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# NOTES

## FAA Preemption by Choice-of-Law Provisions: Enforceable or Unenforceable?

*Puerto Rico Telephone Co., Inc. v. U.S. Phone Manufacturing Corp.*<sup>1</sup>

### I. INTRODUCTION

Generally, choice-of-law provisions allow corporations that do business in several states or countries to draft their agreements and conduct their business in accordance with the law they choose. When the choice-of-law provision is contained in a contract that does not have an agreement to arbitrate, courts generally have no qualms about enforcing them. However, when the contract does contain an agreement to arbitrate, courts are reluctant to enforce the choice-of-law provision as to the arbitration agreement because the Federal Arbitration Act (FAA) governs arbitration agreements. This issue has been the source of much confusion and litigation in the field of arbitration law. The issue is further confused when the underlying issue being litigated is the standard of review that the chosen state's laws would provide if it were applied to the agreement to arbitration. This complex problem provokes issues concerning how good the FAA standard of review is, how stringent courts should be in applying choice-of-law provisions to arbitration agreements, and how parties can preempt the FAA.

### II. FACTS AND HOLDING

In December 1988, U.S. Phone Manufacturing Corp (U.S. Phone) entered into a contract with Puerto Rico Telephone Company, Inc. (PRTC).<sup>2</sup> The contract provided that U.S. Phone would supply PRTC with residential memory telephones for five years.<sup>3</sup> The contract was drafted by PRTC and had a choice-of-law provision stating that the contract would be “governed by and interpreted in accordance with the laws of the Commonwealth of Puerto Rico.”<sup>4</sup> The contract also provided that “[i]f an attempt at settlement has failed, *the disputes shall be finally settled under the Rules of Conciliation and Arbitration of the American Arbitration Association*” and that the “*arbitral award shall be substantiated in writing and the findings shall be final and binding for both parties.*”<sup>5</sup>

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1. 427 F.3d 21 (1st Cir. 2005).

2. *Id.* at 23.

3. *Id.* U.S. Phone was awarded the bid jointly with two other companies and it was estimated that PRTC would require 25,000 residential memory telephones per year. *Id.*

4. *Id.*

5. *Id.*

Various disputes arose throughout the course of performance and PRTC eventually terminated the contract pursuant to the contract's termination clause.<sup>6</sup> Subsequently, U.S. Phone commenced arbitration against PRTC with the American Arbitration Association (AAA) on September 13, 1993.<sup>7</sup> As a result of the difficulty in selecting an arbitration panel, the panel did not convene until June 1997, and then spent over two years considering the matter.<sup>8</sup> Finally, on March 4, 2003, the panel unanimously awarded U.S. Phone \$2,552,123.99 in damages.<sup>9</sup>

PRTC then filed a motion to vacate the arbitration award in the United States District Court for the District of Puerto Rico on June 2, 2003.<sup>10</sup> PRTC argued that because the contract provided for judicial review of all errors of law in the arbitration award, the limited FAA standard of judicial review of awards should not apply.<sup>11</sup> PRTC's motion also alleged various problems with the arbitration in general, including "errors in the structure of the arbitration, the procedures of the arbitration, and the ultimate findings of the arbitration."<sup>12</sup> The district court held that the FAA review standards applied and denied PRTC's motion to vacate.<sup>13</sup> The district court found that PRTC's challenge to the award was not sufficient under the FAA to allow court review. Further, the district court held that PRTC's objections were "essentially disagreements with the arbitrators' conclusions."<sup>14</sup> The court granted U.S. Phone's motion to amend the judgment to reflect confirmation of the award, but denied U.S. Phone's request for attorneys' fees.<sup>15</sup>

PRTC brought the instant action in the First Circuit for the United States Court of Appeals to overturn the denial of its motion to vacate and the judgment confirming U.S. Phone's award.<sup>16</sup> U.S. Phone cross-appealed the denial of attorneys' fees.<sup>17</sup> Both parties agreed that the contract was governed by the FAA and that the FAA, by its terms, provides for very limited review of an arbitration award.<sup>18</sup> However, PRTC claimed the contract provided for more rigorous review of arbitration awards than that provided for by the FAA.<sup>19</sup>

6. *Id.* at 24. The effective date for the termination was January 2, 1993.

7. *Id.*

8. *Id.* The length of the arbitration hearing can be explained by the fact that the hearing included approximately 175 exhibits, 10 days of testimony, and approximately 1700 pages of documents in the record. *See id.*

9. *Id.* The arbitrators' decision did not contain a discussion of the arbitrators' reasoning. *Id.*

10. *Id.* The Federal Arbitration Act (FAA) allows a district court to vacate an arbitration award under very limited circumstances, including fraud or corruption, evidence of partiality, arbitrator misconduct, or an arbitrator's misuse of power. 9 U.S.C. § 10(a) (2004).

11. *U.S. Phone*, 427 F.3d at 24.

12. *Id.* U.S. Phone also brought an action in the Southern District of New York to confirm the award pursuant to the FAA and the two cases were ultimately consolidated. *Id.*

13. *Id.* "The district court concluded that under the FAA standard, judicial review of arbitral awards is only allowed in cases of corruption, serious error, misconduct, and miscalculation." *Id.* (citations omitted.).

14. *Id.*

15. *Id.*

16. *Id.* at 25.

17. *Id.*

18. *Id.*

Section 10 permits courts to vacate an award only: (1) Where the awards was procured by corruption, fraud, or undue mean. (2) Where there was evident partiality or corruption in the arbitrators, or either of them. (3) 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

The court discussed the background and purpose of the FAA and analyzed the effect of the choice-of-law clause regarding the appropriate standard of review.<sup>20</sup> The First Circuit ultimately found the choice-of-law clause was insufficient to override the FAA and there were no other provisions that would contradict the district court's finding that "PRTC's objections to the arbitration [were] essentially disagreements with the arbitrators' conclusions."<sup>21</sup> The First Circuit also affirmed the district court's decision denying U.S. Phone attorneys' fees because PRTC's filing of its motion could not properly be categorized as frivolous.<sup>22</sup> Affirming the district court's decision not to vacate the arbitration award, the First Circuit found that, when parties wish to displace the FAA standard of review, the displacement can only be achieved by clear contractual language making the intent of the parties "abundantly clear."<sup>23</sup>

### III. LEGAL BACKGROUND

Most arbitration issues arising under the FAA have been well-settled by the courts in the 81 years since the FAA was enacted.<sup>24</sup> However, one area within commercial arbitration law that remains unsettled is the enforcement of parties' express choice-of-law clauses by federal courts.<sup>25</sup>

When conducting international transactions, businesses often include a choice-of-law clause as part of their arbitration agreement.<sup>26</sup> This clause is of particular importance to both of the parties because it designates the law governing the parties' contractual agreement as a whole.<sup>27</sup> The problem with these clauses stems from the fact that federal courts, after historically ignoring such clauses and applying federal law, have recently "adopted an approach that upheld the autonomous decision of the parties to incorporate specific rules of arbitration procedure through the inclusion of an express choice-of-law clause within the terms of their agreement."<sup>28</sup>

In an attempt to resolve this dilemma, the United States Supreme Court in *Mastrobuono v. Shearson Lehman Hutton, Inc.*,<sup>29</sup> articulated an objective test that focuses on a determination of the "specific intent" of the parties at the time the agreement was entered into.<sup>30</sup> To satisfy this test the clause must state an un-

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prejudiced. (4) Where the arbitrators exceeded their powers, or so imperfectly executed them at a mutual, final and definite award upon the subject matter submitted was not made.

*Id.* (citing 9 U.S.C. § 10(a) (2000)).

19. *Id.* at 26.

20. *See id.* at 26-30.

21. *Id.* at 32.

22. *Id.* at 33. The court stated that attorneys' fees would only be awarded for either obstinate conduct or frivolous litigation. *Id.*

23. *Id.* *See also id.* at 29, n.5.

24. Jessica Thrope, *A Question of Intent: Choice of Law and the International Arbitration Agreement*, DISP. RESOL. J., Nov. 1999, at 16, 18.

25. *Id.*

26. *Id.* at 19.

27. *Id.* at 18.

28. *Id.*

29. 514 U.S. 52 (1995).

30. Thrope, *supra* note 24, at 18 (citing *Mastrobuono*, 514 U.S. at 59).

equivocal expression to incorporate the chosen law's procedural arbitration rules into the parties' arbitration agreement.<sup>31</sup>

An issue that often stems from the choice-of-law dilemma is determining the appropriate standard of review. Generally, the "standards of review for arbitral awards are defined in the Federal Arbitration Act (FAA) and are extremely narrow."<sup>32</sup> Problems arise when parties attempt to contract for more rigorous review of arbitration awards through choice-of-law clauses. Interpreting choice-of-law clauses and applying the appropriate standard of review in arbitration disputes has caused many problems and has led to "complex divisions even among individual circuits."<sup>33</sup> It is important to understand how courts have dealt with these issues and the trends they are following.

### A. Choice-of-Law Clauses and the Courts' Dilemma of Enforcement

One of the most oft-cited cases dealing with choice-of-law clauses in arbitration agreements is *Volt Information Sciences, Inc. v. Board of Trustees of the Leland Stanford Junior University*.<sup>34</sup> In *Volt*, the parties to the transaction agreed to arbitrate all disputes arising out of the contract and that "[t]he Contract shall be governed by the law of the place where the Project is located."<sup>35</sup> *Volt*, under the terms of the agreement, was supposed to install a series of electrical systems on Stanford's campus.<sup>36</sup> A dispute arose and *Volt* invoked arbitration.<sup>37</sup> Stanford countered by filing an action in state court and moved to stay arbitration pending resolution of related litigation pursuant to California Rules of Civil Procedure.<sup>38</sup> *Volt* argued that the stay was preempted by section 4 of the FAA.<sup>39</sup> The court ultimately concluded that even if the FAA preempted the state statute as applied to other parties, the choice-of-law clause in the contract demonstrated that the parties agreed to be governed by the statute.<sup>40</sup> The Court rejected *Volt's* argument that the choice-of-law clause was to be construed as incorporating only substantive law.<sup>41</sup> Essentially, the Supreme Court reasoned that because the FAA requires courts to enforce privately negotiated agreements to arbitrate, the choice-of-law clause made state rules governing the conduct of arbitration applicable.<sup>42</sup> This

31. *Id.* (citing *Mastrobuono*, 514 U.S. at 59).

32. Jonathan R. Bunch, Note, *Arbitration Clauses Should Be Enforced According to Their Terms—Except When They Shouldn't Be: The Ninth Circuit Limits Parties' Ability to Contract for Standards of Review of Arbitration Awards*, 2004 J. DISP. RESOL. 461, 461 (2005).

33. *Id.*

34. 489 U.S. 468 (1989).

35. *Id.* at 470. The project was located in California. *Id.*

36. *Id.*

37. *Id.*

38. *Id.* at 470-71.

39. *Id.* at 471 n.2. 9 U.S.C. § 4 states that:

[a] party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition any United States district court which, save for such agreement, would have jurisdiction under Title 28, in a civil action or in admiralty of the subject matter of a suit arising out of the controversy between the parties, for an order directing that such arbitration proceed in the manner provided for in such agreement.

9 U.S.C. § 4 (2000).

40. *Id.* at 478-79.

41. *Id.*

42. *Id.*

decision marked the “first U.S. case to favor application of an express clause to the procedural aspects of arbitration instead of federal substantive arbitration law under the FAA.”<sup>43</sup>

In a more recent case, *Mastrobuono v. Shearson Lehman Hutton, Inc.*,<sup>44</sup> the United States Supreme Court came to a slightly different conclusion regarding a choice-of-law clause. In *Mastrobuono*, the Court stressed that the choice-of-law clause and the arbitration clause in the contract should be read separately, not conjunctively.<sup>45</sup> The issue in this case was whether the choice-of-law clause trumped the arbitration clause; under New York law,<sup>46</sup> punitive damages were barred for this type of dispute, but the FAA allowed for recovery of punitive damages.<sup>47</sup> Therefore, if the two clauses had been read together, a huge ambiguity would have existed as to whether punitive damages were to be awarded. To avoid this ambiguity, the Court reiterated the established rule that when there is ambiguity as to the scope of arbitrable issues, they are to be resolved in favor of arbitration.<sup>48</sup> This case was the Court’s attempt to limit and define the scope of choice-of-law clauses after *Volt*.<sup>49</sup>

### B. Effect of *Mastrobuono*

The Supreme Court’s decision in *Mastrobuono* has had a significant impact on subsequently decided cases. Courts have been reluctant to enforce choice-of-law provisions in arbitration agreements unless the agreement contains an “un-ambiguous expression to incorporate the chosen law’s procedural arbitration rules.”<sup>50</sup>

In *Roadway Package System, Inc. v. Kayser*,<sup>51</sup> the Third Circuit stated that “the presence of a generic choice-of-law clause tells us little (if anything) about whether contracting parties intended to opt out of the FAA’s default standards and incorporate ones borrowed from state law.”<sup>52</sup> The court went on to hold that the “generic choice-of-law clause” is insufficient by itself to support a finding that the parties intended to opt out of the FAA’s default rules.<sup>53</sup>

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43. Thrope, *supra* note 24, at 78.

44. 514 U.S. 52 (1995).

45. *Id.* at 64. “[T]he choice-of-law provision covers the rights and duties of the parties, while the arbitration clause covers arbitration; neither sentence intrudes upon the other.” *Id.*

46. New York was the state listed in the choice-of-law clause. *Id.* at 52.

47. Thrope, *supra* note 24, at 82.

48. *Id.* The court also noted that as a basic premise to contract law, that ambiguous language within an agreement is interpreted against the drafting party. *Id.*

49. *Id.* at 81.

50. *Id.* at 18.

51. 257 F.3d 287 (3d Cir. 2001).

52. *Id.* at 288-89. Based on the court’s reasoning, the choice-of-law clause was generic because it did not explicitly state that it was to override the FAA default rules for arbitration.

53. *Id.* at 289. The court then listed the reasoning for its decision not to recognize the generic choice-of-law clause by stating that the rule will: “(1) ensure that parties who have never thought about the issue will not be found to have elected out of the FAA’s default regime; (2) be comparatively simple for arbitrators and district courts to apply and (3) preserve the ability of sophisticated parties to opt out.” *Id.*

In *PaineWebber Inc. v. Elahi*,<sup>54</sup> the First Circuit held that these generic choice-of-law clauses are not applicable because there is a strong federal policy requiring limited review.<sup>55</sup> The First Circuit stressed that this is particularly so when the state law at issue is “specifically and solely applicable to arbitration agreements.”<sup>56</sup>

*Volt* and *Mastrobuono* are both still good law, so the issue facing most courts dealing with an arbitration dispute involving a choice-of-law clause is whether the case is more like *Volt* or more like *Mastrobuono*. If the case is more like *Volt*, it is more likely the court will enforce the choice-of-law provision. Conversely, if the case is more like *Mastrobuono*, it is more likely the court will not enforce the choice-of-law provision.

### C. Standard of Review

In 1925 the FAA was enacted.<sup>57</sup> In 1947, it was reenacted and codified as Title 9 of the United States Code.<sup>58</sup> The FAA’s “purpose was to reverse the long-standing judicial hostility to arbitration agreements that had existed at English common law and had been adopted by American courts, and to place arbitration agreements upon the same footing as other contracts.”<sup>59</sup> Two policies underlying the FAA include: (1) “as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration;”<sup>60</sup> and (2) the “congressional desire to enforce agreements into which parties had entered.”<sup>61</sup>

These two policies may come into conflict when an arbitration agreement adopts a particular arbitration rule different from that of the FAA standard, even where federal law governs. The argument is that “the agreement should be enforced according to its terms, and that the specific rule chosen by the parties should prevail over the FAA standard.”<sup>62</sup>

Generally, standards of review for arbitral awards are extremely narrow as defined by the terms of the FAA.<sup>63</sup> However, with the rising popularity of parties submitting disputes to arbitration, “the issue of whether parties can contractually expand the standard of review has become extremely unclear, with complex divisions even among individual circuits.”<sup>64</sup> Part of this conflict stems from courts interpreting the holding in *Volt* to mean that because parties’ agreements should be enforced according to their terms, they should, therefore, be free to contract for non-statutory standards of review.<sup>65</sup>

The United States Supreme Court has yet to decide whether parties can contract for a standard of review greater than the FAA standards. Therefore, when

54. 87 F.3d 589 (1st Cir. 1996).

55. *Id.* at 593.

56. *Id.*

57. *P.R. Tel. Co. v. U.S. Phone Mfg. Corp.*, 427 F.3d 21, 26 (1st Cir. 2005).

58. *Id.*

59. *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 24 (1991).

60. *Moses H. Cone Mem. Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1983).

61. *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 220 (1985).

62. *P.R. Tel. Co.*, 427 F.3d at 27.

63. *Id.* at 25.

64. *Bunch*, *supra* note 32, at 461.

65. *Id.*

the issue arises, there is a split of authority as to whether expansion is or is not permissible. For instance, in *Fils et Cables D'Acier de Lens v. Midland Metals Corp.*,<sup>66</sup> the Southern District of New York reasoned that, as long as there are no jurisdictional or public policy barriers, parties should be allowed to alter the standards of review.<sup>67</sup> In contrast, the Seventh Circuit became one of the first federal circuits to prohibit contractual expansion of the standard for review of arbitral awards beyond the terms of the FAA in *Chicago Typographical Union No. 16 v. Chicago Sun-Times, Inc.*<sup>68</sup>

In *Chicago Typographical Union*, the parties had not actually agreed to expand the standard of review of the arbitral award, but rather the losing party sought to have the award vacated due to the arbitrator's error in interpreting the contract.<sup>69</sup> Although this case differs in that there was not a provision in the contract to expand the standard of review, Judge Posner explicitly stated in the opinion that contracting for judicial review of an arbitration award was impossible.<sup>70</sup> The court pointed out that agreements to arbitrate a labor or other contract are "a contractual commitment to abide by an arbitrator's interpretation."<sup>71</sup>

There are only a few cases in which courts have held that parties explicitly contracted for more searching judicial review of arbitral awards than that provided for in the FAA.<sup>72</sup> In *Gateway Technologies, Inc. v. MCI Telecommunications Corp.*,<sup>73</sup> the Fifth Circuit held that language stating that "[t]he arbitration decision shall be final and binding on both parties, except that errors of law shall be subject to appeal"<sup>74</sup> was enough to trump the FAA standard. The Fifth Circuit also found the language in *Harris v. Parker College of Chiropractic*<sup>75</sup> sufficient to trump the FAA standard when the contract stated that "each party shall retain his right to appeal any question of law."<sup>76</sup>

More recently, in *Kyocera Corp. v. Prudential-Bache Trade Services, Inc.*,<sup>77</sup> the Ninth Circuit declared that its previous decision in *Lapine Technology Corp. v. Kyocera Corp.*,<sup>78</sup> allowing parties to expand the standard of review was erroneous. The court held that "private parties may not contractually impose their own standard on the courts."<sup>79</sup> The court reasoned that "Congress had provided the standard of review for arbitral awards in the FAA, and that contractual provisions providing for judicial review on any other grounds than those set forth in the FAA were invalid."<sup>80</sup>

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66. 584 F. Supp. 240 (S.D.N.Y. 1984).

67. *Id.* at 244.

68. 935 F.2d 1501 (7th Cir. 1991).

69. *Id.* at 1505.

70. *Id.*

71. Bunch, *supra* note 32, at 467.

72. *P.R. Tel. Co.*, 427 F.3d at 31.

73. 64 F.3d 993 (5th Cir. 1995).

74. *Id.* at 996.

75. 286 F.3d 790 (5th Cir. 2002).

76. *Id.* at 793.

77. 341 F.3d 987 (9th Cir. 2003).

78. 130 F.3d 884, 888 (9th Cir. 1997).

79. *Kyocera*, 341 F.3d at 994.

80. Bunch, *supra* note 32, at 464.



## IV. INSTANT DECISION

In *Puerto Rico Telephone Company, Inc. v. U.S. Phone Manufacturing Corp.*,<sup>81</sup> the First Circuit Court of Appeals considered the enforceability of a choice-of-law provision, which, if applied, would require a more expansive standard of review than that provided for in the FAA.<sup>82</sup> After analyzing case law on the issue, the court ultimately held that the choice-of-law provision was insufficient to override the FAA.<sup>83</sup>

The court first discussed the appropriate standard of judicial review for arbitration disputes and stated that neither party disputed that the contract was governed by the FAA.<sup>84</sup> The court then considered the circumstances under which arbitration awards can be vacated under section 10 of the FAA.<sup>85</sup> The court finally relied on two First Circuit decisions<sup>86</sup> and held that section 10 “carefully limits judicial intervention to instances where the arbitration has been tainted in certain specific ways . . . [and] contains no express ground upon which an award can be overturned because it rests on garden-variety factual or legal [errors,]” and therefore, only where there is “manifest disregard for the law” can an award be vacated.<sup>87</sup> Because PRTC contended that the parties contracted for a more rigorous review of arbitration awards than that provided for by the FAA, the court had to determine the enforceability of the clause before deciding the standard of review issue.<sup>88</sup>

In considering the choice-of-law issue, the court examined the two leading U.S. Supreme Court decisions on the issue: *Volt* and *Mastrobuono*.<sup>89</sup> Summarizing *Mastrobuono*, the court stated that “a choice-of-law clause, standing alone, generally will not be interpreted to require the application of state law restricting ‘the authority of arbitrators.’”<sup>90</sup> In summarizing *Volt*, the court stated that “application of state law rules is appropriate only when there is no conflicting federal policy.”<sup>91</sup>

The First Circuit then concluded that this case is more parallel to *Mastrobuono* than to *Volt* because the policies of the FAA are implicated here.<sup>92</sup> The court quickly shot down PRTC’s argument that the choice-of-law provision requires application of “Puerto Rican law to determine whether the contract requires more searching judicial review . . . than that provided for in the FAA” because the “extremely limited judicial review contemplated by the FAA clearly implicates the federal policy favoring final resolution of disputes by arbitration.”<sup>93</sup> The court

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81. 427 F.3d 21 (1st Cir. 2005).

82. *Id.*

83. *Id.* at 33.

84. *Id.* at 25.

85. *Id.*

86. *Advest, Inc. v. McCarthy*, 914 F.2d 6 (1st Cir. 1990); *Wonderland Greyhound Park, Inc. v. Autotote Sys., Inc.*, 274 F.3d 34 (1st Cir. 2001).

87. *P. R. Tel. Co.*, 427 F.3d at 25 (quoting *Advest*, 914 F.2d at 8 and *Wonderland*, 274 F.3d at 35-36).

88. *P. R. Tel. Co.*, 427 F.3d at 26-27.

89. *See supra* Part III.A.

90. *P. R. Tel. Co.*, 427 F.3d at 28.

91. *Id.* at 28-29.

92. *Id.* at 29.

93. *Id.*

found the choice-of-law provision “insufficient to render applicable Puerto Rican law concerning the scope of judicial review.”<sup>94</sup> Before moving on, the court concluded that absent an “abundantly clear” intent by the parties to invoke state law providing for more searching judicial review, the FAA will not be precluded in the court’s interpretation of the agreement.<sup>95</sup>

The next issue for the court was the appropriate standard of review. PRTC argued that even if federal law was applied, more searching judicial review should be explicitly evidenced by the contract itself.<sup>96</sup> The court, citing *Kyocera*, stated that “private parties may not contractually impose their own standard on the courts.”<sup>97</sup> The court concluded that even if the language was sufficient under Puerto Rican Law, it was not nearly enough to satisfy the explicit language required by federal law to trump the FAA standard of review.<sup>98</sup>

The last issue the court faced was the cross-appeal by U.S. Phone for the award of attorneys’ fees.<sup>99</sup> U.S. Phone relied on the opinion of the district court stating that “[t]he mere filing of this motion controverts the purpose of the Federal Arbitration Act and is a waste of time and resources of this Court.”<sup>100</sup> The court determined that Puerto Rican law governs the question of fees and that U.S. Phone failed to prove that PRTC’s claim was either “(1) obstinate conduct or (2) frivolous litigation.”<sup>101</sup> The court concluded that the district court acted within its discretion in disallowing the award of attorneys’ fees to U.S. Phone.<sup>102</sup>

## V. COMMENT

When the courts discuss a “generic choice-of-law clause” they are speaking of a choice-of-law provision that is contained in a contractual agreement which also contains an agreement to arbitrate.<sup>103</sup> In a normal contract, this provision would accomplish all of the parties’ goals with respect to the laws governing their relationship.<sup>104</sup> However, when an agreement to arbitrate is also contained in a contract, the courts treat the arbitration agreement separate and distinct from all other provisions in the contract.<sup>105</sup> The reason the arbitration agreement gets this separate treatment is because Congress enacted the FAA to govern arbitration agreements.<sup>106</sup> This is a confusing rule that leads to costly litigation for many parties contracting for arbitration. Most parties probably intuitively believe that any provision (i.e., one specifying choice of law) applies to the whole contract and does not exclude other provisions (i.e., requiring arbitration). If courts gave more

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94. *Id.* at 30.

95. *Id.* at 29.

96. *Id.* at 30.

97. *Id.* See also *Kyocera Corp.*, 341 F.3d at 994.

98. *P.R. Tel. Co.*, 427 F.3d at 31. See *supra* Part III.C. (discussing cases where the court held that the language in the parties’ contract was explicit enough to trump the FAA standard).

99. *P. R. Tel. Co.*, 427 F.3d at 32.

100. *Id.* at 33.

101. *Id.*

102. *Id.*

103. See *P. R. Tel. Co.*, 427 F.3d at 27-30.

104. See *Fin. One Pub. Co. Ltd. v. Lehman Bros. Special Fin., Inc.*, 414 F.3d 325, 333-34 (2d Cir. 2005) (discussing the enforceability of choice-of-law provisions).

105. *Mastrobuono*, 514 U.S. at 63-64.

106. See *supra* Part III.C. (discussing Congress’s purpose for enacting the FAA).

of a comprehensive effect to choice-of-law provisions, it would help parties in the contracting process tremendously because they would not be so concerned about the exact wording of the choice-of-law provision. Parties would all be on the same footing and know that if the contract contains a choice-of-law provision, then it applies to the entire contract and every provision contained in the contract.

In deciding *Puerto Rico Telephone Co., Inc. v. U.S. Phone Manufacturing Corp.*,<sup>107</sup> the First Circuit was guided by logic and its conclusions were supported by current caselaw. However, the opinion illustrates the confusion many parties still have regarding choice-of-law provisions in arbitration agreements. Knowing what language in the provision will preempt the FAA seems to be the source of most of the confusion. Contemplating this issue begs the questions: Is the review provided for in the FAA sufficient?; Should courts be so stringent in the enforcement of these provisions in arbitration agreements?; What exactly must the agreement state in order for the choice-of-law provision to preempt the FAA?

### A. *Is the FAA standard of review sufficient?*

One matter worth considering is whether the FAA standard of review is sufficient.<sup>108</sup> The first criticism is often that the FAA standard of review is extremely narrow.<sup>109</sup> The fact that the standard of review is narrow does not appear to be that big of a problem in jurisdictions that allow contractual expansion,<sup>110</sup> but in jurisdictions that do not allow contractual expansion, it seems unfair that the parties must deal with a standard that is so narrow.

One argument in favor of the FAA standard of review is that parties contracting for arbitration are agreeing to settle their disputes outside of court; therefore, the standard for allowing them to bring a dispute in court should be narrow. Further, parties should know the standard of review of arbitral awards prior to agreeing to arbitration and should be held to that standard regardless of whether or not their jurisdiction allows contractual expansion of the standard.

However, the standard of review provided by the FAA has been described as the "narrowest known to the law."<sup>111</sup> Leaving losing parties in an arbitration proceeding with so few options is not just. There are many circumstances under which an arbitral proceeding could be flawed and not fall within the circumstances providing review under the FAA. The standard of review should be narrower for arbitration than regular litigation, but the current standard is too narrow. If the standard of review were the same as that provided in regular litigation, it would cut away at the efficiency of resolving disputes that arbitration provides. Therefore, the FAA standard of review should be somewhere in between the current FAA standard and that of regular litigation.

In *Puerto Rico Telephone Company*,<sup>112</sup> the First Circuit did not allow the expansion of the standard of review because they found the choice-of-law provision

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107. 427 F.3d 21 (1st Cir. 2005).

108. See *supra* note 18 (discussing FAA standard of review).

109. Bunch, *supra* note 32.

110. See *supra* notes 63-65 and accompanying text.

111. *Litvak Packing Co. v. United Food & Commercial Workers, Local Union No. 7*, 886 F.2d 275, 276 (10th Cir. 1989).

112. *P.R. Tel. Co.*, 427 F.3d at 21.

unenforceable as to the arbitration agreement.<sup>113</sup> Given the facts of the case, this seems to be consistent with other case law on the matter, but that does not make it just. While the First Circuit had no control over the standard of review provided by the FAA, they did have control over the choice-of-law provision, and could have given PRTC the Puerto Rican standard of review they contracted for.

### *B. Should Courts Be So Stringent in the Enforcement of Choice-of-Law Provisions in Arbitration Agreements?*

There is only so far a party can go in writing its arbitration agreement to explicitly preempt the FAA. Based on the current case law, the best advice appears to be to have the agreement state that the choice-of-law provision is intended to preempt the FAA's standard of review and that the arbitration agreement's standard of review will be the standard of review of the chosen state.

It is actually the FAA that gives parties the ability to contract around the FAA's standards in the first place.<sup>114</sup> Sections 2 and 4 of the FAA allow a party to an arbitration agreement to "petition any United States district court . . . for an order directing that such arbitration proceed in the manner provided for in such agreement."<sup>115</sup> This appears to give the agreement superiority over everything else, but for some reason choice-of-law clauses have been treated as separate from the arbitration agreement when the provisions are within the same contract.

One could conclude that by making it so difficult to preempt the FAA with a choice-of-law provision, courts are simply avoiding having to review arbitration awards. Initially, it seems undesirable for the courts to avoid reviewing awards. However, avoiding costly litigation is one of the main reasons parties agree to arbitrate, and making certain that review is rare helps to ensure that goal is reached. Also, by making the parties explicitly state that their intent to preempt the FAA erases any ambiguity that would normally exist when there is a choice-of-law provision and an agreement to arbitrate all within the same contract.

The concurrence by Third Circuit Judge Ambro in *Roadway Package System Inc.*, suggests that courts should not be so stringent in enforcing choice-of-law provisions in arbitration.<sup>116</sup> Judge Ambro looked at this issue from the other direction and reasoned that "absent express preemption by the FAA," the chosen state's laws shall govern the arbitration section.<sup>117</sup> This is basically the same argument courts generally make about why the choice-of-law provision should not preempt the FAA. While this is a candid argument, it is not without problems. One major problem with this argument is that requiring Congress to amend the FAA statutes is a lot of trouble. Currently, under the FAA, parties are required to be more educated as to arbitration and this provides for more efficient contracting. However, if courts followed Judge Ambro's reasoning it would also lead to more efficient contracting because all parties would know that a choice-of-law provision applies to all sections of the contract and the FAA would not need to be amended unless Congress disliked the results.

113. *Id.* at 31.

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

115. *Id.* at 474 (quoting 9 U.S.C. §§ 2, 4 (2000)).

116. *See Roadway Package Sys. Inc.*, 257 F.3d 289 (Ambro, J., concurring).

117. *Id.* at 308.

Courts should not be so stringent in the enforcement of choice-of-law provisions in arbitration, especially when it is remembered that the FAA was originally used as a default to fill in agreements. Why should it be so hard to preempt something that was merely intended as a default? As previously stated, the FAA gives parties the power to have their agreement enforced according to its terms, and if one of those terms involves a choice-of-law provision, then that should apply to the whole contract, including the agreement to arbitrate. In *Volt*, the Court stated that "[t]here 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."<sup>118</sup> While Judge Ambro's reasoning may be a little extreme in requiring the FAA to preempt the choice-of-law provision, it would be more logical and result in more efficient contracting if courts followed this reasoning.

### C. What language is required to preempt the FAA?

In *Roadway Package System, Inc. v. Kayser*,<sup>119</sup> the Third Circuit was very clear that a "generic choice-of-law clause" is insufficient by itself to support a finding that the parties intended to opt out of the FAA's default rules.<sup>120</sup> *Mastrobuono* articulated that a choice-of-law clause, in a contract that also provides for arbitration, will be read in isolation, thereby keeping the FAA default rules for the arbitration and applying the choice-of-law clause to the rights and duties of the parties.<sup>121</sup>

While these cases go far in explaining what language *does not* work to preempt the FAA with a choice-of-law provision, they do little in explaining what language *will* work for parties attempting to preempt the FAA. The Fifth Circuit has allowed parties to preempt the FAA's standard of review with explicit language reserving the parties' right to appeal the arbitration decision.<sup>122</sup> However, neither of these Fifth Circuit cases attempted to expand the standard of review by using a choice-of-law provision; there does not appear to be a reason why using a choice-of-law provision to expand the standard of review would have any significance on how explicit the language must be. Another consideration to keep in mind when analyzing these cases is that they were both decided by the Fifth Circuit and there really is no way of knowing whether other jurisdictions would give the same effect to the language in those agreements that the Fifth Circuit did. The only rule that seems to hold true, in all jurisdictions, is that the language intended to preempt the FAA must be explicit.

In *Puerto Rico Telephone Company, Inc.*, the First Circuit concluded that the case was more similar to *Mastrobuono* than to *Volt* and, therefore, read the choice-of-law provision and the arbitration provision separately.<sup>123</sup> In doing so, the FAA default standard of review was applied to the agreement. This does not

118. *Volt*, 489 U.S. at 469.

119. *Roadway Package Sys., Inc.*, 257 F.3d at 287.

120. *Id.* at 288-89.

121. *Mastrobuono*, 514 U.S. at 64.

122. See *supra* Part III.C. (discussing cases in which the Fifth Circuit allowed the parties to preempt the FAA).

123. *P.R. Tel. Co.*, 427 F.3d at 29.

seem like a very just decision. The parties' contract stated that it "shall be governed by and interpreted in accordance with the laws of the Commonwealth of Puerto Rico."<sup>124</sup> Nowhere does the contract state that the FAA rules shall apply to the arbitration agreement within the contract. The choice-of-law provision states that the "contract" shall be governed by Puerto Rican law, and that should mean the whole contract and everything contained in it. This may be contrary to most of the case law on this issue, but it is a more logical conclusion.

Another phrase courts use to explain the language required to preempt the FAA is, "abundantly clear." The Eighth Circuit stated in *UHC Management Co. v. Computer Sciences Corp.*,<sup>125</sup> that they "[would] not interpret an arbitration agreement as precluding the application of the FAA unless the parties' intent that the agreement be so construed is abundantly clear."<sup>126</sup> Whether this means that language used in *Gateway Technologies* and *Harris* is "abundantly clear" is unknown.<sup>127</sup> However, it seems unreasonable for a court to require more than an express reservation of a party's right to appeal. An express statement that the laws of the chosen state are to preempt the FAA should be more than sufficient.

It appears that the problems illustrated by *Puerto Rico Telephone Co., Inc.* can be alleviated either by Congress amending the FAA to provide for a broader standard of review of arbitral decisions, or by courts applying choice-of-law provisions to contracts as a whole, including the agreement to arbitration. The latter appears to be the easiest alternative because any amendment to the FAA would likely provoke more litigation until the meaning of the amended version was settled.

## VI. CONCLUSION

Although it appears that courts, including the First Circuit, will allow parties to preempt the FAA with a choice-of-law provision, the parties must be very explicit in stating that they intend to preempt the FAA. This explicit language requirement has caused a lot of litigation and probably will continue until the high court finally settles the matter and defines the explicit language required to preempt the FAA, or acknowledges that it will not preempt the FAA when it comes to expanding standard of review. Until then, courts will have somewhat broad discretion in determining what language is explicit enough to preempt the FAA. With the FAA standard of review being so narrow, it is unacceptable for courts to be so stringent in applying choice-of-law provisions to arbitration agreements that are both within the same contract. If every court would consistently apply the choice-of-law provision to the agreement to arbitration, it would result in less confusion and more efficient resolution in arbitration.

ROSS BALL

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124. *Id.* at 23.

125. 148 F.3d 992 (8th Cir. 1998).

126. *Id.* at 997.

127. *See supra* Part III.C. (discussing these cases).

