Supreme Court Addresses

*Volt’s Choice-of-Law Trap:*

Is the End of the Problem in Sight?

The Supreme Court’s view of which law applies when parties select the law of a particular state in their arbitration agreement seems to be evolving. This article discusses the High Court’s thinking in the *Volt, Mastrobuono* and *Preston* decisions and provides practical guidance for parties who wish to have the Federal Arbitration Act apply to the arbitration and state law apply to the merits of the dispute.

**BY ARCHIS A. PARASHARAMI AND KEVIN RANLETT**

Archis A. Parasharami is a partner and Kevin Ranlett an associate in the Supreme Court and Appellate Practice Group at Mayer Brown LLP.

Many contracts with arbitration provisions contain choice-of-law clauses specifying which state’s law governs the contract. Attorneys drafting these clauses typically consider the chosen state’s substantive law, not its arbitration procedures—which often differ from those of the Federal Arbitration Act (FAA), a statute enacted in 1925 to enforce arbitration agreements and preempt state laws that are hostile to arbitration. For example, state laws that single out arbitration agreements for special treatment or make certain disputes inarbitrable would ordinarily be preempted by the FAA.

But during the last 20 years, some drafters of arbitration agreements have fallen into a trap for the unwary, as courts have interpreted choice-of-law clauses to choose state arbitration procedures as well as substantive law. Recently, in a largely overlooked portion of the decision in *Preston v. Ferrer*, the U.S. Supreme Court took a welcome step toward eliminating this trap. This article describes the evolution of the trap and offers guidance to attorneys on how to avoid it.

The Choice-of-Law Trap
The choice-of-law trap emerged two decades ago out of a construction contract between Stanford University and Volt Information Sciences, an engineering firm. The parties had agreed to arbitrate disputes arising out of the contract, and to apply the law of the place where the project was located (California). Stanford later filed suit in California Superior Court against Volt and two non-parties to the agreement. Volt moved to compel arbitration under the FAA, and Stanford opposed the motion and requested a stay of arbitration. The trial court held that the choice-of-law clause incorporated California arbitration procedures, and therefore granted Stanford’s request for a stay. The California Court of Appeal affirmed, agreeing that the seemingly innocuous choice-of-law clause incorporated California arbitration rules in place of the FAA. The California Supreme Court denied Volt’s petition for discretionary review.

The Court Begins to Limit Volt
In *Mastrobuono v. Shearson Lehman Hutton*, decided six years after *Volt*, the Supreme Court began to fix the trap it had created. Here the Court construed a choice-of-law provision more narrowly, holding that it incorporated only the chosen state’s substantive law, not its arbitration procedures.

The decision in *Preston v. Ferrer* suggests that a general choice-of-law clause should not be read to trump the FAA, even if state law might read it otherwise, and especially when particular arbitral rules are chosen.

The parties in *Mastrobuono* agreed to arbitrate disputes “in accordance with the rules of the National Association of Securities Dealers (NASD)” or other self-regulatory organizations, and also to apply “the laws of the State of New York.”

During an NASD arbitration, the arbitrators awarded punitive and compensatory damages to Mastrobuono. Shearson Lehman moved to vacate the award because New York does not permit arbitrators to award punitive damages. The district court agreed and vacated the award, concluding that the choice-of-law clause incorporated New York arbitration law. The 7th Circuit affirmed.

However, the Supreme Court granted review and reversed. It held that the *Mastrobuono* choice-of-law clause might “reasonably be read” to incorporate “only New York’s substantive rights and obligations,” without the state’s “allocation of power” between courts and arbitrators. The Court added that choice-of-law provisions are...
generally designed to determine the relevant substantive law, while procedural rules of arbitration are decided separately. Accordingly, the choice-of-law clause was not “an unequivocal exclusion of punitive damages claims” under New York arbitration procedures. Considering the parties’ selection of the NASD’s arbitration rules, the Court held that the best way to “harmonize” the agreement was to read the choice-of-law clause “to encompass substantive principles” of New York law without any “special rules limiting the authority of arbitrators.”

Mastrobuono’s reasoning was persuasive—but hard to square with Volt, as Justice Clarence Thomas noted in a spirited dissent. The Mastrobuono majority reconciled the two decisions by noting that in Volt the Court deferred to a state court’s construction of the contract, whereas in Mastrobuono, the Court reviewed the judgment of a federal district court de novo, which freed it to adopt its own best reading.

Mastrobuono helped close the trap the Supreme Court created in Volt, but it did not completely eliminate the problem. For the next decade, many lower courts found the holding in Mastrobuono to be confusing, perhaps because they did not perceive a difference between Mastrobuono’s facts and those in Volt. Some courts read Mastrobuono as largely abrogating Volt and adopting a new rule for all courts as a matter of federal law. Others recognized the distinction between the plenary review in Mastrobuono and Volt’s deference to state courts.10

Meanwhile, a few state courts took pains to limit Mastrobuono’s influence. In Cronus Investments v. Concierge Services, for example, a contract specified that California law would govern, but added that this designation “shall not be deemed an election to preclude application of the [FAA], if it would be applicable.” The California Supreme Court applied California arbitration law nonetheless, holding that because the FAA did not fully preempt state procedural rules under Volt, the federal statute was not “applicable,” and thus the “shall not be deemed” clause did not apply. The court also sought to limit Mastrobuono to its facts, stating that California arbitration law was not “a special rule limiting the authority of arbitrators.”11

Other state courts have also taken steps to apply their own state law, finding that parties who had not explicitly invoked the FAA could not expect to have its protections apply.12

The Preston Decision

The confusion spawned by Volt and Mastrobuono has lasted for over a decade. In 2008, however, the Supreme Court signaled a different approach. In Preston, the Court abandoned the state-law underpinnings of Volt and protected parties’ federal arbitration rights by applying a federal interpretation of choice-of-law provisions.

The contract in Preston contained a general choice-of-law clause selecting California law, and also provided for arbitration under American Arbitration Association (AAA) rules. After Preston initiated arbitration to recover management fees he alleged were owed him, Ferrer (better known as television’s “Judge Alex”) claimed that the contract was unenforceable because Preston was not licensed as required by state law. Relying on Volt, Ferrer further argued that the choice-of-law clause incorporated state arbitration procedures, which in

<table>
<thead>
<tr>
<th>The Volt Decision</th>
<th>The Mastrobuono Decision</th>
<th>The Preston Decision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trial Court: state Choice of Law: California and AAA construction arbitration rules California Superior Court held choice-of-law clause incorporated California arbitration law. California Court of Appeal affirmed. California Supreme Court denied review. U.S. Supreme Court affirmed the Court of Appeal. • FAA permits state procedures to apply. • Court defers to the state court’s interpretation of choice-of-law clause.</td>
<td>Trial Court: federal Choice of Law: New York and NASD arbitration rules Northern District of Ohio relied on Volt. 7th Circuit affirmed. U.S. Supreme Court reversed. • Choice-of-law clause could reasonably read to only include substantive New York law. • Choice-of-law provision was not an unequivocal election of New York law on punitive damages. • Court harmonized choice-of-law clause with selection of AAA rules.</td>
<td>Trial Court: federal Choice of Law: California and AAA arbitration rules California Labor Commissioner accepted jurisdiction. California Superior Court denied motion to compel arbitration. California Court of Appeal affirmed. California Supreme Court denied review. U.S. Supreme Court reversed the Court of Appeal. • FAA overrides state law. • Distinguished Volt, which never argued AAA rules applied to the dispute.</td>
</tr>
</tbody>
</table>
this case called for the dispute to be decided by the state Labor Commissioner rather than an arbitrator.

The Court rejected Ferrer’s choice-of-law argument by distinguishing Vol. First, it stated that state law was used as a gap-filler in Vol because the arbitration agreement in that case had not addressed the particular proceedings at issue—i.e., litigation involving third parties who were strangers to the arbitration agreement. By contrast, in Preston, the Court said there was “no other procedural void for the choice-of-law clause to fill.”

Next, the Court pointed out that although the agreement in Vol had also chosen AAA rules, the petitioner there had never argued that this designation “trumped the choice-of-law clause contained in the contract.” Thus, as in Mastrobuono, the Court limited Preston’s choice-of-law clause to substantive state law, leaving procedural issues to be resolved by the AAA’s rules.

What is significant about this decision—something largely overlooked—is that Preston departs from the approach in Vol, which left the interpretation of choice-of-law clauses to the state courts to decide. To be sure, in Preston there was no state interpretation to accept, since the California Court of Appeal’s error on the federal question had kept it from reaching the choice-of-law issue. But once the Supreme Court corrected the error of federal law, it could have let a state court resolve any state-law issues on remand. It did not. Instead, the Preston Court construed the parties’ contract on its own and determined the “best way to harmonize” the adoption of the AAA rules with the selection of California law.

The Court saw no need to consult the state courts on what reading was best.

Preston suggests that a general choice-of-law clause should not be read to trump the FAA, even if state law might read it otherwise, and especially when particular arbitral rules are chosen. By noting that Vol had not addressed the parties’ selection of AAA rules, Preston implied that the result in Vol would have been different had the Court considered that fact. The Preston Court applied the interpretive principles it found appropriate in light of the FAA, principles rooted in the federal substantive law of arbitrability, and it arrived at a decision consistent with common sense as well as the federal policy favoring arbitration.

Conclusion

Once Preston’s holding is recognized by the lower courts, parties to arbitration agreements will no longer have to fear that a choice-of-law clause might frustrate their intent to arbitrate. The 8th Circuit recently held that, under Preston, “an arbitration provision’s incorporation of the AAA rules supersedes a choice-of-law provision contained in the same agreement.”

In addition, since Preston was decided, at least one state court has interpreted that case to demand clear evidence of the parties’ intent—not just the existence of a choice-of-law clause designating state law—before finding a waiver of the FAA’s protections.

So far, however, Preston’s implications for the choice-of-law trap have not been widely recognized—perhaps because Preston focused primarily on other issues. As a result, some courts have continued to invoke Vol’s choice-of-law rule without so much as mentioning Preston. A few courts have sought to limit Preston in the same way as Mastrobuono, interpreting Preston (like Vol) to treat state arbitration law as an acceptable gap filler whenever there is any arguable ambiguity for state law to fill.

Until Preston’s holding is more widely recognized, drafters should take care to specify precisely which procedures will govern the enforcement of arbitration agreements. A choice-of-law clause should not be read to select state arbitration procedures if the agreement explicitly provides that the interpretation and enforcement of the arbitration provision shall be governed by the FAA.

So long as the choice-of-law trap exists, it is vital that drafters not leave the application of the FAA for future courts to decide.

Additionally, litigants should consider removing cases to federal court when possible. Doing so will offer the parties a stronger chance of obtaining a sensible reading of their contracts and avoiding state-law hostility to arbitration.

2 Under the FAA, the motion to compel arbitration would have been granted, even if Stanford’s claims against the other defendants continued in litigation. See Dean Witter Reynolds v. Byrd, 470 U.S. 213, 221 (1985); Moses H. Cone Memorial Hosp. v. Mercury Const. Corp., 460 U.S. 1, 20 (1983).

3 See Cal. Civ. Proc. Code § 1281.2(c) (permitting a court to deny a petition to compel arbitration when “[a] party to the arbitration agreement is also a party to a pending court action … 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”).


8 Id. at 64, 66-67 (Thomas, J., dissenting).


