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.

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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*,[1] 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,[2] 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.[3] 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 U.S. Supreme Court granted Volt's petition for review. It held that the FAA permitted state procedures to apply because the statute simply enforces arbitration agreements according to their terms. Although there was little evidence that the parties intended to abandon the FAA in favor of California arbitration law, the Court deferred to the state courts' interpretation of the choice-of-law clause, reasoning that "the interpretation of private contracts," even when they involve federal rights, "is ordinarily a question of state law, which this Court does not sit to review."[4]

Most drafters of arbitration agreements intend the FAA to apply because the FAA applies to all contracts "involving" interstate commerce. This concept has been understood to reach to the fullest extent of Congress's interstate commerce power.[5] Yet after the Supreme Court's decision in *Volt Information Sciences Inc. v. Leland Stanford Jr. University*, in one arbitration-related case after another, the courts have misread *Volt* to hold that choice-of-law clauses waive the application of the FAA unless the arbitration agreement explicitly invokes the federal statute. As a result, parties who have relied on the FAA's protections became subject to the vagaries of often-hostile state laws that hindered, if not prohibited, arbitration of the parties' disputes.[6]

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.[7]

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.[8] 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.[9] 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

The Volt *Decision*	*The* Mastrobuono *Decision*	*The* Preston *Decision*
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.	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.	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.

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 *Volt*. First, it stated that state law was used as a gap-filler in *Volt* 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 *Volt* 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.

In Preston v. Ferrer, the Supreme Court said there was "no procedural void" for the choice-of-law clause to fill and so limited that 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 *Volt*, 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.[13] 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.[14] 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 *Volt* had not addressed the parties' selection of AAA rules, *Preston* implied that the result in *Volt* 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."[15] 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.[16]

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 *Volt's* choice-of-law rule without so much as mentioning *Preston*.[17] A few courts have sought to limit *Preston* in the same way as *Mastrobuono*, interpreting *Preston* (like *Volt*) to treat state arbitration law as an acceptable gap filler whenever there is any arguable ambiguity for state law to fill.[18]

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.[19]

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. ■

ENDNOTES

[1] 128 S. Ct. 978 (2008).

[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").

[4] *Volt Info. Sciences. v. Board of Trustees of Leland Stanford Jr. Univ.*, 489 U.S. 468, 474 (1989).

[5] See *Citizens Bank v. Alafabco, Inc.*, 539 U.S. 52, 56 (2003); *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265, 274-77 (1995).

[6] See, e.g., *Rhodes v. Consumers' Buyline*, 868 F. Supp. 368, 373 (D. Mass. 1993); *Armco Steel Co. v. CSX Corp.*, 790 F. Supp. 311, 319-20 (D.D.C. 1991); *Henry v. Alcove Inv.*, 284 Cal. Rptr. 255, 289 (Cal. Ct. App. 1991); *Hotz Corp. v. Carabetta Builders*, 1991 WL 321922 (Conn. Super. Ct. Nov. 29, 1991); *Yates v. Doctor's Assocs.*, 549 N.E.2d 1010, 1015-16 (Ill. App. Ct. 1990); *Albright v. Edward D. Jones & Co.*, 571 N.E.2d 1329, 1332-33 (Ind. Ct. App. 1991).

[7] 514 U.S. 52 (1995).

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

[9] See *Action Indus., Inc. v. U.S. Fid. & Guar. Co.*, 358 F.3d 337, 342 (5th Cir. 2004); *Sovak v. Chugai Pharm. Co.*, 280 F.3d 1266, 1269 (9th Cir. 2002); *Roadway Package Sys. v. Kayser*, 257 F.3d 287, 288-89 (3d Cir. 2001), superseded on other grounds, *Hall Street Assocs. v. Mattel, Inc.*, 128 S. Ct. 1396 (2008); see also *1745 Wazee Ltd. v. Castle Builders Inc.*, 89 P.3d 422, 424-25 (Colo. Ct. App. 2003).

[10] See, e.g., *Wolsey, Ltd. v. Foodmaker, Inc.*, 144 F.3d 1205, 1212-13 (9th Cir. 1998); *Ferro Corp. v. Garrison Indus.*, 142 F.3d 926, 935 (6th Cir. 1998); *Porter Hayden Co. v. Century Indem. Co.*, 136 F.3d 380, 383 n.6 (4th Cir. 1998); *Goff Group, Inc. v. Greenwich Ins. Co.*, 231 F. Supp. 2d 1147, 1151 (M.D. Ala. 2002).

[11] 107 P.3d 217 (Cal. 2005).

[12] See, e.g., *Glazer's Distribs. of Ill., Inc. v. NWS-Ill., LLC*, 876 N.E.2d 203, 212-13 (Ill. Ct. App. 2007); *Manson v. Dain Bosworth Inc.*, 623 N.W.2d 610, 614-16 (Minn. Ct. App. 1998); *Sterling Truck Corp. v. Sacramento Valley Ford Truck Sales, Inc.*, 751 N.E.2d 517, 519-20 (Ohio Ct. App. 2001); *Moscatiello v. J.J.B. Hilliard*, 939 A.2d 325, 329 (Pa. 2007); *Frizzell Construction Co. v. Gatlinburg, L.L.C.*, 9 S.W.3d 79, 85-86 (Tenn. 1999).

[13] See 489 U.S. at 474; *Ferrer v. Preston*, 51 Cal. Rptr. 3d 628, 633-34 (Cal. Ct. App. 2006).

[14] Quoting *Mastrobuono*, 514 U.S. at 63-64.

[15] *Fallo v. High-Tech Inst.*, 559 F.3d 874, 879 (8th Cir. 2009).

[16] See *Personnel Decisions, Inc. v. Bus. Planning Sys., Inc.*, 2008 WL 1932404, at *6 & n.37 (Del. Ch. May 5, 2008).

[17] See, e.g., *Best Interiors, Inc. v. Millie & Severson, Inc.*, 75 Cal. Rptr. 3d 1, 5-8 (Ct. App. 2008); *Duffens v. Valenti*, 74 Cal. Rptr. 3d 311, 324 (Ct. App. 2008); *Hill v. NHC HealthCare/Nashville, LLC*, 2008 WL 1901198 (Tenn. Ct. App. April 30, 2008).

[18] See *Empire Film Prods., Inc. v. Arenas Entertainment*, 2008 WL 1799770, at *9 (Cal. Ct. App. Apr. 22, 2008).

[19] See, e.g., *Barrett v. Investment Mgmt. Consultants, Ltd.*, 190 P.3d 800, 801, 803 (Colo. Ct. App. 2008).