 36.3.2; Edward Brunet, *Arbitration and Constitutional Rights*, 71 N.C. L. Rev. 81, 104-08 (1992); Constantine N. Katsoris, *Punitive Damages in Securities Arbitration: The Tower of Babel Revisited*, 18 Fordham Urb. L.J. 573, 593-96 (1991); Richard J. Oparil, *Preemption and the Federal Arbitration Act*, 13 Geo. Mason U. L. Rev. 325, 338-45 (1990); G. Richard Shell, *The Power to Punish: Authority of Arbitrators to Award Multiple Damages and Attorney's Fees*, 77 Mass. L. Rev. 26, 34 (1987); Thomas J. Stipanowich, *Punitive Damages in Arbitration: Garrity v. Lyle Stuart, Inc. Reconsidered*, 66 B.U. L. Rev. 953, 1007-1010 (1986); Brian R. Hajicek, Comment, *Punitive Damages in New York Arbitration: Who is Really Being Punished?*, 2 J. Disp. Resol. 361, 372 (1992). *Accord* Dreyfus Service Corp. v. Kent, 584 N.Y.S.2d 483 (App. Div. 1992) (Asch, J., concurring), *appeal denied*, 594 N.Y.S.2d 715 (1992). See generally Perry E. Wallace, Jr., *Securities Arbitration After McMahon, Rodriguez and the New Rules: Can Investors' Rights Really Be Protected?*, 43 Vand. L. Rev. 1199 (1990) (discussing need for improved arbitration procedures).

53. Arbitration agreements are enforceable "save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. See *Perry v. Thomas*, 482 U.S. 483, 492-93 n.9 (1987); Macneil, *American Arbitration Law*, *supra* note 25, at 68 ("Arbitration agreements [are] burdened with whatever protections against one-sidedness that law and equity provide[] contracts in general, but no more."); Note, *Incorporation of State Law Under the Federal Arbitration Act*, 78 Mich. L. Rev. 1391, 1411-12 (1980) (Section 2 of the FAA allows a Court to "hold[] an arbitration agreement unconscionable for reasons that do not arise solely because an arbitrator rather than a judge or jury decides the dispute.").

A good example of a case involving a form arbitration agreement is *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 812 F. Supp. 845 (N.D. Ill. 1993), *aff'd*, 20 F.3d 713 (7th Cir. 1994), *cert. granted*, 63 U.S.L.W. 3064 (U.S. Oct. 7, 1994). *Mastrobuono* held that a New York choice-of-law clause in an arbitration agreement (standard form brokerage agreement) constituted a waiver of punitive damages in any forum because New York law prohibits arbitrators from awarding punitive damages, and pertinent state law prohibits a separate court action solely for punitive damages. *Id.* at 848. Macneil et al. cite *Mastrobuono* with disapproval as an example of the harm that flows from allowing arbitration agreements to waive punitive damages. Macneil et al., *supra* note 1, § 36.3.2.2 n.31.

Mastrobuono's conclusion that New York law governed the punitive damages issue is mistaken for the reasons discussed *infra* at part II. B. 2, and note 125. For present purposes, however, assume New York law governed the punitive damages issue. Even with that assumption, *Mastrobuono* may be wrong, but its wrongfulness does not support Macneil et al.'s conclusion that parties should be denied the freedom to waive punitive damages. The doubt about *Mastrobuono* is doubt about whether a waiver of punitive damages occurred, that is, doubt about whether to enforce arbitration agreement terms buried in the fine print of a form contract. Declining to enforce "waivers" of punitive damages when buried in the fine print of a form contract is consistent with Section 2 of the FAA to the extent that contract law generally declines to enforce terms in the fine print of form contracts. On the other hand, enforcing waivers of punitive damages when there is no contract law defense against doing so is required by Section 2 of the FAA.

the terms of form arbitration agreements than to enforcing the terms of other form contracts.⁵⁴ If an arbitration agreement term (expressly or impliedly) denying the arbitrator the power to award punitive damages is not rendered unenforceable by contract law then, as far as the FAA is concerned, it must be enforced.

II. STATE LAW REGARDING THE ARBITRABILITY OF PUNITIVE DAMAGES

The foregoing analysis of the arbitrability of punitive damages does not discuss state law on the subject. That is because the FAA "rests on the authority of Congress to enact substantive rules under the Commerce Clause,"⁵⁵ and is applicable in state, as well as federal, courts.⁵⁶ The FAA, like any federal statute, is the "Supreme Law of the Land" and any state law in conflict with it is unenforceable.⁵⁷ The FAA applies if the pertinent arbitration agreement evidences a transaction involving interstate commerce.⁵⁸ In such cases, therefore, courts must apply the FAA, rather than conflicting state law, to determine whether an arbitrator may award punitive damages.

A somewhat different approach to state law on the arbitrability of punitive damages prevails in the Second Circuit.

A. *The Second Circuit Approach*

In *Fahnestock & Co. v. Waltman*,⁵⁹ the Second Circuit applied state law in affirming a district court decision vacating an arbitrator's award of punitive damages. The Second Circuit did so even though the arbitration agreement at issue indisputably evidenced a transaction involving interstate commerce.⁶⁰ The state law relied upon in

Commentators have lamented that courts too rarely decline to enforce arbitration agreement terms on grounds such as adhesion and unconscionability. See, e.g., Brunet, *supra* note 52, at 107 (discussing the scarcity of cases "willing to reject arbitration clauses on adhesion contract grounds"). See also Jeffrey W. Stempel, *A Better Approach to Arbitrability*, 65 Tul. L. Rev. 1377 (1991). Stempel makes the excellent suggestion that:

courts confronted with arbitrability questions should enforce written agreements to arbitrate without regard to the subject matter of the dispute or to the legal claims in the dispute unless the party resisting arbitration can demonstrate . . . that the arbitration 'contract' between the parties is voidable because it was not the product of sufficiently genuine consent between the parties.

Id. at 1426.

54. See *supra* notes 25-31 and accompanying text.

55. *Southland Corp. v. Keating*, 465 U.S. 1, 11 (1984). For criticism of *Southland*, see *infra* note 68.

56. *Southland*, 465 U.S. at 12.

57. U.S. Const. art. VI, cl. 2.

58. See *supra* note 21 and accompanying text.

59. 935 F.2d 512 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 380 (1991).

60. *Id.* at 517.

*Fahnestock*⁶¹ is *Garrity v. Lyle Stuart, Inc.*,⁶² in which the Court of Appeals of New York ruled that "[a]n arbitrator has no power to award punitive damages, even if agreed upon by the parties."⁶³

The Second Circuit's justification for applying state law in *Fahnestock* was that the federal subject matter jurisdiction in that case was based solely on the diversity of citizenship of the parties.⁶⁴ In diversity actions, federal courts have applied state, rather than federal, substantive law since the landmark decision of *Erie R.R. v. Tompkins*.⁶⁵

Federal jurisdiction in *Fahnestock* was based solely on diversity. There was no federal question jurisdiction.⁶⁶ Yet the case arose out of an arbitration agreement evidencing a transaction involving interstate commerce, thus implicating the FAA. This anomaly was explained by the Supreme Court in *Moses H. Cone Memorial Hospital v. Mercury Construction Corporation*.⁶⁷

The Arbitration Act is something of an anomaly in the field of federal-court jurisdiction. It creates a body of federal substantive law establishing and regulating the duty to honor an agreement to arbitrate, yet it does not create any independent federal-question jurisdiction under 28 U.S.C. § 1331 (1976 ed., Supp. V) or otherwise. Section 4 [of the FAA] provides for an order compelling arbitration only when the federal district court would have jurisdiction over a

61. *Id.* at 515.

62. 353 N.E.2d 793 (1976).

63. *Id.* at 794. Other state cases prohibiting arbitrators from awarding punitive damages include *United States Fidelity & Guar. Co. v. De Fluiter*, 456 N.E.2d 429, 432 (Ind. Ct. App. 1983); *Shaw v. Kuhnelt & Assocs., Inc.*, 698 P.2d 880, 882 (N.M. 1985) (dicta); *Anderson v. Nichols*, 359 S.E.2d 117, 121 n.1 (W. Va. 1987). The *Garrity* rule leads to practical problems because the distinction between compensatory and punitive damages, while clear in theory, may not be so clear in practice. If arbitrators know they are prohibited from awarding punitive damages, they may make larger awards of "compensatory" damages to incorporate what would otherwise be the punitive damages component. Few of these inflated compensatory awards are likely to be modified or vacated because of the deferential standard of review that courts give to arbitral awards. *Stipanowich*, *supra* note 52, at 959 n.23; Richard P. Hackett, Note, *Punitive Damages in Arbitration: The Search for a Workable Rule*, 63 Cornell L. Rev. 272, 295-99 (1978). Cf. Macneil et al., *supra* note 1, § 36.8.4 ("[J]udicial scrutiny of an [arbitral] award of attorneys' fees may be dramatically limited by the arbitrators' failure to identify it as such. Lump-sum awards could often easily be tailored to avoid revealing that attorneys' fees were included."). The New York Court of Appeals has had to remind New York courts that *Garrity* "should not be interpreted as an indication that whenever compensatory damages are somewhat speculative" an arbitrator's award may be vacated on the ground that "punitive" damages were awarded. *Board of Educ. v. Niagara-Wheatfield Teachers Ass'n*, 389 N.E.2d 104, 106 (N.Y. 1979).

64. *Fahnestock*, 935 F.2d at 518.

65. 304 U.S. 64, 78 (1938). See generally Charles A. Wright et al., *Federal Practice and Procedure* § 4504 (1982 & Supp. 1994). In *Fahnestock*, the Second Circuit characterized *Garrity* as substantive before affirming *Garrity*'s application to vacate the award of punitive damages. *Fahnestock*, 935 F.2d at 518.

66. 28 U.S.C. § 1331 provides that "[t]he district courts shall have original jurisdiction of all civil actions arising under the Constitution, laws, or treaties of the United States."

67. 460 U.S. 1 (1983).

suit on the underlying dispute; hence, there must be diversity of citizenship or some other independent basis for federal jurisdiction before the order can issue.⁶⁸

So the Second Circuit, while not denying that the arbitration agreement in *Fahnestock* involved interstate commerce, correctly stated that federal jurisdiction was based solely on diversity. But in diversity cases—like all cases, state or federal—state law does *not* apply when preempted by federal law.⁶⁹ The weakness in *Fahnestock* stems from

68. *Id.* at 25 n.32. The conclusion of *Moses H. Cone* and *Southland*, that the FAA creates federal substantive law applicable in state and federal courts, has been widely criticized as inconsistent with the original understanding of the FAA, that is, that the FAA governs only in federal courts. See, e.g., Barbara Ann Atwood, *Issues in Federal-State Relations Under the Federal Arbitration Act*, 37 U. Fla. L. Rev. 61, 81 (1985) (agreeing with Justice Black's dissent in *Prima Paint Corp. v. Flood & Conklin Mfg.*, 388 U.S. 395 (1967), that Congress intended the FAA to provide a federal remedy for specific performance of arbitral awards); Rita M. Cain, *Preemption of State Arbitration Statutes: The Exaggerated Federal Policy Favoring Arbitration*, 19 J. Contemp. L. 1, 14-15 (1993) (criticizing *Moses H. Cone* for ignoring legislative history in holding that FAA is applicable outside federal courts); Macneil et al., *supra* note 1, § 10.5.3 (criticizing the majority opinion in *Southland* that Congress intended the FAA to apply outside the federal system); Macneil, *supra* note 25, ch. 9-11, 14 (1992) (arguing that the legislature intended that the FAA's applicability be limited to federal courts). And the plaintiffs in *Allied-Bruce Terminix Cos., Inc. v. Dobson*, 628 So. 2d 354 (Ala. 1993), *cert. granted*, 114 S. Ct. 1292 (1994), along with 20 state attorneys general, writing as friends of the court, argue that *Southland* should be reconsidered. See Henry C. Strickland, *Does Federal Law Mandate Enforcement of Boilerplate Arbitration Provisions in Consumer Contracts?*, Preview of United States Supreme Court Cases, Oct. 1, 1994, at 6.

The original understanding of the FAA as governing only federal courts was jeopardized by *Erie* and *Guaranty Trust Co. v. York*, 326 U.S. 99 (1945), which adopted the "outcome determinative" test that placed the FAA on the "substance" side of *Erie*'s substance/procedure line. *Id.* at 109. If Congress enacted the FAA as an exercise of its power to provide a rule of decision only for diversity cases already in the federal courts, then the Supreme Court "would have had to decide if Congress could legislate where *Erie* had forbidden the federal courts to create common law." Linda R. Hirshman, *The Second Arbitration Trilogy: The Federalization of Arbitration Law*, 71 Va. L. Rev. 1305, 1320 (1985). The Court avoided this difficult issue in *Prima Paint Corp. v. Flood & Conklin Mfg.*, by concluding that Congress had enacted the FAA pursuant to its commerce and admiralty power. 388 U.S. 395, 404-05 (1967). In *Moses H. Cone* and *Southland* the Court stated that the FAA governs actions in state, as well as federal, court. While one can quarrel with the way *Prima Paint*, *Moses H. Cone* and *Southland* departed from the original understanding of the FAA, it is important to recognize that:

the anomalies [in these decisions] result from the passage of the FAA prior to the *Erie* decision. The Supreme Court later construed the FAA as federal substantive law to avoid a conflict with *Erie* Faced with a choice between two imperfect formulations, the Court aligned its pro-arbitration inclination with the perceived "broader purpose" of Congress and took an expansive view of the Act.

Hirshman, *supra*, at 1345-46.

69. U.S. Const. art. VI, cl. 2.

the Second Circuit's analysis of whether *Garrity* is preempted by the FAA.⁷⁰

The FAA's preemption of state law was addressed by the Supreme Court in *Volt Information Sciences, Inc. v. Board of Trustees of the Leland Stanford Junior University*.⁷¹ "The FAA contains no express pre-emptive provision, nor does it reflect a congressional intent to occupy the entire field of arbitration."⁷² But, the Supreme Court continued,

Even when Congress has not completely displaced state regulation in an area, state law may nonetheless be preempted to the extent that it actually conflicts with federal law—that is, to the extent that it "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."⁷³

The preemption question, therefore, is whether application of a state law "would undermine the goals and policies of the FAA."⁷⁴ Under this standard, *Garrity* is preempted by the FAA because it conflicts with Section 2 of the FAA and would severely "undermine the goals and policies of the FAA."

Garrity's rationale is that "[p]unitive damages is a sanction reserved to the State."⁷⁵ "The law does not and should not permit private persons to submit themselves to punitive sanctions of the order reserved to the State. The freedom of contract does not embrace the freedom to punish, even by contract."⁷⁶ *Garrity*'s restriction of freedom of contract could not more clearly conflict with a statute whose core command is freedom of contract for arbitration agreements.⁷⁷ "[A] state law which limits freedom of contract with respect to arbitration agreements covered by the FAA conflicts with the FAA and is preempted by it."⁷⁸

70. See *Fahnestock & Co. v. Waltman*, 935 F.2d 512, 517 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 380 (1991).

71. 489 U.S. 468 (1989).

72. *Id.* at 477.

73. *Id.* (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)).

74. *Id.* at 478. Absent a choice-of-law clause, see *infra* part II.B, state arbitration law cannot limit federal arbitration law in a case arising out of an arbitration agreement involving interstate commerce. See Macneil et al., *supra* note 1, § 10.8.1.1. However, other areas of state law, most notably state contract law, do play an essential role in such cases. The FAA, particularly the savings clause of Section 2, presupposes state contract law. *Id.* § 10.6.2.1. The FAA is a "specialized and very limited contract act[] adding to, modifying, and limiting the general contract law which otherwise would govern arbitration agreements." *Id.* "The contract infrastructure underlying the FAA is the general contract law of the particular state governing the parties' relationships." *Id.* § 10.6.2.3.

75. *Garrity v. Lyle Stuart, Inc.*, 353 N.E.2d 793, 794 (N.Y. 1976).

76. *Id.* at 797.

77. See *supra* notes 29-30 and accompanying text.

78. *Fahnestock & Co. v. Waltman*, 935 F.2d 512, 520 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 380 (1991) (Mahoney, J., concurring in part and dissenting in part). Commentators agree that *Garrity* is preempted by the FAA and recognize that *Garrity*

The core of the FAA is Section 2's command that arbitration agreements are as enforceable as other contracts.⁷⁹ The FAA was enacted to overrule the judiciary's long-standing refusal to enforce agreements to arbitrate.⁸⁰ "[The FAA] simply requires courts to enforce privately negotiated agreements to arbitrate, like other contracts, in accordance with terms."⁸¹ *Garrity* defies this requirement. *Garrity* refuses to enforce arbitration agreements giving arbitrators the power to award punitive damages.⁸² Because *Garrity* singles out arbitration agreements and limits their enforceability, it is preempted by the FAA.⁸³

This preemption of limitations on freedom of contract works both ways. *Garrity* singles out arbitration agreements by limiting the free-

allows that which the FAA forbids—the courts' attempts to weaken their private sector competitors by refusing to enforce arbitration agreements. See Macneil et al., *supra* note 1, § 10.8.1 (*Garrity* "constitutes a serious 'obstacle' to the accomplishment and execution of the full purposes and objectives of Congress in enacting the FAA."); Hirshman, *supra* note 68, at 1361 ("The policy underlying New York's attempt to retain a public monopoly on the use of coercive sanctions—the superiority of court adjudication—is identical to the policy underlying the old common-law prohibition on arbitration ousting the courts of their jurisdiction."); Stipanowich, *supra* note 52, at 1001 ("Similar arguments [to those articulated in *Garrity*] were once used to deny enforcement of contractual agreements to arbitrate future disputes.").

79. See *supra* notes 25-31 and accompanying text.

80. See *supra* notes 25-29 and accompanying text.

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

82. Hirshman suggests that "[s]trictly speaking, the New York rule [*Garrity*] does not fall within the terms of section 2 of the FAA, which governs enforceability of agreements to arbitrate, because a dispute over an arbitrator's award does not arise until after arbitration is completed." Hirshman, *supra* note 68, at 1362-63. This is an overly restrictive definition of "enforce." If the parties have agreed to comply with an arbitrator's award, and that award turns out to include punitive damages, then compelling the loser to pay the punitive damages is part of "enforcing" the agreement.

In any event, Hirshman recognizes that:

although courts will always retain authority to reject egregious awards, they should not be permitted to vacate an arbitral award on the basis of a public policy [such as *Garrity*] that discriminates against arbitration. Otherwise, litigants would be able to eviscerate the protections of section 2 by waiting until after arbitration to advance otherwise prohibited defenses.

Id.

83. See *Perry v. Thomas*, 482 U.S. 483, 492-93 n.9 (1987) (declaring that the FAA preempts provision of California Labor Law stating that wage collection actions may be maintained notwithstanding existence of arbitration agreement because "[a] state-law principle that takes its meaning precisely from the fact that a contract to arbitrate is at issue does not comport with" section 2 of the FAA); *Saturn Distribution Corp. v. Williams*, 905 F.2d 719, 722 (4th Cir. 1990) (finding that the FAA preempts Virginia statute forbidding nonnegotiable arbitration clauses in automobile franchise agreements, because "with few limitations, if a state law singles out arbitration agreements and limits their enforceability it is preempted"), *cert. denied*, 498 U.S. 983 (1990); *Securities Indus. Ass'n v. Connolly*, 883 F.2d 1114, 1120 (1st Cir. 1989) (holding that FAA preempts Massachusetts regulations prohibiting securities broker-dealers from requiring customers to sign pre-dispute arbitration agreements as a condition of opening an account, because "any separate regulatory action or sanction singling out arbitration agreements from contracts generally would be preempted"), *cert. denied*, 495 U.S. 956 (1990).

dom to contract *for* punitive damages in arbitration. If a state singles out arbitration agreements by limiting the freedom to contract *against* punitive damages in arbitration that too would be preempted.⁸⁴

The implications of this preemption are profound. Contrary to *Garrity*, punitive damages are not a sanction reserved to the State. The law permits parties to contractually submit themselves to punishment.⁸⁵ The freedom of contract embodied in the FAA encompasses private punishment.

Is this good? It is if you value freedom and diversity. Denying the freedom to privatize the award of punitive damages imposes a mandatory rule on everyone regardless of his or her preferences. The freedom to privatize the award of punitive damages allows parties with different preferences about punitive damages to create different rules. Like freedom of contract generally, it allows diversity. Parties who feel besieged by astronomical punitive damages awards can contract out of that threat. Parties who wish to be able to recover punitive damages from others, or who wish to reap the gains that come from giving others the right to recover punitive damages from them,⁸⁶ can contract into punitive damages.

Garrity's conflict with the core of the FAA—freedom of contract for arbitration agreements—is so profound that the Second Circuit could not entirely escape from it in *Fahnestock*. The Second Circuit virtually conceded that if the parties to an arbitration agreement expressly address the question of punitive damages then the agreement must be enforced, regardless of conflicting state law:

We emphasize that an agreement between the parties specifically to award punitive damages may well have dictated a different outcome. The *Garrity* rule, to the extent that it purports to prevent arbitrators from awarding punitive damages in the face of such an agreement, seems to invoke preemption concerns, since it runs afoul of the federal substantive law rules that sweep aside any state attempt to interfere with the agreement of the parties.⁸⁷

84. In contrast, a state law denying parties to any contract (not just an arbitration agreement) the capacity to waive punitive damages is not preempted by the FAA because such a state law is a restriction on contracts generally, not a "principle that takes its meaning precisely from the fact that a contract to arbitrate is at issue." *Perry*, 482 U.S. at 493 n.9. "If the applicable substantive law, state or federal, precludes waiver of [punitive damages], nothing in the FAA calls for allowing arbitration clauses to constitute waivers." Macneil et al., *supra* note 1, § 36.3.2.2. Similarly, a state law restricting the award of punitive damages (on some or all claims) by courts and arbitrators alike is not preempted by the FAA.

85. See *infra* part III.A.1.

86. You might be suspicious of me and unwilling to contract with me unless you are confident that you will recover punitive damages if I do something malicious to you. Given your suspicion and my desire to contract with you, I may, at the time of contracting, want you to have the right to recover punitive damages against me.

87. *Fahnestock & Co. v. Waltman*, 935 F.2d 512, 518 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 380 (1991).

In *Fahnestock*, however, the arbitration agreement contained no express term addressing the arbitrability of punitive damages. In the Second Circuit's view, this resolved the preemption question. Because there was no express term in the agreement relating to punitive damages, the Second Circuit believed that "there was no agreement as to whether punitive damages were allowable."⁸⁸ According to the Second Circuit, "State law relating to the propriety of a punitive damages award by arbitrators in the absence of an agreement on the subject is not preempted by any federal substantive law bearing on the subject."⁸⁹

The Second Circuit's position can be restated as follows: The FAA requires that arbitration agreements be enforced. Therefore, if the arbitration agreement expressly states that the arbitrator is empowered to award punitive damages, a state law to the contrary (*Garrity*) is preempted by the FAA. In the absence of such an express term in the arbitration agreement, however, there is no agreement regarding the arbitrability of punitive damages so a state law such as *Garrity* is not preempted by the FAA. The flaw in this analysis is its misconception of the nature of an agreement. *Fahnestock* fails to recognize that "contracts have implied as well as express terms."⁹⁰ An arbitration agreement may address the question of punitive damages by implication.⁹¹ And, even if there is no implied term governing punitive damages, there are the default rules against which all contracts are made.⁹² In *Fahnestock*, for instance, the relevant default rule, derived from the federal policy favoring arbitration, allows arbitrators to award punitive damages.⁹³ Implied terms and default rules are as much a part of an agreement as express terms, and it is the entire agreement, not just

88. *Id.*

89. *Id.* Macneil et al. state that "the majority in *Fahnestock* never examined" whether *Garrity* is an obstacle to the accomplishment and execution of the full purposes and objectives of the FAA. Macneil et al., *supra* note 1, § 10.8.1. I suggest that Macneil et al., who describe the *Fahnestock* majority opinion as "confused," *id.*, understate the opinion's craftiness. The *Fahnestock* majority recognizes that it must address preemption but finds a way to do so while still resisting punitive damages awards by arbitrators. To accomplish this, the majority distinguishes between (preemptive) express terms and (nonpreemptive) other terms. *Fahnestock*, 935 F.2d at 517-18.

90. *Ethyl Corp. v. United Steelworkers of America*, 768 F.2d 180, 186 (7th Cir. 1985) (Posner, J.), *cert. denied*, 475 U.S. 1010 (1986).

91. See *supra* part I.B.2.

92. See generally Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 Va. L. Rev. 821 (1992) (arguing that contracting parties may indirectly consent to default rules). Implied terms (formerly called "implied-in-fact") are, like express terms, a product of the direct consent of the parties. Default rules (a subset of those terms formerly called "implied-in-law") are, at most, a product of the "indirect consent" of the parties because the parties have consented to be legally bound. *Id.* at 827-28, 860-68. (Besides default rules, the other subset of the terms formerly called "implied-in-law" are mandatory rules.).

93. See *supra* part I.B.3.

the express terms, which the FAA requires courts to enforce.⁹⁴ Accordingly, it is the entire agreement, not just the express terms, which preempts inconsistent state law.

Fahnestock should not have applied state arbitration law on the punitive damages issue. As discussed above, the FAA governs arbitration pursuant to an agreement evidencing a transaction involving interstate commerce. If punitive damages awarded in such an arbitration are before a court, then the court (federal or state) must apply federal arbitration law. Applying federal arbitration law means enforcing the arbitration agreement—all of the agreement, not just the express terms. State arbitration law is inapplicable to the punitive damages issue because all arbitration agreements—whether by express terms, implied terms or the default rule—address that issue.

B. Choice of Law Clauses

While state laws regarding the arbitrability of punitive damages are (in arbitrations arising out of agreements evidencing transactions involving interstate commerce) preempted by the FAA, they, nevertheless, may become relevant. A party may argue that a particular state's law on the arbitrability of punitive damages applies because of a clause in the arbitration agreement stating that disputes arising out of the agreement are to be resolved according to the law of that state.⁹⁵ This argument is based on the Supreme Court's opinion in *Volt Information Sciences, Inc. v. Board of Trustees of the Leland Stanford Junior University*.⁹⁶

94. Note that this is an interpretation of the FAA, not the creation of "federal common law" or federal contract law respecting arbitration agreements. The view that implied terms and default rules in arbitration agreements preempt inconsistent state law follows from the premise that a "written provision in any . . . contract . . . to settle by arbitration," 9 U.S.C. § 2, includes implied terms and default rules. This interpretation follows from "the legal realist insight that all contracts are, by necessity, incomplete to some degree." Barnett, *supra* note 92, at 821. Because parties drafting a contract "cannot foresee every future event or know precisely how their own purposes may change, they cannot negotiate terms specifically to cover all contingencies." *Id.* at 822. Thus, a written contract includes, besides express terms, terms that can fairly be implied or "interpreted" from express terms ("implied terms") and the default rules against which the contract is made. The mandatory rules against which the contract is made are not properly considered part of the contract because, in our legal system, they are not a product of consent. (Even mandatory rules could be a product of consent in a non-monopolistic legal system in which parties were free to choose which, if any, set of government rules they wish to live under.)

95. See, e.g., *Todd Shipyards Corp. v. Cunard Line*, 943 F.2d 1056, 1061 (9th Cir. 1991) (Cunard argued that "a New York choice of law provision in the contract should have led the arbitration panel to apply New York law" on the question of whether arbitrators may award punitive damages.).

96. 489 U.S. 468 (1989).

1. *Volt* and Preemption as a Default Rule

In *Volt*, the California Superior Court stayed arbitration pending resolution of related litigation.⁹⁷ A California statute permits such a stay.⁹⁸ The FAA does not.⁹⁹ The decision to apply California arbitration law, rather than the FAA, initially seems to be a mistake because the arbitration agreement evidenced a transaction involving interstate commerce.¹⁰⁰ Without more, the FAA preempts the inconsistent California arbitration law.¹⁰¹ The California Court of Appeal, however, held that California arbitration law applied because the arbitration agreement included a choice-of-law clause, which stated that the contract would be "governed by the law of the place where the project is located."¹⁰² The project at issue was located in California.¹⁰³ The California Court of Appeal stated that the parties "have agreed, as we interpret their choice of law provision, that the laws of California, of which [the stay provision] is certainly a part, are to govern their contract."¹⁰⁴ The California Court of Appeal held "that enforcement of the arbitration agreement in accordance with the chosen California rules of procedure does not create a conflict with the [FAA], since the purpose of the [FAA] was to ensure that private agreements to arbitrate are enforceable contracts."¹⁰⁵ The United States Supreme Court affirmed.¹⁰⁶

Chief Justice Rehnquist's opinion for the majority in *Volt* did not review, but accepted as a matter of state law, the California Court of Appeal's interpretation of the choice-of-law clause "to mean that the parties had incorporated the California rules of arbitration into their

97. Board of Trustees of the Leland Stanford Junior Univ. v. Volt Info. Sciences, Inc., 240 Cal. Rptr. 558, 559 (Cal. Ct. App. 1987), *aff'd*, 489 U.S. 468 (1989).

98. Under California law, on petition of a party to an arbitration agreement alleging the existence of a written agreement to arbitrate, the court shall order the petitioner and the respondent to arbitrate the controversy if it determines that an agreement to arbitrate the controversy exists, unless it determines, inter alia, that:

(c) A party to the arbitration agreement is also a party to a pending court action or special proceeding with a third party, arising out of the same transaction or series of related transactions and there is a possibility of conflicting rulings on a common issue of law or fact. . . . If the court determines that a party to the arbitration is also a party to litigation in a pending court action or special proceeding with a third party as set forth under subdivision (c) herein, the court . . . (4) may stay arbitration pending the outcome of the court action or special proceeding.

Cal. Civ. Proc. Code § 1281.2(c) (West 1982).

99. 9 U.S.C. § 3 (1988).

100. *Volt*, 240 Cal. Rptr. at 559.

101. See *supra* notes 55-58 and accompanying text.

102. *Volt*, 240 Cal. Rptr. at 559.

103. *Id.*

104. *Id.*

105. *Id.*

106. *Volt Info. Sciences, Inc., v. Board of Trustees of the Leland Stanford Junior Univ.*, 489 U.S. 468, 479 (1989).

arbitration agreement.”¹⁰⁷ Justice Brennan, in dissent, stated, “I can accept neither the state court’s unusual interpretation of the parties’ contract, nor this Court’s unwillingness to review it.”¹⁰⁸ Leaving aside whether the Supreme Court should have reviewed the state court’s interpretation of the choice-of-law clause in *Volt*,¹⁰⁹ to assess this controversial case it is necessary to analyze how courts (any courts) ought to interpret choice-of-law clauses in arbitration agreements.

Choice-of-law clauses (in all sorts of agreements) are virtually always interpreted as giving the parties’ answer to the question “Which state’s law governs?”, not “Does federal or state law govern?”¹¹⁰ Because the clause in *Volt* is best interpreted as the parties’ choice of California law over other state law, rather than California law over

107. *Id.* at 474.

108. *Id.* at 481 (Brennan, J., dissenting).

109. *Volt* has been criticized for failing to review the state court’s interpretation of the contract. See Zhaodong Jiang, *Federal Arbitration Right, Choice-of-Law Clauses and State Rules and Procedure*, 22 Sw. U. L. Rev. 159, 229 (1992); Arthur S. Feldman, Note, *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University: Confusing Federalism with Federal Policy Under the FAA*, 69 Tex. L. Rev. 691, 719 (1991). According to Feldman:

It is one thing to say, as the Court did, that the FAA will respect agreements to arbitrate in a manner different than that provided by the limited provisions of the Act itself. It is quite another to ratify a trial court’s interpretation that itself can potentially control any issue of the enforcement of the arbitration agreement notwithstanding the general federal policy favoring arbitration of disputes.

Id.

110. Justice Brennan stated:

It seems to me beyond dispute that the normal purpose of such choice-of-law clauses is to determine that the law of one State rather than that of another State will be applicable; they simply do not speak to any interaction between state and federal law. A cursory glance at standard conflicts texts confirms this observation: they contain no reference at all to the relation between federal and state law in their discussions of contractual choice-of-law clauses.

Volt, 489 U.S. at 488-89 (Brennan, J., dissenting) (citing R. Weintraub, Commentary of the Conflict of Laws § 7.3C (2d ed. 1980); Eugene F. Scoles & Peter Hay, Conflict of Laws 632-52 (1982); Robert A. Leflar et al., American Conflicts Law § 147 (4th ed. 1986)). Justice Brennan concluded,

The same is true of standard codifications. See Uniform Commercial Code § 1-105(1) (1978); Restatement (Second) of Conflict of Laws § 187 (1971). Indeed, the Restatement of Conflicts notes expressly that it does not deal with “the ever-present problem of determining the respective spheres of authority of the law and courts of the nation and of the member States.” *Id.*, § 2, Comment c.

Id. at 489 (Brennan, J., dissenting). “Choice-of-law clauses simply have never been used for the purpose of dealing with the relationship between state and federal law.” *Id.* at 490 (Brennan, J., dissenting). See also Robert Coulson, *AAA President Says Volt Decision Creates Setback for Arbitration*, 3 ADR Report (BNA), Apr. 13, 1989, at 136 (“Choice-of-law clauses are commonly used in domestic contracts to determine which state law will apply, not to dilute the pre-emptive effect of federal statutes.”).

federal law, the California Court of Appeal did a bad job of interpreting the contract.¹¹¹

One might go further and say, not only did the California Court of Appeal do a bad job of contractual interpretation, but *any* court that interprets *any* choice-of-law clause as a choice of state law over federal law does a bad job of contractual interpretation. That is because, while courts often allow parties to choose which state's law governs their disputes, courts do not permit parties to choose whether state or federal law governs their disputes.¹¹² That choice is made by the federal government in deciding whether to enact federal law. If federal law is enacted, then it governs the parties who have no choice in the matter. Federal preemption of state law is a mandatory rule, not a default rule that the parties are free to contract around—except for the FAA.

The FAA is special because its core provision, Section 2, gives the terms of arbitration agreements the force of federal law. If an arbitration agreement evidencing a transaction involving interstate commerce states that arbitration is to be conducted under the arbitration law of California, then federal law states that arbitration of disputes covered by that agreement is to be conducted under the arbitration law of California.

Section 2 of the FAA makes federal preemption of state law a default rule rather than a mandatory rule. It allows the parties to an arbitration agreement evidencing a transaction involving interstate commerce to choose whether to be governed by state or federal arbitration law. If the parties choose state law, then it would be inconsistent with Section 2 to apply any substantive¹¹³ arbitration law other than that of the chosen state.

On this fundamental and somewhat startling point, the majority and dissent in *Volt* agree. The majority opinion affirms the California Court of Appeal's holding that the parties contracted around preemption of state law by the FAA.¹¹⁴ The dissent agrees that parties "are free if they wish to write an agreement to arbitrate outside the coverage of the FAA. Such an agreement would permit a state rule, otherwise preempted by the FAA, to govern their arbitration."¹¹⁵ The importance of *Volt*, then, is the unanimous view of the Justices that

111. Cf. Richard J. Oparil, *Preemption and the Federal Arbitration Act*, 13 Geo. Mason U. L. Rev. 325, 335-36 (1990) (arguing that construing a choice-of-law clause to encompass a state's arbitration law generally will be misinterpreting the contract).

112. See *supra* note 110.

113. C. Edward Fletcher argues that the parties' power to choose state law over the FAA does not include the power to force a federal court to apply state *procedural* law in lieu of FAA procedural provisions such as 9 U.S.C. §§ 3-4, 9-11, 15-16. C. Edward Fletcher, *Arbitrating Securities Disputes* 357-58 (1990).

114. *Volt Info. Sciences, Inc. v. Board of Trustees of the Leland Stanford Junior Univ.*, 489 U.S. 468, 479 (1989).

115. *Id.* at 485 (Brennan, J., dissenting).

FAA preemption of state law is not a mandatory rule. It is a default rule that the parties are free to contract around.¹¹⁶ On this crucial point (if not on its refusal to review the state court's contract interpretation), *Volt* is laudable.

Some commentators are comfortable with FAA preemption as a default rule.¹¹⁷ But at least one commentator vehemently resists it.¹¹⁸ Zhaodong Jiang states that "party autonomy, whose salient feature is to add certainty and predictability to anarchical interstate choice-of-law cases, loses its reason for existing in the context of a federal-state conflict."¹¹⁹ This may be true if one sees added predictability as the sole virtue of respecting party autonomy regarding choice of law. But there is a greater virtue involved—freedom. Respecting party autonomy regarding choice of law, like respecting party autonomy regarding any contract term, advances the parties' freedom to define their legal rights and obligations as they wish. Respecting party autonomy regarding choice of law is a particularly liberating application of freedom of contract because it allows parties to contract out of a government's entire body of law. It converts entire bodies of law into default rules.¹²⁰ Application of the contract-enforcing rule of Section 2 to choice-of-law clauses is entirely consistent with the freedom of contract core of the FAA.

116. One might object that I am making a broader claim than is supported by *Volt* or the FAA. *Volt* only allowed parties to contract out of the FAA into state law "manifestly designed to encourage resort to the arbitral process." *Id.* at 476. Perhaps the Court would not allow the parties to contract around FAA preemption by choosing rules designed to impede and burden the arbitral process. *Volt* might be read to imply that the parties cannot choose state arbitration law that "stands as an obstacle to the accomplishment . . . of the full purposes and objectives of Congress." *Id.* at 477 (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)). See Macneil et al., *supra* note 1, § 40.6.3. This reasoning, however, is self-contradictory. It is impossible for the parties to choose state arbitration law that is an obstacle to the purpose of the FAA. The purpose of the FAA is to insure the enforcement of arbitration agreements in accordance with their terms. *Volt*, 489 U.S. at 478. Whatever rules parties choose are consistent with the FAA's purpose precisely because the parties have chosen them.

A related point: *Volt* held that parties may contract around Sections 3 and 4 of the FAA by choosing to be governed by state law inconsistent with Sections 3 and 4. *Id.* at 476. This does not necessarily mean, one might argue, that parties may contract around *all* federal arbitration law because the Supreme Court has reserved decision on whether Sections 3 and 4 apply in state court. *Id.* at 477. See Macneil et al., *supra* note 1, § 10.8.1. This argument fails because *Volt*'s reasoning applies "even if §§ 3 and 4 of the FAA are fully applicable in state-court proceedings." *Volt*, 489 U.S. at 477.

117. Macneil et al., *supra* note 1, § 10.9.1 ("[P]arties should be able to choose state arbitration law over the FAA if they wish."); Feldman, *supra* note 109, at 711 ("The primary task of a court . . . is to interpret how the contracting parties *intended* to resolve the interaction between state and federal law.").

118. Jiang, *supra* note 109, at 175-78.

119. *Id.* at 177. •

120. Cf. Larry Kramer, *Rethinking Choice of Law*, 90 Colum. L. Rev. 277, 329 (1990) (arguing that allowing parties unrestricted freedom to choose the law that governs their contract would "enabl[e] parties to opt out of any limitation [on freedom of contract] not imposed by every state or nation in the world").

2. Application of Preemption as a Default Rule

Given that FAA preemption of state law is merely a default rule and that courts must enforce choice-of-law clauses in arbitration agreements, the proper inquiry becomes "Should a given choice-of-law clause be interpreted as choosing to be governed by state arbitration law that would otherwise be preempted by the FAA?"¹²¹

As stated above, choice-of-law clauses are virtually always interpreted as choosing one state's laws over another state's laws, not as choosing state law over federal law.¹²² This is the best interpretation of virtually all choice-of-law clauses in arbitration agreements because it will undoubtedly surprise most parties and their lawyers to learn that they have the power to choose state law over otherwise preemptive federal law.¹²³ Therefore, it is almost certainly a bad job of contractual interpretation to read a typical choice-of-law clause in an arbitration agreement as choosing to be governed by state arbitration law that would otherwise be preempted by the FAA. More specifically, it is almost certainly a bad job of contractual interpretation to read a typical choice-of-law clause in an arbitration agreement as

121. The Ninth Circuit rejected the argument that a choice-of-law clause chooses state over federal law on the arbitrability of punitive damages. According to the Ninth Circuit, "issues of arbitrability . . . are governed by federal law." *Todd Shipyards Corp. v. Cunard Line*, 943 F.2d 1056, 1062 (9th Cir. 1991). This is true, as far as it goes, but it does not go far enough. Issues of arbitrability arising out of an agreement involving interstate commerce are governed by federal law. Federal law, however, does not mandate whether an arbitrator may award punitive damages. Rather, federal law declares that the parties, by agreement, may specify whether or not the arbitrator is empowered to award punitive damages. See *supra* notes 30-31 and accompanying text. A choice-of-law clause may provide the specification. See *infra* note 127 and accompanying text. *Todd Shipyards*, however, made no attempt to explain why the choice-of-law clause in that case did not constitute such a specification of the arbitrator's authority. 943 F.2d at 1062. The Eighth and First Circuits are subject to the same criticism for failing to recognize preemption as a default rule and for failing to explain why particular choice-of-law clauses should not have been interpreted as specifications of the law governing the arbitrability of punitive damages. *Lee v. Chica*, 983 F.2d 883, 887-88 (8th Cir. 1993), *cert. denied*, 114 S. Ct. 287 (1993); *Raytheon Co. v. Automated Business Sys., Inc.*, 882 F.2d 6, 11 n.5 (1st Cir. 1989).

122. See *supra* note 110 and accompanying text. Macneil et al., *supra* note 1, § 10.9.2.4, entitled "Ascertaining Party Intention Respecting Choice of Law Clauses," does not discuss this point. Macneil et al. state that "[g]eneral clauses providing that the law of State X shall govern all questions relating to the contract also would normally be read to include the arbitration law of State X." *Id.* But recognizing that a choice-of-law clause represents a choice of State X's arbitration law does not determine whether that is a choice of State X over State Y or a choice of State X over federal. Macneil et al. may recognize this distinction at another point: "A cautious reading of *Volt* respecting the freedom of the parties to choose state law is bolstered by consideration of [doubt about?] . . . whether the parties understood that they were adopting state arbitration law over the FAA." *Id.* § 16.6.3.

123. This may change after *Volt* becomes widely understood. "In light of *Volt*, if parties know that they can displace the FAA [with otherwise preempted state law], then their intent to do so can be enforced." Faith A. Kaminsky, *Arbitration Law: Choice-of-Law Clauses and the Power to Choose Between State and Federal Law*, 1991 Ann. Surv. Am. L. 527, 557 (1991).

choosing state over federal law on the question of whether arbitrators may award punitive damages.¹²⁴

Some courts interpreting New York choice-of-law clauses in arbitration agreements have concluded that such clauses designate only the "substantive law . . . that the arbitrators must apply in determining whether the conduct of the parties warrants an award of punitive damages," not the arbitration law specifying whether or not arbitrators may award punitive damages.¹²⁵ This distinction between substantive law and arbitration law gets the right result for the wrong reason. The distinction between substantive law and arbitration law does not hold up. Whether arbitrators may award punitive damages is a substantive question.¹²⁶ Typical New York choice-of-law clauses, for example, should be interpreted as choosing New York law over other state law on this question. They should not, however, be interpreted as choosing New York law over federal law on this question.

On the other hand, an arbitration agreement evidencing a transaction involving interstate commerce might contain an unusual choice-of-law clause. It might say, "The law of New York, rather than federal law, governs whether our arbitrator has the power to award punitive damages." In such a situation, New York law would ultimately govern the punitive damages question even though, as an initial matter, federal law is controlling because federal law incorporates the parties'

124. Like the language of the other contract terms, the language of a particular choice-of-law clause in an arbitration agreement is to be considered by a court in determining whether the agreement empowers the arbitrator to award punitive damages. As Judge Robert J. Ward wrote in *Barbier v. Shearson Lehman Hutton, Inc.*, 752 F. Supp. 151 (S.D.N.Y. 1990), *aff'd in part and rev'd in part*, 948 F.2d 117 (2d Cir. 1991), "The primary question . . . is whether the parties to the [arbitration] Agreement . . . intended, by their inclusion of a New York choice-of-law clause, that New York arbitration law (including the New York prohibition on arbitral punitive damages awards) govern disputes between them." *Id.* at 156. Judge Ward persuasively concluded that the parties did not intend New York law to govern the punitive damages issue. *Id.* at 156-57. The Second Circuit reversed on the ground that the choice-of-law clause chose New York arbitration law, including *Garrity*, over federal arbitration law. *Barbier v. Shearson Lehman Hutton Inc.*, 948 F.2d 117, 122 (2d Cir. 1991). "It is apparent from the inclusion of the choice-of-law provision that the parties intended to be bound by *Garrity*." *Id.* For the reasons stated in the text of this Article, this is a bad job of contractual interpretation. Other cases (wrongly) interpreting choice-of-law clauses as choosing state over federal law on the arbitrability of punitive damages include: *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 20 F.3d 713, 717 (7th Cir. 1994), *cert. granted*, 63 U.S.L.W. 3064 (Oct. 7, 1994); *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Jana*, 835 F. Supp. 406, 413 (N.D. Ill. 1993); *Thomson McKinnon Sec., Inc. v. Cucchiella*, 594 N.E.2d 870, 874 (Mass. App. Ct. 1992).

125. *J. Alexander Sec., Inc. v. Mendez*, 21 Cal. Rptr. 2d 826, 830 (Cal. Ct. App. 1993), *cert. denied*, 114 S. Ct. 2182 (1994). See also *Barbier*, 752 F. Supp. at 156 (holding that choice-of-law clause requires application of New York substantive law but not New York arbitration law).

126. *Fahnestock & Co. v. Waltman*, 935 F.2d 512, 518 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 380 (1991).

agreement which, in turn, incorporates New York law.¹²⁷ This hypothetical choice-of-law clause is truly unusual because it expressly chooses state law *over federal* law. Most choice-of-law clauses manifest no intention to displace otherwise preemptive federal law and should not be interpreted to do so.

III. DUE PROCESS AND THE AWARD OF PUNITIVE DAMAGES BY ARBITRATORS

While courts have unanimously rejected Constitutional challenges to arbitral punitive damages awards,¹²⁸ commentators have argued that such awards violate the Due Process Clauses of the Fifth and Fourteenth Amendments.¹²⁹ This argument is appealing because

127. If the parties "agreed" to a choice-of-law clause (or other contract term) only because state law required that the term be included in the contract, then the FAA does *not* compel enforcement of the term. In fact, the term must be disregarded if the law requiring it "undermine[s] the goals and policies of the FAA." *Volt Info. Sciences, Inc. v. Board of Trustees of the Leland Stanford Junior Univ.*, 489 U.S. 468, 478 (1989). Otherwise, a state law that would be preempted by the FAA could survive preemption by simply requiring the parties to "agree" to the substance of the offending law. See *Seymour v. Gloria Jean's Coffee Bean Franchising Corp.*, 732 F. Supp. 988 (D. Minn. 1990). See also Macneil et al., *supra* note 1, § 10.9.2.1 (discussing *Seymour*).

128. See *Todd Shipyards Corp. v. Cunard Line*, 943 F.2d 1056, 1064 (9th Cir. 1991) (having voluntarily entered into arbitration, "Cunard cannot now argue that its due process was denied"); *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Jana*, 835 F. Supp. 406 n.8 (N.D. Ill. 1993) (citing cases upholding arbitrability of treble damages claims); *Kline v. O'Quinn*, 874 S.W.2d 776, 782 (Tex. Ct. App. 1994) (rejecting due process argument that there was insufficient notice that arbitrators could award punitive damages); *Rifkind & Sterling, Inc. v. Rifkind*, 33 Cal. Rptr. 828, 831-34 (Cal. Ct. App. 1994) (rejecting due process objection to arbitral punitive damages award because defendant's agreement to arbitrate probably waived due process and because confirmation proceeding constituted due process in view of the fact that "only a limited degree of state action is involved in confirming an arbitration award"); *J. Alexander Sec.*, 21 Cal. Rptr. 2d at 832-33 (assessing fairness of the arbitration); *Tate v. Saratoga Sav. and Loan Ass'n*, 265 Cal. Rptr. 440, 447 (Cal. Ct. App. 1989) (quickly dismissing "sugges[tion] that to allow punitive damages in arbitration absent express agreement is unconstitutional"). With the exception of *Rifkind & Sterling* and the possible exception of *Todd Shipyards*, these cases do not decide the constitutional issue on the grounds discussed in this Article (lack of state action and waiver of due process rights). The courts' reasoning in these cases, where apparent, is that due process was given.

129. See Ira P. Rothken, Comment, *Punitive Damages in Commercial Arbitration: A Due Process Analysis*, 21 Golden Gate U. L. Rev. 387, 387-88 (1991) ("Punitive damages violate due process by giving the arbitrator unfettered discretion in determining punitive damage awards."); Karen Ruga, Note, *An Argument Against the Availability of Punitive Damages in Commercial Arbitration*, 62 St. John's L. Rev. 270, 283-84 (1988) ("The 'fundamental fairness' requirement of fourteenth amendment due process . . . is not safeguarded by arbitral procedures as generally employed."); Margaret P. Sullivan, Comment, *The Scope of Modern Arbitral Awards*, 62 Tul. L. Rev. 1113, 1137 (1988) ("There may well be due process violations inherent in an arbitral award of punitive damages."). See generally Edward Brunet, *Arbitration and Constitutional Rights*, 71 N.C. L. Rev. 81, 119 (1992) ("The doctrine of waiver of constitutional rights is, at this time, simply inadequate to explain the absence of constitutional rights in all arbitration settings."). See also Stephen P. Bedell, *Punitive*

"[p]unitive damages pose an acute danger of arbitrary deprivation of property."¹³⁰ The Supreme Court held in *Honda Motor Co. v. Oberg* that a state's failure to provide judicial review of the size of a jury's punitive damages award violates due process.¹³¹ As there is no judicial review of the size of arbitral punitive damages awards (apart from the deferential review given to arbitral awards generally), one might be tempted to extend *Oberg's* reasoning to arbitration.¹³² The state action and the waiver doctrines, however, pose major difficulties for the argument that the award of punitive damages by arbitrators violates due process.¹³³

A. State Action

The Due Process Clauses of the Fifth and Fourteenth Amendments¹³⁴ restrict only "the State or . . . those acting under color of its authority."¹³⁵ Determining what constitutes "state action" may, therefore, be "the most important problem in American law."¹³⁶

Unfortunately, the importance of the state action doctrine has not been matched by its clarity. Despite the doctrine's long history, and recurring litigation concerning the doctrine, the strong academic

Damages in Arbitration, 21 J. Marshall L. Rev. 21, 44 (1987) (stating that FAA should be amended so any punitive damages award more than three times actual damages is subject to *de novo* judicial review); Donald L. Carper, *Punitive Damages in Commercial Arbitration*, 41 Arb. J., Sep. 1986, at 27, 33 (1986) (calling for special rules and processes to handle punitive damages claims in arbitration); Leo P. Dreyer, *Arbitration Agreements After Volt and Browning-Ferris*, 38 Kan. L. Rev. 667, 719-25 (1990) (discussing constitutionality of arbitral punitive damages awards from a "practical standpoint" and leaving normative issues "to constitutional scholars"); Katsoris, *supra* note 52, at 599-600 (proposing more extensive procedures in arbitral awards of punitive damages and judicial review of them); Christa Arcos, Comment, *Arbitration—First Circuit Allows Punitive Damage Awards in Commercial Arbitration—Raytheon Co. v. Automated Business Systems, Inc.*, 882 F.2d 6 (1st Cir. 1989), 24 Suffolk U. L. Rev. 189, 196-97 (1990) (same); Erin Parks, *Punitive Damages in California Arbitration After Baker v. Sadick: A Proposed Statutory Reform*, 27 Santa Clara L. Rev. 735, 757-61 (1987) (same).

130. *Honda Motor Co. v. Oberg*, 114 S. Ct. 2331, 2333 (1994).

131. *Id.* Prior to *Oberg*, the Supreme Court had consistently rejected due process challenges to punitive damage awards. See, e.g., *TXO Production Corp. v. Alliance Resources Corp.*, 113 S. Ct. 2711, 2713-14 (1993) (affirming award of \$19,000 compensatory damages; \$10 million punitive damages); *Pacific Mut. Life Ins. Co. v. Haslip*, 499 U.S. 1 18-19 (1991) (stating that as long as a jury exercises reasonable restraint in awarding punitive damages, due process requirements are satisfied).

132. As arbitrations commonly have more streamlined procedures than courts, it is plausible to contend that arbitral punitive damages awards require judicial review even more than do juries' punitive damages awards.

133. See Brunet, *supra* note 52, at 109-13.

134. Laurence H. Tribe, *American Constitutional Law* 1688 (1988) (noting that the Thirteenth Amendment's prohibition of slavery is an exception to the state action doctrine).

135. *District of Columbia v. Carter*, 409 U.S. 418, 423 (1973).

136. Charles L. Black, Jr., *Foreword: "State Action," Equal Protection, and California's Proposition 13*, 81 Harv. L. Rev. 69, 69 (1967).

consensus is that the state action doctrine has been, and remains, a conceptual disaster area.¹³⁷

Because of the importance and complexity of the state action doctrine, a full-scale discussion of state action and arbitration must await another article. It is possible, however, to take the state action doctrine as it has developed in the Supreme Court and apply it with some, if not complete, confidence to the issue of arbitral punitive damages awards.

Numerous courts have held that the state action element of a due process claim is not present in arbitration.¹³⁸ Without challenging this holding, Ira P. Rothken contends that awarding punitive damages

137. R. George Wright, *State Action and State Responsibility*, 23 Suffolk U. L. Rev. 685, 685 (1989).

138. See *Federal Deposit Ins. Corp. v. Air Florida Sys., Inc.*, 822 F.2d 833, 842 n.9 (9th Cir. 1987) ("Although Congress, in the exercise of its commerce power, has provided for some governmental regulation of private arbitration agreements, we do not find in private arbitration proceedings the state action requisite for a constitutional due process claim."), *cert. denied*, 485 U.S. 987 (1988); *Elmore v. Chicago & I.M. Ry.*, 782 F.2d 94, 96 (7th Cir. 1986) ("The fact that a private arbitrator denies the procedural safeguards that are encompassed by the term 'due process of law' cannot give rise to a constitutional complaint."); *International Ass'n of Heat and Frost Insulators Local Union 42 v. Absolute Envtl. Servs., Inc.*, 814 F. Supp. 392, 402-03 (D. Del. 1993); *Cort v. Am. Arbitration Ass'n*, 795 F. Supp. 970, 973 (N.D. Cal. 1992); *United States v. Am. Soc'y of Composers*, 708 F. Supp. 95, 96-97 (S.D.N.Y. 1989); *Sportasticks, Inc. v. Beltz*, No. 88 C 9293, 1989 WL 26825, at *4 (N.D. Ill. March 22, 1989); *Joint Bd. of Cloak, Skirt and Dressmakers Union v. Senco, Inc.*, 289 F. Supp. 513, 518 (D. Mass. 1968); *Morris v. Metriyakool*, 344 N.W.2d 736, 743-58 (Mich. 1984) (Ryan, J., concurring).

Unfortunately, the term "arbitration" is often used to describe, not only dispute-resolution proceedings chosen privately by contract, but also various quasi-governmental and even plainly governmental proceedings. See generally Macneil et al., *supra* note 1, § 2.4 (comparing private arbitration with court-annexed arbitration). Arbitrators in these proceedings are likely to be state actors. See, e.g., *Elmore*, 782 F.2d at 96 (finding that while private arbitration cannot support a due process claim, arbitration by National Railroad Adjustment Board can); *United States v. Gullo*, 672 F. Supp. 99, 103 (W.D.N.Y. 1987) ("If the mediation/arbitration proceeding out of which Gullo's statements emanate had been private and not state action, the Fifth and Fourteenth Amendments would not serve as vehicles to dismiss the Indictment or to suppress statements made."); *Mount St. Mary's Hosp. v. Catherwood*, 311 N.Y.S.2d 863, 867 (1970) ("The simple and ineradicable fact is that voluntary arbitration and compulsory arbitration are fundamentally different if only because one may, under our system, consent to almost any restriction upon or deprivation of right, but similar restrictions or deprivations, if compelled by government, must accord with procedural and substantive due process.").

Somewhere in between private arbitration and governmental "court-annexed arbitration" is arbitration by self-regulatory organizations ("SROs") like the National Association of Securities Dealers ("NASD") or the New York Stock Exchange. Members of the NASD suggest that NASD arbitrators are state actors. See National Association of Securities Dealers, Notices To Members No. 94-95, NASD Solicits Public Comment on Approaches Governing Award of Punitive Damages in Arbitration (July 1994) available in 1994 NASD LEXIS 52, at *34-35 ("Federal law requires broker/dealers to be members of SROs, and as a result, to be subject to the SROs' rules of arbitration. . . . [The Federal Government] cannot compel membership in the NASD unless the NASD provides [due process] guarantees.").

converts an arbitrator from a private actor to a state actor.¹³⁹ Courts have not yet addressed the contention that otherwise private arbitrators become state actors when they award punitive damages.¹⁴⁰ The Supreme Court, however, has spoken on a related point. In *Shearson/American Express, Inc. v. McMahon*,¹⁴¹ the Court held that arbitrators may award treble damages under the Racketeer Influenced and Corrupt Organizations Act.¹⁴² The Court did not specifically refer to the Due Process Clauses but did reject the notion that the "policing function" of treble damages should affect their arbitrability.¹⁴³

1. "Government Function" Theory of State Action

Rothken contends that awarding punitive damages converts an arbitrator from a private actor to a state actor because an arbitrator awarding punitive damages is "a private party exercising traditional

For an insightful comparison of private arbitration and government "alternative" dispute-resolution, see Lisa Bernstein, *Understanding the Limits of Court-Connected ADR: A Critique of Federal Court-Annexed Arbitration Programs*, 141 U. Pa. L. Rev. 2169, 2239-52 (1993). This Article has studiously avoided use of the now-common phrase "Alternative Dispute Resolution" or "ADR" for the following reasons:

The word alternative means alternative to dispute resolution processes of the State—the judges, juries, administrative dispute resolvers, and the like of the State legal system. Thus the term ADR presupposes that the primary, fundamental dispute resolution system is that provided by the State, alternative methods being secondary, supplemental, and probably suspect.

This statist view of dispute resolution simply turns the world upside down, whether we look to history or to present socioeconomic behavior.

Macneil, *American Arbitration Law*, *supra* note 25, at 4.

139. Rothken, *supra* note 129, at 397. See also National Association of Securities Dealers, *supra* note 138, at *34 ("An award of punitives, by its nature, is state action.").

140. See *supra* note 128 and cases cited therein.

141. 482 U.S. 220 (1987).

142. *Id.* at 241-42.

143. *Id.* at 240 (citing *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 635 (1985) (holding that treble damages antitrust claims are arbitrable)). Compare Stephen P. Bedell et al., *Current Developments in Arbitration: Arbitrability and Punitive Damages*, 22 J. Marshall L. Rev. 603, 626 (1992) (arguing that *McMahon* implicitly recognized arbitrability of punitive damages) and Katsoris, *supra* note 52, at 582-83 ("[I]t is noteworthy that the Supreme Court in *McMahon* unanimously held that contractual agreements to arbitrate claims asserted under RICO are specifically enforceable, suggesting that a punitive-like damage award is available through arbitration, at least for RICO claims.") and David E. Robbins, *Securities Arbitration* 125 (1988) ("It would be hard to imagine that if the Supreme Court empowers an arbitration panel to award treble damages in RICO cases it would preclude punitive damages in appropriate cases.") and Thomas J. Kenny, Note, *Punitive Damages in Securities Arbitration: The Unresolved Question of Pendent State Claims*, 37 Cath. U. L. Rev. 1113, 1123 n.110 (1988) ("[T]he Court unanimously held that the punitive treble damages remedy available under RICO did not impede arbitration of such claims.") with Ruga, *supra* note 129, at 282-83 (arguing that *McMahon* does not compel the conclusion that arbitrators may award punitive damages because "it is only when imposing punitive damages that a judge must ascertain the relevant public policy issues" and "treble damages require a finding of actual damages, whereas punitive liability will often be imposed even when only nominal injury has resulted").

and exclusive State power."¹⁴⁴ This is an invocation of the "government function" theory of state action,¹⁴⁵ one of many theories used to find state action.¹⁴⁶ Under this theory, the conduct of a private entity constitutes state action only when that entity exercises "powers traditionally exclusively reserved to the State."¹⁴⁷ So the present test under this theory seems to be whether punishing, or at least awarding punitive damages, has traditionally been exclusively reserved to the State.

Rothken's support for the assertion that awarding punitive damages has traditionally been exclusively reserved to the State is *Garrity* and Edward M. Morgan's article, *Contract Theory and the Sources of Rights: An Approach to the Arbitrability Question*.¹⁴⁸ Morgan's article is *normative* legal theory—Morgan's views on what arbitrators ought to be allowed to do—and does not support the *descriptive* point that awarding punitive damages has traditionally been exclusively reserved to the State.¹⁴⁹ *Garrity*, on the other hand, does make this descriptive point. It quotes Hans Kelsen for the proposition that "[f]or centuries the power to punish has been a monopoly of the State."¹⁵⁰ *Garrity*, however, misreads Kelsen.

144. Rothken, *supra* note 129, at 397.

145. See, e.g., *Terry v. Adams*, 345 U.S. 461, 466-70 (1953) (finding that association holding primary election is state actor); *Marsh v. Alabama*, 326 U.S. 501, 505-10 (1946) (holding that corporation operating entire town including streets, sewers, residences, etc., is state actor).

146. See Henry C. Strickland, *The State Action Doctrine and the Rehnquist Court*, 18 *Hastings Const. L.Q.* 587, 596-633 (1991) (categorizing distinct state action theories by which each of the following types of conduct may be considered state action: (1) overt actions of state employees, officers, and agencies; (2) the creation and enforcement of substantive civil law; (3) state inaction through the denial of judicial relief or other state intervention; (4) governmentally regulated private conduct; (5) joint participation between state officials and private entities; and (6) private entities assuming government functions or powers).

147. *Jackson v. Metropolitan Edison Co.*, 419 U.S. 345, 352 (1974). *Accord* *Flagg Bros., Inc. v. Brooks*, 436 U.S. 149, 157-58 (1978). The Rehnquist Court is likely to characterize private activities as state action only "if: (1) the activities constitute a function that traditionally has been performed only by government; and (2) the private entity's assumption of the function substantially replaces the government's traditional performance of the function." Strickland, *supra* note 146, at 633.

148. 60 *S. Cal. L. Rev.* 1059 (1987).

149. Morgan contends that punitive damages claims, like treble damages antitrust claims, ought not to be arbitrable because they are a "distributive or regulatory creation of the state." *Id.* at 1075, 1079-80. For arbitration "to make minimal jurisprudential sense" to Morgan, "the legal parameters of the dispute must not be seen as created by the state for the collective benefit of its members." *Id.* at 1070. Arbitration, Morgan believes, "presumes a context of rights whose theoretical foundations lie in direct personal interchange rather than in the state." *Id.* at 1059. Although not relevant to the descriptive issue at hand, Morgan does come close to identifying the great opportunity/threat posed by arbitration: it allows people to contract out of substantive law. Used to its full potential, arbitration could turn all mandatory rules into default rules. It could privatize public law.

150. *Garrity v. Lyle Stuart, Inc.*, 353 *N.E.2d* 793, 796-97 (N.Y. 1976) (citing Hans Kelsen, *General Theory of Law and State* 21 (1945)). Kelsen, like political theorists

Kelsen, described as one of "the two most prominent modern legal positivists,"¹⁵¹ maintains that "[t]he dualism of law and State is an animistic superstition."¹⁵² The "necessary unity of State and law,"¹⁵³ means, for Kelsen, that the "use of force" is monopolized by the modern State.¹⁵⁴ The monopoly Kelsen attributes to the modern State encompasses the "use of force." It does not distinguish between the "use of force to punish" and the "use of force to compensate." But that is how *Garrity* (mis)reads Kelsen. In short, *Garrity* cites Kelsen for the proposition that awarding punitive damages, *as distinguished from compensatory damages*, has traditionally been exclusively reserved to the State, but Kelsen provides no support for that proposition.

What Kelsen does say—that the "use of force" has for centuries been a monopoly of the State—is consistent with the award of punitive damages by arbitrators. That is because the State does not permit arbitrators to use force to compel compliance with their awards.¹⁵⁵ The State has continued to monopolize the use of force to compel compliance with both punitive and compensatory arbitration awards.¹⁵⁶

The power to punish, that is, to impose a sanction other than compensation, has traditionally *not* been exclusively reserved to the State. American arbitration has been in "widespread and continuous" use as a means of deciding disputes since the seventeenth century.¹⁵⁷ The New York Stock Exchange, for instance, has, since its first constitution in 1817, provided arbitration to resolve disputes among its mem-

generally, uses the term "the State" with a capital "S" to mean "government." It should not be read as referring to one of the component commonwealths of the United States of America.

151. Michael Rustad & Thomas Koenig, *The Supreme Court and Junk Social Science: Selective Distortion in Amicus Briefs*, 72 N.C. L. Rev. 91, 102 n.42 (1993) (noting that the other is H.L.A. Hart).

152. Kelsen, *supra* note 150, at 191.

153. *Id.*

154. *Id.* at 21. In contrast to the modern legal state are "primitive" legal orders that allowed for a decentralization of the use of force. *Id.* at 338-39.

155. See Fletcher, *supra* note 113, at 364 ("[T]o suggest that arbitrators may award punitive damages in arbitration is not to attack generally the monopoly of the State in punitive sanctions. No one suggests that arbitrators be given the authority to incarcerate anyone.").

156. 9 U.S.C. § 9 (1988). Thus, present day arbitration is not "coercive dispute-resolution" which, Laurence Tribe suggests, may be "inherently governmental and therefore . . . a 'public function.'" Tribe, *supra* note 134, at 1707.

157. William Catron Jones, *Three Centuries of Commercial Arbitration in New York: A Brief Survey*, 1956 Wash. U. L.Q. 193, 194 (1956). Compare Morton J. Horwitz, *The Transformation of American Law, 1780-1860*, at 140-59 (1977) with Eben Moglen, Note, *Commercial Arbitration in the Eighteenth Century: Searching for the Transformation of American Law*, 93 Yale L.J. 135, 147-48 (1983) (questioning Horwitz's suggestion that commercial arbitration declined at the opening of the nineteenth century).

bers.¹⁵⁸ Arbitration, broadly defined as private dispute resolution, has traditionally occurred within countless private voluntary associations such as trade associations, professional associations, labor unions, churches, civic groups, and fraternal organizations.¹⁵⁹ The result of these arbitration proceedings is often punishment, rather than compensation. The punishment is generally the "excluding, expelling and disciplining" of members who have violated the association's rules.¹⁶⁰ These private punishments, "concerted refusals to deal," are an "important mechanism by which trade associations, privately run markets, cooperatives and professional associations enforce rules and standards governing product or service quality."¹⁶¹ Trade association arbitration is a particularly well-established forum for punishment by expulsion.¹⁶² The private punishment imposed by trade association arbitrators—with attendant damage to reputation—is often "far more fearsome" than the cost of compensatory damages.¹⁶³

These examples of punishment by private arbitrators show that punishment, generally, has *not* traditionally been exclusively reserved to the State.¹⁶⁴ Furthermore, even the specific form of punishment at issue—the award of punitive damages—has not been exclusively re-

158. Jones, *supra* note 157, at 217.

159. See generally Note, *Exhaustion of Remedies in Private Voluntary Associations*, 65 Yale L.J. 369, 370-71 (1956) ("The constitutions and bylaws of private associations generally establish internal, semi-judicial procedures by which association officials are empowered to adjudicate disputes between members and association.").

160. *Id.*

161. Herbert Hovenkamp, Federal Antitrust Policy § 5.4(C) (1994). Concerted refusals to deal may be challenged under the antitrust laws, but these actions are not per se illegal and will be judged under the rule of reason. *Id.*

162. See generally Macneil et al., *supra* note 1, § 6.4.1 (reporting that a survey of more than 2,000 associations indicates that almost one-fifth of the associations provide facilities for arranging arbitration); National Indus. Conference Bd., *Trade Associations: Their Economic Significance and Legal Status* ch. XX (Hein & Co. 1982) (1925) (noting that membership in some trade associations is contingent upon associate's willingness to forgo resort to the legal system and to participate in arbitration proceedings instead); Irving S. Paull et al., U.S. Dep't of Commerce, *Trade Association Activities* ch. X (Hein & Co. 1983) (1927) (stating that various associations punish their members' refusal to arbitrate by expulsion).

163. Bruce L. Benson, *The Enterprise of Law: Justice Without the State* 221 (1990) (quoting William C. Woolridge, *Uncle Sam, The Monopoly Man* 100-01 (1970)). See, e.g., Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. Legal Stud. 115, 149 (1992) ("Unlike a court, the [New York Diamond Dealers Club arbitrator] has the ability to bring unique pressures on the losing party to pay: it can put him out of business almost instantaneously by hanging his picture in the clubroom of every bourse in the world with a notice that he failed to pay his debt.").

164. Under an Illinois statute enacted in 1873, arbitrators had the power to punish for contempt committed in their presence during arbitration hearings. Macneil, *American Arbitration Law*, *supra* note 25, at 18 (citing Ill. Rev. Stat. ch. 10 § 4 (Smith-Hurd 1915-16)). Other examples of private punishment include the fining of professional athletes by their leagues. See, e.g., *Charles O. Finley & Co. v. Kuhn*, 569 F.2d 527, 535 (7th Cir. 1978) (discussing Art. 1, Sec. 3 of the Major League Agreement), *cert. denied*, 439 U.S. 876 (1978).

served to the State.¹⁶⁵ Bruce H. Mann has shown that court enforcement of arbitral punitive damages awards occurred in eighteenth century Connecticut.¹⁶⁶ And arbitral awards of punitive damages did not end in the 1800s. Awarding punitive damages is a regular part of contemporary arbitration in, for example, the diamond business.¹⁶⁷ Because punishment has not traditionally been exclusively reserved to the State and there is a history of arbitral punitive damages awards from the early days of the Republic to the present, the award of punitive damages does not seem to convert a private arbitrator into a state actor under the present Supreme Court's "government function" theory of state action.¹⁶⁸

2. *Shelley's* Theory of State Action

In addition to the "government function" theory, there is another theory of state action that might apply to punitive damages in arbitration.¹⁶⁹ This theory notes that when a government court enforces an arbitrator's award (whether or not the award includes punitive damages), there is clearly a state action.¹⁷⁰ This state action violates the

165. "Medieval merchant tribunals provide an ancient precedent for awards of punitive damages outside the courts of law." Stipanowich, *supra* note 52, at 1002 n.266 (quoting I. Gross, *Select Cases on the Law Merchant* 102-03 (1908)).

166. See Bruce H. Mann, *The Formalization of Informal Law: Arbitration Before the American Revolution*, 59 N.Y.U. L. Rev. 443 (1984). During the late seventeenth and early eighteenth centuries, parties to arbitration

would execute bonds in each other's favor for a penal amount conditioned on non-performance of any award granted by arbitrators named in the bonds. They would then exchange bonds and proceed to arbitration. . . . A person who refused to perform an award risked being sued for the full penal sum of the bond he had given.

Id. at 459. In the eighteenth century, bonds were

replaced by promissory notes that the parties executed in favor of each other and deposited with the arbitrators as pledges to perform the award. After making the award, the arbitrators could either return the notes to their makers or turn them both over to the party in whose favor they had decided.

Id. at 460. The arbitrators "could endorse the loser's note down to the amount of the award before delivering it to the winner for collection, or they could deliver it unendorsed and thereby enable the victor to sue for the full face amount." *Id.* at 462-63. Awarding the loser's unendorsed note to the winner was awarding punitive damages. Mann states that this procedure "amounted to private enforcement of arbitration awards." *Id.* But, to be precise, it must be noted that the State, not the arbitrator, enforced the loser's duty to pay his or her promissory note. *Id.* at 469-79.

167. See Bernstein, *supra* note 163, at 127, 148.

168. One might quarrel with a theory under which a finding of state action turns upon whether scholars have found historical evidence of private entities performing the activity in question. But this quarrel involves how state action *ought* to be determined, rather than how it *is* determined, and is, for that reason, beyond the scope of this Article.

169. See *Rifkind & Sterling, Inc. v. Rifkind*, 33 Cal. Rptr. 828, 833-34 (Cal. Ct. App. 1994); Brunet, *supra* note 52, at 109-13.

170. *Rifkind & Sterling, Inc.*, 33 Cal. Rptr. at 834 ("A proceeding confirming an arbitration award and converting it into a judicial judgment constitutes state action, governed by requisites of due process."); Brunet, *supra* note 52, at 109-13.

Due Process Clauses unless the underlying arbitration proceeding—and the court's review of it—followed certain procedures not now generally followed.¹⁷¹ This argument concedes that an arbitrator's award of punitive damages, without more, is not state action.¹⁷² But if there is more, namely court enforcement of the arbitrator's award, then there is state action.

When a court enforces an arbitral award it is enforcing a contract because the parties to an arbitration agreement agree to comply with the arbitrator's award. The proposition that a court's enforcement of a contract is state action may seem at first to be plainly correct. But courts and commentators have been troubled by this reasoning because they believe that, "consistently applied, [it] would require individuals to conform their private agreements to constitutional standards whenever, as almost always, the individuals might later seek the security of potential judicial enforcement."¹⁷³ Probably because of these worries, the argument that contract enforcement constitutes state action has not succeeded outside the race discrimination context of *Shelley v. Kraemer*.¹⁷⁴ Although Cass Sunstein has argued that recognizing contract enforcement as state action "does not suggest that . . . the decisions of ordinary people are subject to constitutional constraints,"¹⁷⁵ he acknowledges that present law generally does not

171. See Brunet, *supra* note 52, at 112 ("[T]he modern interpretation of the FAA has created a federal delegation to private parties and encourages them to resolve disputes in private at their expense in return for easy and public court enforcement.").

172. Rifkind & Sterling, Inc. 33 Cal. Rptr. at 833 ("Before its confirmation, the [arbitral] award possessed the legal status of a private contract. . . . Consequently, the arbitration and award themselves were not governed or constrained by due process."); Brunet, *supra* note 52, at 112.

173. Laurence H. Tribe, *American Constitutional Law* 1697 (2d ed. 1988).

174. 334 U.S. 1 (1948). *Shelley* involved land subject to a covenant forbidding sales to racial minorities. *Id.* at 5. When the landowner attempted to sell the land to a member of a racial minority, the persons with an interest in the restrictive covenant sued to enjoin the sale. *Id.* at 5-6. The Supreme Court held that such an order would constitute state action and a violation of the Equal Protection Clause of the Fourteenth Amendment. *Id.* at 14-15. According to Professor Tribe:

The Court appeared to find the requisite state action in the fact that the state courts had indeed enforced the covenants; but such reasoning, consistently applied, would require individuals to conform their private agreements to constitutional standards whenever, as almost always, the individuals might later seek the security of potential judicial enforcement.

Tribe, *supra* note 173, at 1697.

"[C]ourts and commentators have characteristically viewed *Shelley* with suspicion." *Id.* at 1711-12.

Shelley's finding of state action in court enforcement of a private agreement has remained a little used doctrine of constitutional law. Neglect of the *Shelley* doctrine can be explained by its being a case of racial discrimination, to which the Court has been particularly hostile, and by the acceptance of the enforcement of other private agreements as beyond the scope of the fourteenth amendment.

The Supreme Court, 1968 Term, 83 Harv. L. Rev. 60, 118 n.21 (1969).

175. Cass R. Sunstein, *The Partial Constitution* 160 (1993). "[T]he enforcement of a contract and the availability of contract law are state action; but usually contract law

regard contract enforcement as state action.¹⁷⁶ So *Shelley* is likely to remain an aberration,¹⁷⁷ and its reasoning is not likely to be extended to the enforcement of arbitration agreements/awards.¹⁷⁸ As the Supreme Court recently stated, "Any argument driven to reliance upon an extension of that volatile case [*Shelley*] is obviously in serious trouble."¹⁷⁹

B. Waiver of Due Process

Even if the definition of state action is expanded to include court enforcement of an arbitrator's award of punitive damages, a due process challenge to such an award is likely to fail on the ground of waiver. "The orthodox view holds that parties who consent by contract to arbitration expressly waive their constitutional rights."¹⁸⁰

The leading Supreme Court case on waiver of due process rights is *D.H. Overmyer Co. v. Frick Co.*,¹⁸¹ in which the Court held that "[t]he due process rights to notice and hearing prior to a civil judgment are subject to waiver."¹⁸² *Overmyer* rejected a due process challenge to a cognovit note, which is a contractual provision "by which the debtor consents in advance to the holder's obtaining a judgment without no-

does not offend the Constitution. The decisions of private people to reach agreements are not state action at all. It is only state action that is state action." *Id.* at 161.

176. *Id.* at 73.

177. *Einhorn v. LaChance*, No. H-86-3406, 1987 WL 8391, *3 (S.D. Tex. Mar. 18, 1987) ("*Shelley* was a necessary but aberrational ruling.").

178. In fact, some courts have rejected the argument that, because of the state action inherent in court enforcement of arbitral awards, arbitration must be conducted in accordance with the Due Process Clauses. See *United States v. American Soc'y of Composers*, 708 F. Supp. 95, 96-97 (S.D.N.Y. 1989) (rejecting this argument because under it "all arbitrations could be subject to due process limitations through the simple act of appealing the arbitrators' decisions to the court system"); *Sportastiks v. Beltz*, No. 88C9293, 1989 WL 26825, *4 (N.D. Ill. Mar. 22, 1989) (finding no state action and confirming award). On the other hand, the court that has most thoroughly analyzed the issue concluded that the "limited degree of state action . . . involved in confirming an arbitration award . . . does require a traditional measure of due process." *Rifkind & Sterling, Inc., v. Rifkind*, 33 Cal. Rptr. 828, 833 (Cal. Ct. App. 1994). The court indicated, however, that the process required is only "notice and a hearing" rather than any judicial review of the arbitral award itself. *Id.* Brunet, who most ably argues for finding *Shelley*-type state action in arbitration, concedes that "the recent contraction of the state-action doctrine means an uphill fight" for this argument. Brunet, *supra* note 52, at 113.

179. *Bray v. Alexandria Women's Health Clinic*, 113 S. Ct. 753, 766 n.14 (1993).

180. Brunet, *supra* note 52, at 102. "By contracting to submit their disputes to arbitration, the parties have waived their right to more protective procedures." Hirshman, *supra* note 68, at 1361. Courts have not expressly addressed whether arbitration agreements constitute waivers of due process rights. They have, however, addressed whether collective bargaining agreements to arbitrate constitute due process waivers. Although there is disagreement, most find waiver. See *Romano v. Canuteson*, 11 F.3d 1140, 1141 (2d Cir. 1993).

181. 405 U.S. 174, 185-86 (1972).

182. *Id.* at 185.

tice or hearing."¹⁸³ *Overmyer* repeated the waiver standard applicable to criminal proceedings: a waiver must "be voluntary, knowing, and intelligently made."¹⁸⁴ But *Overmyer* did not state whether that standard (or some less exacting standard) governs in the civil context because even the criminal standard was satisfied on the facts before the Court.¹⁸⁵ *Overmyer*, however, noted that a cognovit note might not be enforceable "where the contract is one of adhesion, where there is great disparity in bargaining power, and where the debtor receives nothing for the cognovit provision."¹⁸⁶ The Court's invocation of contract law defenses as grounds for finding that there was no waiver has led commentators to read *Overmyer* as "suggest[ing] . . . that contract law provides the standard for determining whether civil law waivers satisfy the due process clause."¹⁸⁷

G. Richard Shell's thorough analysis of the Supreme Court's recent contracts jurisprudence¹⁸⁸ also supports the view that the Court is using contract law standards to assess civil waivers of due process, rather than the higher level of consent required in the criminal context. Shell cites *Mitchell v. W.T. Grant Co.*¹⁸⁹ and *Burger King Corp. v. Rudzewicz*¹⁹⁰ as establishing that contractual waivers of due process

183. *Id.* at 176. The cognovit note is barred by statute in some states. *Id.* at 177 nn.6, 7.

184. *Id.* at 185.

185. *Id.* at 185-86.

186. *Id.* at 188.

187. Edward L. Rubin, *Toward a General Theory of Waiver*, 28 UCLA L. Rev. 478, 518 (1981). Rubin criticizes the use of contract law in determining whether a waiver of due process rights has occurred. *Id.* at 545. Rubin contends that to create a valid waiver, "[e]ach party must be aware of the right that is being waived, and there must be some process of negotiation or bargaining connected with that right." *Id.* at 539. See also Brunet, *supra* note 52, at 108 (expressing dissatisfaction that "the present threshold for waiving civil constitutional rights seems to be that the waiving party only have satisfied contract law principles"); Linda S. Mullenix, *Another Choice of Forum, Another Choice of Law: Consensual Adjudicatory Procedure in Federal Court*, 57 Fordham L. Rev. 291, 365 (1988) (decrying application of contract principles to determine whether a forum-selection clause is enforceable waiver because of "ominous" implications for surrender of constitutional rights).

188. G. Richard Shell, *Contracts in the Modern Supreme Court*, 81 Cal. L. Rev. 433, 477-78 (1993).

189. 416 U.S. 600 (1974). *Mitchell* involved the sale of consumer goods on credit with the seller retaining a lien on the goods to secure payment of the purchase price. *Id.* at 601-02. The Supreme Court rejected a due process challenge to a state court's order sequestering the debtor's property pending resolution of a suit by the seller/lien creditor. *Id.* at 619-20. The order was issued upon the application of the lien creditor without notice to the debtor. *Id.* at 601-03. The Court stated that the debtor "was not deprived of procedural due process," rather than speaking in terms of waiver. *Id.* at 620. Nevertheless, the waiver principle is central because under Louisiana law the lien creditor's rights to sequestration of the property are created by an installment sales contract with the debtor. *Id.* at 605-06 (discussing La. Code Civ. Proc. Ann. art. 3571).

190. 471 U.S. 462 (1985). *Burger King* rejected a due process challenge to a Florida court's exercise of personal jurisdiction over a Michigan defendant because the defendant had entered into a franchise agreement with Burger King, a Florida corpora-

rights may involve unsophisticated parties and form contracts.¹⁹¹ Shell cites cases involving enforcement of arbitration agreements and choice-of-forum clauses in concluding that the Court also analyzes waiver of litigation rights according to contract law standards.¹⁹² Given that the Court uses contract law standards to assess civil waivers of due process generally and contract law standards to assess waivers of litigation rights, the Court will likely use contract law standards to assess whether an arbitration agreement waives due process rights to certain procedures prior to a civil judgment.

Assuming that contract law standards govern (civil) waiver of due process rights, whether a particular arbitration agreement constitutes such a waiver is an inherently case-by-case question that will turn on whether the party disputing waiver can prove a contract law defense such as fraud or duress. It is, however, important to note that unless a given arbitration agreement constitutes a waiver of due process rights, it is unenforceable under non-constitutional law. That is because Section 2 of the FAA only "make[s] arbitration agreements as enforceable as other contracts, but not more so."¹⁹³ Either an arbitration agreement constitutes a valid waiver of due process or the Due Process Clauses are superfluous because the arbitration agreement is unenforceable anyway.

tion. *Id.* at 487. As in *Mitchell*, the Court did not speak in terms of "waiving" due process, but the waiver concept is central because, had the defendant not entered into the franchise agreement, due process would have been offended by the Florida court's exercise of jurisdiction over him. *Id.* at 479-80.

191. Shell, *supra* note 188, at 477-78.

192. *Id.* at 458-62. Accord Michael E. Solimine, *Forum-Selection Clauses and the Privatization of Procedure*, 25 Cornell Int'l. L.J. 51, 64 n.95 (1992).

In *Carnival Cruise Lines v. Shute*, 499 U.S. 585 (1991), the Court enforced a choice-of-forum clause in a form contract (cruise ticket) requiring consumer plaintiffs to sue in a distant forum. *Carnival Cruise* was decided as a matter of federal admiralty law; due process was not expressly addressed. *Id.* at 590. But choice-of-forum clauses would be ineffective unless they constituted waivers of due process requirements for personal jurisdiction. "It does no good to preselect the forum if one party can still contest personal jurisdiction or other venue requirements." Solimine, *supra*, at 65. See also Edward A. Purcell, Jr., *Geography As a Litigation Weapon: Consumers, Forum-Selection Clauses, and the Rehnquist Court*, 40 UCLA L. Rev. 423, 465 (1992) ("In cases like *Carnival Cruise* consumer-plaintiffs should receive the full protection that the Due Process Clause guarantees for a simple but compelling reason: the function of forum-selection clauses in consumer form contracts is precisely to reverse the standard position of the parties with respect to forum selection."). Waiver of due process rights would not have been found in *Carnival Cruise* had the standard used in the criminal context applied because the plaintiffs' "consent was neither knowing nor informed." *Id.* at 466. Accord *Northwestern Nat'l Ins. Co. v. Donovan*, 916 F.2d 372, 376-77 (7th Cir. 1990) (Posner, J.).

An arbitration agreement is "a specialized kind of forum-selection clause," *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 519 (1974), thus it is quite possible that the Court will apply contract law standards to waiver in the arbitration agreement context. On the other hand, an agreement to arbitrate generally waives more procedural rights than an agreement to a particular judicial forum, so the Court may develop a different standard for waiver in the arbitration context.

193. *Prima Paint Corp. v. Flood & Conklin Mfg.*, 388 U.S. 395, 404 n.12 (1967).

One might worry that viewing an arbitration agreement as a waiver of due process rights could lead to courts enforcing shockingly harsh punitive damages awards.¹⁹⁴ The first reply to this worry is that it finds little support in experience. "The little available empirical data suggests that giving arbitrators authority to make punitive awards has not resulted in 'oppressive misuse of coercive economic sanctions.'"¹⁹⁵ The more common worry among knowledgeable observers of arbitration is precisely the opposite—that arbitrators will be reluctant to impose punitive damages on defendants who could count on no such reluctance from a court.¹⁹⁶ In short, runaway punitive damages awards are a problem that is likely to be reduced, rather than aggravated, by shifting disputes from courts to arbitration.

That said, suppose an arbitration agreement empowers an arbitrator to award punitive damages and one of the parties to the agreement has been ordered by the arbitrator to pay an obscenely high punitive damages award. Given that arbitration agreements are as enforceable as other contracts,¹⁹⁷ what legal reasoning might a court employ to avoid confirming that award?

Section 10 of the FAA allows a court to vacate an arbitral award when it was "procured by corruption, fraud, or undue means,"¹⁹⁸ "where there was evident partiality or corruption in the arbitrators,"¹⁹⁹ or "[w]here the arbitrators were guilty of . . . misbehavior by which the rights of any party have been prejudiced."²⁰⁰ In addition, all of the usual contract defenses—such as fraud, duress, mistake and incapacity—are available as grounds for declining to enforce an arbitral award.²⁰¹ If none of these applies, then a court can turn to unconscionability.²⁰² In short, arbitration law²⁰³ and contract law provide the tools necessary for avoiding enforcement of truly shocking arbitral awards, whether they involve punitive damages or any other sanction. There is nothing gained, then, by interpreting the state action and

194. This worry could extend to any arbitral remedy, not just punitive damages. Court enforcement of other arbitral remedies also might be challenged on due process grounds. Although a full discussion of the universe of possible arbitral remedies is beyond the scope of this Article, it is sufficient to note that the same non-Constitutional doctrines available to vacate a shocking punitive damages award are available to vacate any shocking arbitral award.

195. Macneil et al., *supra* note 1, § 36.3.4 (quoting *Garrity v. Lyle Stuart, Inc.*, 386 N.Y.S.2d 831, 833-34 (1976)).

196. *See supra* note 52.

197. *See supra* notes 29-31 and accompanying text.

198. 9 U.S.C. § 10(a)(1).

199. 9 U.S.C. § 10(a)(2).

200. 9 U.S.C. § 10(a)(3).

201. Macneil et al., *supra* note 1, § 19.2.

202. *Id.* § 19.3. *See supra* note 53.

203. *See Brunet, supra* note 52, at 117-119 (discussing prospects for increased procedural protection in arbitration despite inapplicability of the Due Process Clause); *Stipanowich, supra* note 52, at 1003-05 (discussing judicial powers to control abusive arbitral awards).

waiver doctrines to require that arbitrators awarding punitive damages adhere to constitutional due process standards.

IV. CONCLUSION

This Article started with the core of the FAA, which is freedom of contract with respect to arbitration agreements. The FAA prevents government courts from weakening their private sector competitors by refusing to enforce arbitration agreements. Applying the FAA to punitive damages leads to the conclusion that whether an arbitrator may award punitive damages depends on the agreement by which the dispute was submitted to arbitration. In accordance with the usual methods of contractual interpretation, courts must look to the express and implied terms of an arbitration agreement to determine whether the parties have given their arbitrator the power to award punitive damages. If there is no language in the arbitration agreement that can plausibly be construed as addressing punitive damages, the federal policy favoring arbitration supports a default rule permitting arbitral punitive damages awards.

If an arbitration agreement precludes an arbitral punitive damages award, then, unless the agreement calls for a second (in-court) proceeding on the punitive damages claim, the parties have completely waived their rights to recover punitive damages in any forum. This waiver must be enforced "save upon such grounds as exist at law or in equity for the revocation of any contract."²⁰⁴ Likewise, courts must confirm an arbitral punitive damages award if it is authorized by the parties' arbitration agreement. In short, the FAA allows parties to contract for the privatization of the decision to award punitive damages. This freedom allows diversity. Parties who feel besieged by astronomical punitive damages awards can contract out of that threat. Parties who wish to be able to recover punitive damages from others, or who wish to reap the gains that come from giving others the right to recover punitive damages from them, can contract into punitive damages.

The FAA, like any federal law, preempts inconsistent state law. A state law that limits freedom of contract with respect to arbitration agreements conflicts with the FAA and is preempted by it. *Garrity*, for instance, refuses to enforce arbitration agreements giving arbitrators the power to award punitive damages. Because *Garrity* singles out arbitration agreements and limits their enforceability, it is preempted by the FAA. This preemption works both ways. *Garrity* singles out arbitration agreements in limiting the freedom to contract for punitive damages. If a state singles out arbitration agreements by limiting the freedom to contract against punitive damages in arbitration, that, too, would be preempted.

204. 9 U.S.C. § 2.

The implications of this preemption are profound. Contrary to *Garrity*, punitive damages are not a sanction reserved to the State. The law permits parties to contractually submit themselves to punishment. The freedom of contract embodied in the FAA encompasses private punishment.

While the FAA preempts inconsistent state law regarding arbitration arising out of any agreement evidencing a transaction involving interstate commerce, it does so in an unusual way. Its preemption of state law is a default rule, rather than a mandatory rule. Parties are free to contract out of FAA preemption. If they choose to be governed by state law, which would otherwise be preempted by the FAA, then the FAA requires enforcement of that choice. This choice is not made, however, when parties include an ordinary choice-of-law clause in their agreement. An ordinary choice-of-law clause chooses one state's law over the law of other states, not over federal law. To contract out of FAA preemption, parties must manifest an intent to choose the law of a particular state over federal law. Although this happens rarely, if ever, perhaps it should happen more often. Perhaps there are other federal laws whose preemption of state law ought to be a default rule rather than a mandatory rule. Allowing parties to choose whether to be governed by state or federal law advances the parties' freedom to define their legal rights and duties as they wish.

The benefits of allowing parties to privatize the decision to award punitive damages—and perhaps the benefits of allowing them to contract out of preemption—might be lost if the Due Process Clauses were interpreted to restrict arbitral punitive damages awards. Fortunately, present due process analysis does not seem to restrict such awards. Although the state action doctrine is far from a model of clarity, it appears that the present Supreme Court would not find that an arbitrator is performing a function exclusively reserved to the State when awarding punitive damages. And it is even less likely that *Shelley v. Kraemer* will be extended to make court enforcement of arbitration agreements state action. Finally, it appears that the Court is using contract law standards to assess whether a valid waiver of civil due process rights has occurred. That means that the Due Process Clauses add nothing to the analysis of arbitral awards; non-Constitutional law prevents enforcement of any award that would violate due process.

This is a happy conclusion because allowing privatization of the decision to award punitive damages may greatly benefit parties who take advantage of it. It may also help to defuse the controversy over punitive damages generally by allowing different rules to suit different preferences. Finally, the FAA's model of preemption as a default rule may have the potential to do a great deal of good. If it is applied to other areas of federal law, a new, and more liberating, form of federalism may evolve.