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Avoiding a Punitive Damages Award in Private Arbitration

New York law is a great boon when it comes to private arbitration. The law is well-developed (and in fact served as the basis for the Federal Arbitration Act); New York is home to a plethora of experienced professional arbitrators and arbitration centers; and the enforcement process for arbitration awards in the state courts is well established. Something else that sets New York law apart is that punitive damages are not allowed in private arbitration. Punitive damages are those designed to punish a party for its conduct or deter a party (and others) from wrongfully acting in the future, rather than compensate an injured party for the other's wrongful conduct. The New York rule is clear: "An arbitrator has no power to award punitive damages, even if agreed upon by the parties." Garrity v. Lyle Stuart, Inc., 40 N.Y.2d 354, 356 (1976).

The reasoning for this rule is that punitive damages are "a sanction reserved to the State" and of such import that the State courts are the only fora authorized to award them. Allowing punitive damages as a private remedy (through private arbitration) "would violate strong public policy." Id.

Sounds great, right? New York law proscribes punitive damages in arbitration, so if you choose New York law to govern your arbitration agreement, that should protect you. Not so fast. The U.S. Supreme Court limited the New York rule in 1995 in Mastrobuono v. Shearson Lehman Hutton, 514 U.S. 52 (1995). In that decision, the U.S. Supreme Court found that federal arbitration law, which permits punitive damages awards, superseded New York's rule against punitive damages because the agreement did not affirmatively adopt the New York rule. Id. at 64. The parties' choice of New York law in the agreement (but not in the arbitration provision) was not enough, on its own, to invoke the New York rule against punitive damages in arbitration. Id.

The month before Mastrobuono was decided, the New York Court of Appeals (New York's highest court) determined that a choice-of-law provision that included "enforcement" was enough to apply New York law to the parties' arbitration agreement. Smith Barney, Harris Upham & Co. v. Luckie, 85 N.Y.2d 193, 202 (1995), reargument and reconsideration denied, 85 N.Y.2d 1033 (1995), cert denied sub nom Manhard v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 516 U.S. 811 (1995). The Court of Appeals – without dissent – held that the parties' contractual choice "to apply New York law, 'without excluding its arbitration rules' from that general condition" was an explicit

“adopt[ion] as binding New York’s rule that threshold Statute of Limitations questions are for the courts” not the arbitrators. Id. (internal citation omitted); id. at 207-08 (Kaye, C.J., concurring) (agreements providing “that New York law governs the ‘agreement and its enforcement’” mean that “all of New York arbitration law … would apply”). At the time of the Luckie decision, the U.S. Supreme Court had heard arguments in the Mastrobuono case, but had not issued its decision. The New York Court of Appeals distinguished Mastrobuono based on the parties’ explicit inclusion of “enforcement” in their choice-of-law for the agreement. Id.

After Mastrobuono and Luckie were decided in 1995, business parties and their counsel have augmented the traditional choice-of-law provision with the magic word “enforcement.” For example, a choice-of-law provision reading “shall be governed by the laws of the State of New York” was replaced with “shall be governed and enforced in accordance with the law of New York” to invoke the application of New York arbitration law. Under that view, adding “enforced” or “enforcement” invoked New York law explicitly and therefore excluded any award of punitive damages because such an award was prohibited by New York law. Other parties invoked the New York rule against punitive damages with the explicit inclusion of the Garrity case by name: “enforced in accordance with the law of the State of New York, including Garrity v. Lyle Stuart, Inc., 40 N.Y.2d 354 (1976).” Others limited the power of the arbitrator(s) to exclude an award of punitive damages.

The New York Court of Appeals has emphasized that “enforcement” must be included in a choice-of-law provision for New York arbitration law to be applied. In 2005, the Court of Appeals rejected application of New York arbitration law because the “enforcement” language was missing: “In the absence of more critical language concerning enforcement, however, all controversies, including issues of timeliness, are subjects for arbitration.” Diamond Waterproofing Sys. v. 55 Liberty Owners Corp., 4 N.Y.3d 247, 253 (2005). Again in 2012, the Court rejected application of New York arbitration law because the agreement, “governed by, and construed in accordance with, the laws and decisions of the State of New York,” failed to “unequivocally invoke the New York standard” for incorporating New York’s arbitration rules and law. N.J.R. Assocs. v. Tausend, 19 N.Y.3d 597, 602 (2012).

The “enforcement” choice-of-law approach was called into question by an intermediate appellate court’s decision in 2014. The New York Appellate Division, First Department, rejected the “governed and enforced” approach in Flintrock Construction Services, LLC v. Weiss, 122 A.D.3d 51 (N.Y. App. Div. 1st Dep’t 2014). The Court found that such a choice-of-law provision did not prohibit an arbitrator from awarding punitive damages absent “language expressly invoking the Garrity rule, or expressly excluding claims for punitive damages.” Id. at 54. The parties withdrew the appeal to the New York Court of Appeals before it was decided. Flintlock Constr. Servs., LLC v. Weiss, 4 N.Y.S.3d 590 (2015). Since then, other New York courts have rejected efforts

to avoid arbitration of punitive damages or arbitration awards of punitive damages if the agreement only chooses New York law to govern and enforce without more. E.g., Russo v. Time Moving & Storage, 194 A.D.3d 976, 977 (N.Y. App. Div. 2d Dep't 2021) (reinstating punitive damages in arbitration award). But courts have rejected and vacated punitive damages awards on the basis that the arbitrator exceeded his or her authority because punitive damages were not demanded. E.g., 544 Bloomrest, LLC v. Harding, Index No. 652658/20, Appeal No. 15275 Case No. 2021-03415, 2022 N.Y. App. Div. LEXIS 940, *2-3 (N.Y. App. Div. 1st Dep't Feb. 10, 2022) (vacating punitive damages from arbitration award where not demanded).

It's also important to note that arbitration centers have their own rules that may permit punitive damages awards. The Supreme Court's decision in Mastrobuono harmonized the choice-of-law provision in the agreement (New York) with the arbitration provision calling for arbitration under the NASD or NYSE rules, under which "arbitrators can consider punitive damages as a remedy." 514 U.S. at 59-64.

So what's a savvy business person to do? If you are choosing arbitration in your business dealings, examine the arbitration provision carefully. To ensure the benefit of the New York rule against punitive damages, be sure to both choose New York law – "this agreement shall be governed and enforced in accordance with New York law" and either invoke Garrity or explicitly exclude punitive damages. The same goes for choosing an arbitration center's rules for any arbitration: to avoid the potential for a punitive damages award, explicitly exclude punitive damages from the arbitrator's authority.