ADR Insight: Punitive Damages Must Be Explicitly Excluded in New York Choice-of-Law Arbitration Provisions

I. INTRODUCTION

New York law has long prohibited the award of punitive damages in arbitration as a matter of public policy. However, the United States Supreme Court and a New York intermediate appellate court have held that punitive damages can be awarded in arbitrations under the Federal Arbitration Act ("FAA") *unless* the parties explicitly exclude such a remedy in the governing arbitration clause. Thus, when drafting an arbitration clause, one should consider whether to include language that removes the ability of an arbitrator to award these potentially catastrophic damages. Similarly, when evaluating a draft arbitration agreement from a counterparty, it is essential to explicitly address the availability of punitive damages because New York law no longer provides a complete bar to such an award.

II. PUNITIVE DAMAGES

As the name implies, punitive damages intend to punish. These damages both penalize reprehensible conduct and deter others from engaging in similar behavior.[1] Yet, because the goal of punitive damages has historically been to "vindicate public rights" rather than "remedy private wrongs,"[2] this extreme remedy is ordinarily not available in commercial disputes between private parties. In recent years, however, juries, in particular, have been willing to award punitive damages—sometimes in exceedingly large amounts—in cases where the reprehensible conduct was "aimed at the public generally," involved "fraud evincing a 'high degree of moral turpitude,'" and "demonstrate[d] 'such wanton dishonesty as to imply a criminal indifference to civil obligations.'"[3] One reason to use alternative dispute resolution mechanisms for business disputes is to insulate the parties from these types of damages.

III. PUNITIVE DAMAGES IN ARBITRATION IN NEW YORK

As the business and commercial capital of the world, New York is frequently the venue for arbitrations and its law designated as the choice of law that governs the dispute. For decades, New York law generally prohibited the award of punitive damages in arbitration.

[1] *Walker v. Sheldon*, 10 N.Y.2d 401, 404 (1961).
[2] *Rocanova v. Equitable Life Assurance Soc'y of U.S.*, 83 N.Y.2d 603, 613 (1994).
[3] *Id.* (quoting *Walker*, 10 N.Y.2d at 404-405).

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In 1976, the New York Court of Appeals held in *Garrity v. Lyle Stuart, Inc.* that punitive damages are not available in arbitration governed by New York law because permitting an arbitrator to award punitive damages "displaces the court and the jury, and therefore the State, as the engine for imposing a social sanction."[4]

The United States Supreme Court and the Appellate Division, First Department have since limited *Garrity's* applicability. First, in *Mastrobuono v. Shearson Lehman Hutton, Inc.,* the United States Supreme Court held that merely naming New York as the choice of law in arbitration does not automatically trigger *Garrity*. Instead, the parties must include clear language in their agreement to arbitrate that "constitute[s] evidence of an intent to exclude punitive damages claims."[5] In reaching this conclusion, the Court noted that the FAA both promotes a national policy favoring arbitration of disputes involving interstate commerce and seeks to ensure "that private agreements to arbitrate are enforced according to their terms."[6] Thus, only an arbitration provision with language excluding punitive damages will prevent an arbitrator from awarding this remedy.

In 2014, the Appellate Division, First Department followed *Mastrobuono* when it held that "[a] New York choice-of-law provision does not constitute a manifestation of unequivocal intent sufficient to invoke the *Garrity* rule."[7] The First Department adopted the United States Supreme Court's conclusion that a New York choice-of-law provision governs the rights and duties of the parties under the agreement, but the FAA governs the limitations (or lack thereof) placed on the arbitrator. Accordingly, for arbitrations under the FAA, the arbitration agreement should specify that the arbitrator is not empowered to award punitive damages.

IV. TAKEAWAY

Businesses should be aware that punitive damages are available in New York law arbitrations under the FAA absent specific language to the contrary in the arbitration agreement. Accordingly, parties should address the issue of punitive damages before (i) drafting an arbitration agreement or (ii) deciding whether to agree to such an agreement drafted by a counterparty.

If you have any questions regarding punitive damages in arbitration, please contact Peter A. Bellacosa, Partner, at (212) 508-0474, pbellacosa@phillipslytle.com, or Joseph Schafer, Associate, at (716) 847-5403, jschafer@phillipslytle.com, or another Phillips Lytle attorney with whom you have a relationship. ■

[4] 40 N.Y.2d 354, 358 (1976).
[5] 514 U.S. 52, 59 (1995).
[6] *Id.* at 57 (1995) (*citing Volt Info. Scis., Inc. v. Bd. of Tr. of Leland Stanford Junior Univ.,* 489 U.S. 468, 479 (1989)).
[7] *Flintlock Constr. Servs., LLC v. Weiss,* 122 A.D.3d 51, 55 (1st Dep't 2014).

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