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**AN ARBITRATION PANEL'S AUTHORITY TO AWARD ATTORNEY'S FEES,  
INTEREST AND PUNITIVE DAMAGES**

Richard C. Mason and Catherine E. Hamilton

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## **An Arbitration Panel's Authority to Award Attorney's Fees, Interest and Punitive Damages**

By: Richard C. Mason  
and Catherine E. Hamilton<sup>1</sup>

Courts strongly encourage the resolution of disputes by arbitration. Arbitration is a cost-effective, more efficient, and quicker alternative to traditional litigation. To advance these ends, judicial review of arbitration awards is severely limited. As one court noted, if "it were otherwise, the ostensible purpose for resort to arbitration, *i.e.*, avoidance of litigation, would be frustrated."<sup>2</sup>

Despite these goals, challenges to arbitration awards are not uncommon. In particular, arbitration awards that shift attorney's fees to the prevailing party or award interest and punitive damages are often challenged in court via a motion to vacate or modify the award. The various ways courts resolve these disputes (in the face of their concomitant goal of fostering the process that rendered it) are discussed below.

### **I. FEE SHIFTING IN ARBITRATION**

Pursuant to the "American Rule," attorney's fees incurred in connection with prosecution of litigation in U.S. courts are not recoverable absent statutory authority or contractual agreement.<sup>3</sup> Although the "American Rule" is "deeply rooted in our history and in congressional policy,"<sup>4</sup> it does not control in the arbitration context. Rather, arbitration panels often award attorney's fees and such awards are usually upheld in the

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<sup>2</sup> *Synergy Gas Co. v. Sasso*, 853 F.2d 59, 63 (2d Cir. 1988).

<sup>3</sup> *Alyeska Pipeline Service Co. v. Wilderness Society, et al.*, 421 U.S. 240, 247 (1975); *see also* *Buckhannon Bd. and Care Home, Inc. v. W. Virginia Dep't of Health and Human Res.*, 532 U.S. 598, 602 (2001).

<sup>4</sup> *Alyeska Pipeline Service Co.*, 421 U.S. at 247.

face of challenges based – most often – on whether these awards fall within the proper scope of the panel's authority. Attorney's fees are most frequently awarded when the losing party's claims or defenses are regarded by the arbitration panel as frivolous, or where the losing party's conduct, either prior to or during the arbitration, has been fraudulent or otherwise in bad faith.<sup>5</sup>

A party's liability for attorney's fees, in connection with an arbitration, also can flow from precisely the same sources as in litigation; namely: (i) statutory authority, or (ii) contractual agreement. Statutory authority, which is neither granted nor precluded by the Federal Arbitration Act, 9 U.S.C. § 7, may spring – just as in litigation – from the substantive law governing the arbitration, when a statute authorizes a fee award. Contractual authority may exist when the arbitration clause expressly authorizes the award, or when it incorporates organizational rules so permitting. In other cases parties may consent to mutual liability for attorney's fees. These sources of authority are discussed below.

**A. Equitable Authority to Award Attorney's Fees Where Bad Faith is Involved**

The law governing the power of arbitrators to award attorney's fees is not entirely settled,<sup>6</sup> primarily because of the substantial discretionary powers held by arbitrators. Generally, while an arbitrator may not “transcend[] the limits of the contract of which the agreement to arbitrate is but a part,”<sup>7</sup> if there is “room for doubt or interpretation on the question, then the issue properly lies within the broad authority conferred upon arbitrators of civil disputes.”<sup>8</sup>

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<sup>5</sup> An empirical study of the number of matters in which arbitrators award attorney's fees is precluded by the confidential nature of traditional arbitration.

<sup>6</sup> See *Ludgate Ins. Co. Ltd. v. Banco De Seguros Del Estado*, No. 3653, 2003 WL 443584, \*6 (S.D.N.Y. Jan. 6, 2003).

<sup>7</sup> *City of Lawrence v. Falzarano*, 402 N.E.2d 1017, 1024 (Mass. 1980).

<sup>8</sup> *Grobet File Co. of Am., Inc. v. RTC Systems, Inc.*, 524 N.E.2d 404, 406 (Mass. App. Ct. 1988).

The Second Circuit Court of Appeals has recognized that an arbitrator has, *in general*, the inherent authority to award attorney's fees.<sup>9</sup> An arbitrator is not strictly bound by the law, and may invoke equitable remedies, which include awards of attorney's fees, as well as sanctions.<sup>10</sup> In addition, many arbitration clauses relieve arbitrators from adhering to "strict rules of law," which has been held to afford latitude to award fees.

To be clear, in the U.S., arbitrators do not presumptively apply the "English Rule" which would require the loser to automatically pay the prevailing party's fees. Rather, arbitration panels customarily impose liability for legal fees only when there is a particular reason, such as bad faith or improper conduct, warranting shifting of fees.

Yet while arbitrators may have the power in many cases to award fees, enforceability of the award contemplates a rational basis for imposing such liability. As one court explained, "an arbitrator may, under limited circumstances, award attorney's fees through his equity powers where bad faith or malicious behavior is involved."<sup>11</sup>

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<sup>9</sup> See *Synergy Gas Co. v. Sasso*, 853 F.2d 59, 64; (2d Cir. 1988); *First Interregional Equity Corp. v. Haughton*, 842 F. Supp. 105, 112-3 (S.D.N.Y. 1994).

<sup>10</sup> *In re Northwestern Nat'l Ins. Co.*, 2000 WL 702996, \*1 (S.D.N.Y. May 30, 2000) (noting that arbitrators "have a general power to award attorneys fees absent a specific prohibition.").

<sup>11</sup> *Langemeier v. Kuehl*, 40 P.3d 343, 346 (Mont. 2001); cf. *Milwaukee Teacher's Educ. Ass'n v. Milwaukee Board of Sch. Directors*, 433 N.W.2d 669, 671-72 (Wis. Ct. App. 1988), which strongly condemned decisions upholding arbitrator's fee awards based on bad faith findings, citing the limitation on courts' abilities to review such awards:

To permit an arbitrator's essentially unreviewable finding that one party has acted in "bad faith" to support an award of attorney's fees when the parties have not agreed to that potential remedy would give the arbitrator powers beyond those delegated to him. In essence, it would permit the arbitrator to unlawfully "dispense his own brand of industrial justice [citation omitted] and would be far beyond "the arbitration that [the parties] contracted for."

*Id.* at 801 (citing *United Steelworkers*, 363 U.S. at 597); cf. *Int'l Thunderbird Gaming Corp. v. United Mexican States*, 255 Fed. Appx. 531, 532 (D.C. Cir. 2007) ("the arbitrators had 'wide discretion to award costs and fees.'").

Bad faith conduct comes in many forms. It may consist of improper behavior, such as unwarranted obfuscation or delay, prior to arbitration.<sup>12</sup> It also may include improper conduct during the arbitration process, which results in the unwarranted delay of the arbitration proceeding.<sup>13</sup> Or bad faith may be found where one party's claims or defenses are shown to be entirely baseless.<sup>14</sup>

Note, however, that an arbitrator's equitable authority to award attorney's fees may be restricted or precluded by the parties' contract. The arbitrators' authority to decide the parties' rights springs from the parties' agreement.<sup>15</sup> In an important, recent case, *Reliastar Life Ins. Co. of New York v. EMC Nat'l Life Ins. Co.*, the contracts contained very broad agreements to arbitrate, but expressly provided that "[e]ach party shall bear the expense of its own arbitrator ... and related outside attorneys' fees."<sup>16</sup> The Second Circuit Court of Appeals observed that "we consider only whether, in light of the parties' agreement to arbitrate, the arbitrators were authorized to sanction bad faith conduct by awarding attorney's and arbitrator's fees."<sup>17</sup>

The court observed that the contract contained a "broad" arbitration clause. It provided.

10.1 *Appointment of Arbitrators.* In the event of any disputes or differences arising hereafter between the parties with reference to any transaction under or relating in any way to this Agreement as to which agreement between the parties hereto cannot be reached, the same shall be decided by

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<sup>12</sup> See *Town of Fond du Lac v. City of Fond du Lac*, 463 N.W.2d 880 (Wis. Ct. App. 1990) (attorney's fees award stemmed "from the city's conduct prior to the arbitration process, when the city engaged in bad faith and dilatory tactics which resulted in increased costs to the town.").

<sup>13</sup> *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056, 1064-5 (9<sup>th</sup> Cir. 1991).

<sup>14</sup> *Marshall & Co., Inc. v. Duke*, 114 F.3d 188, 190 (11<sup>th</sup> Cir. 1997); *Ludgate*, 2003 WL 443584, \*1 (Reinsurer offered "no defense worthy of mention" for its failure to pay).

<sup>15</sup> *Painewebber Incorporated v. Bybyk*, 81 F.3d 1193, 1202 (2d Cir. 1996).

<sup>16</sup> *Reliastar Life Ins. Co. of New York v. EMC Nat'l Life Ins. Co.*, No. 07-0828, \_\_\_ F.3d \_\_\_, 2009 WL 941173 (April 19, 2009 2d Cir. 2009) (emphasis supplied).

<sup>17</sup> *Id.* at \*3

arbitration. Three arbitrators shall decide any dispute or difference....

The court held that a broad arbitration clause, such as this, “confers inherent authority on arbitrators to sanction a party that participates in arbitration in bad faith ...”<sup>18</sup> While this discretion may not exceed the power authorized in the contract, a general provision that “each party will bear his own attorney’s fees” does not preclude fee shifting in bad faith cases. Such a provision merely confirms that the American Rule applies in the ordinary case of good faith arbitration conduct.<sup>19</sup>

### **B. Express Contractual Authority**

The clearest case for an authorized award of attorney’s fees exists where the contract expressly allows for them. Where the arbitration clause expressly provides for an award of attorney’s fees and costs, an award including such amounts almost certainly will be upheld by a confirming court.<sup>20</sup>

The wording of the arbitration clause must be carefully analyzed. Some arbitration clauses contain arguably ambiguous language to the effect that: “The expense of the arbitrators and of the arbitration shall be equally divided between the parties.” This could be deemed to signify either (1) attorney’s fees may not be awarded, as they are an “expense” of the arbitration, or (2) attorney’s fees may be awarded, if they are regarded as a service fee rather than an “expense” of arbitration analogous to copying or hearing facility costs (which are undoubtedly considered arbitration “expenses.”)<sup>21</sup> A clause that expressly refers only to “expenses” or “costs” may be

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<sup>18</sup> *Id.* at \*4.

<sup>19</sup> *Id.* at \*5.

<sup>20</sup> *Hope & Associates, Inc. v. Marvin M. Black Co.*, 422 S.E.2d 918 (Ga. Ct. App. 1992) (affirming attorney’s fees award where the contract between the parties provided for the recovery of attorney’s fees by the prevailing party in arbitration proceedings).

<sup>21</sup> *See gen.* *Ludgate*, 2003 WL 443584 at \*6 (stating “It is obvious that the shared ‘expenses’ of arbitration, in addition to the costs of the umpire, refers to items such as the cost of the hearing room, transcription, and other like expenses.”).

susceptible to a narrow interpretation given the existence of more specific clauses that expressly exclude shifting of attorney's "fees."<sup>22</sup> There is a reasonable argument that a clause referring only to division of "costs" permits a fee award, given that it could arguably be self-defeating to mandate sharing of hotel expenses and similar moderate costs while precluding the much greater "cost" of attorney's fees from shifting.

Not infrequently, the contract authorizes an award of fees to the "prevailing party," which may spark a dispute as to which party has "prevailed." In arbitration, where compromise awards are not uncommon, the question of which party has "prevailed" can be a knotty one. A panel may conclude that the Petitioner's claims are not conclusively supported, yet award thirty percent of the damages requested.

Courts generally will not scrutinize an arbitrator's conclusion that one party has "prevailed."<sup>23</sup> For example, in *Softkey, Inc. v. Useful Software, Inc.*,<sup>24</sup> the respondent claimed that the petitioner had not prevailed, because it had recovered less than ten percent of its total claim. The court ruled, however, that determining which party prevailed, "and to what degree," was within the arbitrator's authority.<sup>25</sup> On this basis, the court rejected the respondent's argument that the award was wrong because it had prevailed and should have recovered 100% of *its* fees. Furthermore, the arbitrator was authorized to consider (as it in fact did) the respondent's questionable "conduct" during the arbitration.<sup>26</sup>

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<sup>22</sup> *E.g.*, *Reliastar*, 2009 WL 941173, \*1, \_\_\_ F.3d \_\_; *Palmer v. Prevost Car, Inc.*, No. 3:05-1040, 2006 WL 2035710, \*1 (M.D. Tenn. July 17, 2006) (arbitration agreement provided: "The cost of such arbitration proceedings shall be borne equally by the parties, each of whom shall bear his own attorney's fees, except as hereinafter provided.").

<sup>23</sup> *Phillips Bldg. Co. v. An*, 915 P.2d 1146 (Wash. Ct. App. 1996); *Creative Plastering, Inc. v. Hedley Builders, Inc.*, 24 Cal.Rptr.2d 216 (Cal. Ct. App. 1993).

<sup>24</sup> 756 N.E.2d 631 (Mass. App. Ct. 2001).

<sup>25</sup> *Id.* at 634.

<sup>26</sup> *Id.*



The *Softkey* court observed that an allocation of fees and costs “in ‘proportion to their respective amounts of liability’ could reflect the degree to which the parties participated in the arbitration process.”<sup>27</sup> In *Softkey*, the arbitrator concluded the respondent should reimburse the petitioner one-half its fees on account of respondent’s “stonewalling” in the arbitration.<sup>28</sup> Accordingly, a party’s withholding of evidence may not only harm its prospects for prevailing on its substantive claims or defenses given the loss of credibility that will ensue; it may also expose itself to liability for fees.

The contractual authority to award fees to the prevailing party or the winning party need not necessarily be set forth in the arbitration clause itself. It has been held that, so long as the primary issue decided was within the scope of the arbitration agreement, “it follows the arbiters also had authority to award costs and fees for obtaining the arbitral decision.”<sup>29</sup> Similarly, a fee award was held contractually authorized where the arbitration clause had no provision so providing, but the contract separately provided that the homeowner could be required to pay to the contractor attorney’s fees. The court concluded that the arbitration clause incorporated the contract of which it was a part.<sup>30</sup>

### **C. Authority based on Parties’ Post-Contractual Consent**

Authorization for arbitrators to award fees may arise without the parties being quite conscious of it. Here, we are speaking of the quite common assertion of mutual claims by the opposing parties seeking an award of attorney’s fees against the other. Such submissions – whether or not the parties realize it – may give rise to an operative

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<sup>27</sup> *Id.*

<sup>28</sup> *Id.* at 633.

<sup>29</sup> *Management & Technical Consultants S.A. v. Parsons-Jurden Intern. Corp.*, 820 F.2d 1531, 1535 (9<sup>th</sup> Cir. 1987) (citing *Parsons & Whittemore Overseas Co. v. Societe Generale de L’Industrie Du Papier (RAKATA)*, 508 F.2d 969, 977 (2d Cir. 1974)).

<sup>30</sup> *Marsh v. Loffler Housing Corp.*, 648 A.2d 1081 (Md. Ct. Spec. App. 1994).

*consent* by the parties to attorney fee awards. Thus, a party to an arbitration “can acquiesce to the award of attorney’s fees by either making its own demand for attorney’s fees or by failing to object to the other party’s demand for such fees.”<sup>31</sup> Such consent can provide an arbitration panel with the authority to award fees even where the contract would not have so authorized the panel.

This is based on the broader principle that in arbitration the parties may, by consent, expand the arbitrators’ decisional scope. As one court has held: “Even assuming the questions [regarding award of interest] went beyond the arbitration provisions of the contract, ‘once the parties have gone beyond their promise to arbitrate and have supplemented the agreement by defining the issue to be submitted to an arbitrator, courts must look both to the contract *and to the submission* to determine his authority.”<sup>32</sup>

Accordingly, even a pro forma claim by a party for attorney’s fees can be regarded by the tribunal as a waiver of any contractual prohibition on such an award. Alternatively, a party’s fee demand may be viewed as a freely given and superseding agreement by a party that a prior contractual limitation on such fees should not apply. Therefore, a party that wishes to rely on a contractual prohibition *against* an award of fees may need to eschew asserting a claim *seeking* such fees against its opponent.

#### **D. Where authorized by statute**

The substantive law that governs the parties’ dispute may provide for attorney’s fees for the prevailing party and represents, therefore, a potential source of authority for

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<sup>31</sup> *McDaniel v. Bear Stearns & Co.*, 196 F. Supp.2d 343, 364-65; *see gen. Ludgate Ins. Co., Ltd. v. Banco de seguros del Estate*, 2003 WL 443584, \*6 (S.D.N.Y 2003).

<sup>32</sup> *Sun Ship, Inc. v. Matson Navigation Co.*, 785 F.2d 59, 62 (3d Cir. 1986) (emphasis supplied) (citing *Washington-Baltimore Newspaper Guild, Local 35 v. The Washington Post Co.*, 442 F.2d 1234, 1236 (D.C. Cir. 1971)).

fee awards in arbitrations. In such instances, the arbitrator likely will be regarded as authorized to award fees even if the contract is silent on the issue.<sup>33</sup>

The party ordered to pay the award, however, may contend that the arbitration panel exceeded the scope of its authority, as granted by the parties' contract. In *Taylor v. Van-Catlin Constr.*,<sup>34</sup> the arbitration panel awarded the homeowners damages for the amounts they had to expend to correct their contractor's substandard work, and further awarded \$74,000 in attorney's fees. With respect to the attorney's fees award, the arbitration panel reasoned that although the governing contract between the parties omitted any attorney's fee provision, "Respondents are statutorily entitled to such a recovery as the 'prevailing party' pursuant to [California] Code of Civil Procedure section 1033.5[a]9][c], and by operation of the [American Arbitration] Association's Rule 46[d], permitting such an award where, as here, all parties have requested the same through their respective claims, counterclaims, and answering statements filed in this arbitration."<sup>35</sup>

On appeal, the contractor argued that the "arbitrator exceeded his powers because attorney fees were not authorized under the AAA rules, the contract, or Civil Code section 3260."<sup>36</sup> The Court disagreed, holding that the attorney's fees award was proper pursuant to the civil procedure section code which permitted the award of attorney's fees as costs when authorized by law, and the California Civil Code which

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<sup>33</sup> See *Porzig v. Dresdner, Kleinwort, Benson, N. Am., LLC*, 497 F.3d 133 (2d Cir. 2007) (noting that the arbitration panel's refusal to award attorney's fees was contrary to the statutory requirement of the Age Discrimination in Employment Act that required such an award); *Truserv Corp. v. Ernst & Young LLP*, 876 N.E.2d 77 (Ill. App. Ct. 2007) (affirming arbitration panel's attorney's fees award under section 10a(c) of the Illinois Consumer Fraud and Deceptive Business Practice Act, which provided for such awards).

<sup>34</sup> 130 Cal. App. 4<sup>th</sup> 1061 (Cal. Dist. Ct. App. 2005).

<sup>35</sup> *Id.* at 1064.

<sup>36</sup> *Id.* at 1067.

provided for an attorney's fee award to the prevailing party in an action for the collection of funds wrongfully withheld.<sup>37</sup>

In another case, the substantive law governing the parties' claims, which provided for an attorney's fee award, was held to trump the state's general arbitration statute, which prohibited an attorney's fee award in the absence of an express agreement.<sup>38</sup> The court reasoned that the Massachusetts Unfair Business Practices Act was a statute "that overrides the general unavailability of attorney's fees under [the arbitration statute] both in its language and its purpose."<sup>39</sup> It explained that the Act's provision for attorney's fees reflected the Legislature's "manifest purpose of deterring misconduct by affording private and public plaintiffs who succeed in proving violations of [the Act] reimbursement for their legal services and costs."<sup>40</sup>

Conversely, an arbitrator could be regarded as having ruled in "manifest disregard" of law if the governing substantive law precludes fee awards.<sup>41</sup> Furthermore, where the contract calls for application of state law, attorney's fees likely cannot be awarded if, as is common, the state's law follows the "American Rule."<sup>42</sup> Thus, for example, where Wisconsin law permitted an award of attorney's fees only where authorized by contract or statute, the arbitrator was held to have exceeded his authority in awarding fees (where the contract was silent).<sup>43</sup> Under New York state arbitration

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<sup>37</sup> *Id.* at 1068.

<sup>38</sup> *Drywall Systems, Inc. v. ZVI Constr. Co., Inc.*, 761 N.E.2d 482 (Mass. 2002).

<sup>39</sup> *Id.* at 488.

<sup>40</sup> *Id.* at 489.

<sup>41</sup> *Asturiana De Zinc Marketing, Inc. v. LaSalle Rolling Mills, Inc.*, 20 F. Supp. 2d 670, 675 (S.D.N.Y. 1998). See §V, *infra*, regarding uncertainty as to the continued viability of the "manifest disregard standard."

<sup>42</sup> *Drywall Systems, Inc. v. ZVI Constr. Co., Inc.*, 761 N.E.2d 482 n. 6 (Mass. 2002).

<sup>43</sup> *Milwaukee Teacher's Educ. Ass'n v. Milwaukee Board of Sch. Directors*, 433 N.W.2d 669, 671-72 (Wis. Ct. App. 1988).

law, attorney's fees are precluded unless expressly provided for in the arbitration agreement.<sup>44</sup>

Note that the rules and procedures of the governing arbitration organization may speak to the issue of attorney's fee awards. Some preserve the arbitration panel's authority to award attorney's fees where the governing statute provides for such awards. Thus, Standard No. 1 of the Minimum Standards of JAMS LLC, a prominent mediation organization, provides: "All remedies that would be available under the applicable law in a court proceeding, including attorneys fees and exemplary damages, must remain available in the arbitration." Furthermore, an arbitration panel's authority may also be circumscribed by state statute. For instance, the TEX. CIV. PRAC. & REM. CODE § 171.048 provides: "The arbitrators shall award attorney's fees as additional sums required to be paid under the award only if the fees are provided for: (1) in the agreement to arbitrate; or (2) by law for a recovery in a civil action in the district court on a cause of action on which any part of the award is based."<sup>45</sup>

## II. INTEREST ON THE AWARD

Unless the contract provides otherwise, arbitrators are authorized to impose pre-award and post-award interest. Post-award interest, one court has observed, "encourages swift obedience by the parties to the award."<sup>46</sup> Coincident to this function is the power to determine an appropriate rate of interest.<sup>47</sup>

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<sup>44</sup> *Id.* (citing CPLR §7513). In *CBA Indus., Inc. v. Circulation Mgmt., Inc.*, N.Y.S.2d 234, 235 (N.Y. App. Div. 1992), for example, the trial court was held to have properly eliminated an award of counsel fees and costs from an arbitration award where the arbitration clause provided that each party would bear its own costs and legal expenses

<sup>45</sup> TEX. CIV. PRAC. & REM. CODE § 171.048(c)(2).

<sup>46</sup> *Watertown Firefighters, Local 1347 v. Town of Watertown*, 383 N.E.2d 494, 500 (Mass. 1978).

<sup>47</sup> *See TTMI Constr., Inc. v. Powell Bonney Lake, LLC*, 143 Wash. App. 1041 (Wash. Ct. App. 2008) (referencing AAA Construction Industry Arbitration Rule 44(d), which provides that the "award of the arbitrator may include interest at such rate and from such date as the arbitrator may deem appropriate.").

Arbitrators do not, however, have the authority to determine whether interest should be awarded post-confirmation of the award by judgment of a district court.<sup>48</sup> The confirmation of an award by a court, and the court's entry of an order requiring payment by the losing party, are judicial exercises.<sup>49</sup> Accordingly, the arbitrators have no role, and no authority, to dictate whether or at what rate interest should run following judicial confirmation.

### III. PUNITIVE DAMAGES

Potential liability for punitive damages is frequently a concern of parties to arbitration. Whereas many states' laws bar awards of punitive damages in pure contract actions, arbitrators may not be strictly circumscribed, given that (i) which state's substantive law (if any) is controlling is often murky, and (ii) arbitrators usually have broad discretion to fashion equitable relief. Thus, while punitive damages remain the exception in arbitration, the risk is often difficult to quantify and this uncertainty may cause parties to regard their risk in arbitration as greater relative to litigation.

State law permitting, arbitrators may award punitive damages unless prohibited by contract.<sup>50</sup> The mere circumstance that an arbitration clause is broadly worded, and nothing more, has been held sufficient to permit an award of exemplary damages.<sup>51</sup> The contract need not mention punitive damages for them to be awardable.<sup>52</sup>

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<sup>48</sup> *Sun Ship, Inc. v. Matson Navigation Co.*, 785 F.2d 59, 63 (3d Cir. 1986).

<sup>49</sup> *Id.*

<sup>50</sup> *See Inv. Partners, Inc. v. Glamour Shots Licensing, Inc.*, 298 F.3d 314 (5<sup>th</sup> Cir. 2002); *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378 (11<sup>th</sup> Cir. 1988).

<sup>51</sup> *Pyle v. Securities U.S.A., Inc.*, 758 F. Supp. 638 (D. Colo. 1991). *See also* *Porush v. Lemire*, 6 F. Supp. 2d 178, 185 (E.D.N.Y. 1998) (explaining "unless the arbitration agreement provides an unequivocal exclusion of punitive damages claims from the scope of arbitration, it will be read to empower arbitrators to award punitive damages.").

<sup>52</sup> *Mastrobuono v. Shearson Lehman Hutton*, 514 U.S. 52, 57 (1995).

It also has been held that an arbitration panel may award punitive damages if the governing procedural rules so authorize.<sup>53</sup> The most noteworthy rules that so provide are found in the FINRA (formerly, NASD) Manual, which provides that: “Arbitrators may consider punitive damages as a remedy.”<sup>54</sup>

On the other hand, when the contract contains a choice of law clause providing for application of the law of a state prohibiting exemplary damages in contract actions, then the arbitrators are barred from awarding punitive damages. The Court in *Garrity v. Lyle Stuart, Inc.*,<sup>55</sup> held that, under New York law, “[p]unitive damages is a sanction reserved to the State, a public policy of such magnitude as to call for judicial intrusion to prevent its contravention.”<sup>56</sup> Accordingly, in New York, “[s]ince enforcement of an award of punitive damages as a purely private remedy would violate strong public policy, an arbitrator’s award which imposes punitive damages should be vacated.”<sup>57</sup>

The most notable decision upholding punitive damages in arbitration is the U.S. Supreme Court’s decision in *Mastrobuono v. Shearson Lehman Hutton, Inc.*<sup>58</sup> *Mastrobuono* recognized that just as parties may consent to various procedures governing their arbitration, they also may consent to rules allowing for punitive damages.<sup>59</sup>

In *Mastrobuono*, the arbitration clause authorized arbitration in accordance with NASD rules, which allow arbitrators to award “damages and other relief.”<sup>60</sup> Significantly,

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<sup>53</sup> *Adams v. Securities Am., Inc.*, 2006 WL 2631863, \*3 (E.D. La. Sept. 12, 2006) (upholding award where other courts had noted that the NASD rules “clearly allow for an award of punitive damages.”); *Porush v. Lemire*, 6 F. Supp.2d 178 (E.D.N.Y. 1998).

<sup>54</sup> *Id.*

<sup>55</sup> 353 N.E.2d 793, 794 (N.Y. 1976).

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> 514 U.S. 52, 57 (1995).

<sup>59</sup> *Id.* (stating “Just as they may limit by contract the issues which they will arbitrate, [citation omitted], so too may they specify by contract the rules under which that arbitration will be conducted.”) (citing *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468 (1989)).

<sup>60</sup> *Id.* at 60-61.

moreover, a manual provided to NASD arbitrators provided: “The issue of punitive damages may arise with great frequency in arbitrations.”<sup>61</sup> The Manual warned that “Parties to arbitration are informed that arbitrators can consider punitive damages as a remedy.”<sup>62</sup> Accordingly, the Court held that the arbitrators were authorized to award punitive damages.

What if the state’s substantive law authorizes certain damages, but the state procedural rules would preclude arbitration of the claim? In an instructive case, a contract for the supply of chickens to a farm contained an arbitration clause that provided: “The laws of Arkansas shall exclusively apply and govern this agreement.”<sup>63</sup> The farmer (Hudson) asserted tort claims alleging that the supplier’s actions during the course of the business relationship violated the Arkansas Deceptive Trade Practices Act.<sup>64</sup> The supplier successfully obtained an order compelling arbitration and thereafter obtained summary judgment in the arbitration on the Hudsons’ tort claims.<sup>65</sup>

The Hudsons moved the court to vacate the arbitration award, contending that the arbitration panel should not have decided the tort claims. They argued that, under the Arkansas Uniform Arbitration Act, contractual arbitration clauses do not apply to tort claims.<sup>66</sup> The supplier contended that the arbitration clause, which permitted arbitration of “[a]ll claims ... relating in any way” to performance of the contract, embraced tort as well as contract claims.

The court noted a potential conflict between the primary thrust of the arbitration clause and the choice-of-law provision. It reasoned:

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<sup>61</sup> *Id.* at 61.

<sup>62</sup> *Id.*

<sup>63</sup> *Hudson v. Conagra Poultry Co.*, 484 F.3d 496, 498 (2007).

<sup>64</sup> *Id.* at 499

<sup>65</sup> *Id.*

<sup>66</sup> *Id.* at 500.



Under one interpretation – the interpretation urged by the Hudsons – these provisions create the implication that the parties intended to arbitrate only those claims that would be arbitrable under Arkansas laws. This interpretation would exclude tort claims. Under a second interpretation, these provisions create the implication that the parties intended to arbitrate all claims regardless of their arbitrability under Arkansas law, but wished to apply the substantive law of Arkansas to determine liability for those claims.<sup>67</sup>

The court concluded that excluding the Hudsons’ tort claims from arbitration conflicted with the parties’ agreement to arbitrate “[a]ll claims ... arising out of or relating in any way to the negotiation, execution, interpretation, and performance” of the agreement.<sup>68</sup> This direct statement of intent was, the court concluded, entitled to greater weight than the more general contractual choice of law. Accordingly, the tort claims were properly within the arbitrators’ jurisdiction. A court following this reasoning could conclude that a panel may award punitive damages even if the state arbitration act forbids it, so long as the substantive law would allow it.

#### **IV. EXTRA-CONTRACTUAL DAMAGES SHOULD COMPORT WITH GOVERNING STANDARDS OF REASONABLENESS**

Even when extra-contractual damages are authorized, arbitration awards frequently are challenged on the ground that the award – particularly as to amount – was unreasonable. While awards seldom are disturbed for being excessive, an arbitration panel’s conspicuous disregard of controlling law has been held a sufficient ground for overturning an award.

In an unusual case, a court modified an award of merely \$2,791 to add \$53,676 in attorney’s fees. The Maryland Court of Appeals held that a trial court possessed equitable powers to modify an arbitration award to include costs.<sup>69</sup> However, most

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<sup>67</sup> *Id.* at 500-01.

<sup>68</sup> *Id.* at 503.

<sup>69</sup> *Marsh v. Loffler Hous. Corp.*, 648 A.2d 1081 (Md. Ct. Spec. App. 1994).

courts deciding this issue have declined to add costs or other amounts to an arbitration award.<sup>70</sup> In *Oregon Partners No. 2, Ltd v. Klawler & Nunno Enterprises*, the court ruled that an arbitral award of attorneys fees and costs must be vacated if (1) the award fails to indicate the specific claim or claims on which the party prevailed, and (2) certain of the claims did not permit a fee award. Though such an award could have been specified, under Florida law, by the panel within ninety days of its delivery, that period had expired, and accordingly the court held that the fee award could not stand.<sup>71</sup>

The U.S. Supreme Court's limitation on punitive damages announced in *BMW of N. Am., Inc. v. Gore*,<sup>72</sup> is an example of substantive law that if disregarded by an arbitral panel risks invalidation of its award. In the context of arbitration, it has been held that an award may be found to be grossly excessive if the panel has shown "manifest disregard of the guidelines of reasonableness established in *Gore* and its progeny."<sup>73</sup> In a case in which the panel awarded punitive damages of \$27 million, the reviewing court regarded this as a "grossly excessive award that is arbitrary and irrational under *Gore* [and] should be equally arbitrary and irrational under the FAA." Importantly, an agreement to arbitrate does not waive constitutional protection. Notably, the trial court had found that the panel *knew* of the *Gore* decision and had chosen to ignore it, which supported overturning the decision.<sup>74</sup>

## V. VACATING AN AWARD OF EXTRA CONTRACTUAL DAMAGES

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<sup>70</sup> See *Oregon Partners No. 2, Ltd. v. Klawler & Nunno Enters.*, 837 So.2d 1104 (Fla. Dist. Ct. App. 2003) (arbitrator had ruled on claims, some of which did not permit fees to be awarded); *Preserve Estates v. Bryant Contracting Corp.*, 657 So.2d 59 (Fla. Dist. Ct. App. 1995) (trial judge erred in adding interest to award which arbitrators had stated was in full settlement of claims and interest due under contract had been considered by the arbitrator); *accord Stier, Kent & Canady, Inc. v. Jackson*, 452 S.E.2d 606 (S.C. Ct. App. 1994); *Canon Sch. Dist. No. 50 v. W.E.S. Constr. Co., Inc.*, 882 P.2d 1274 (Ariz. 1994) (court had no authority, because fees were not provided for in the arbitration agreement).

<sup>71</sup> *Id.* at 1105-06 (citing FLA. STAT. ANN § 682.161(1)(C)(2001)).

<sup>72</sup> 517 U.S. 559 (1996).

<sup>73</sup> *Sawtelle v. Waddell & Reed, Inc.*, 754 N.Y.S.2d 264, 270 (N.Y. App. Div. 2003).

<sup>74</sup> *Sawtelle*, 789 N.Y.S.2d 857, 858 (N.Y. Sup. 2004).

Judicial review of an arbitration award is very limited.<sup>75</sup> One court described the permissible standard of review as according “an extraordinary level of deference” to the award and noted that “federal courts are not authorized to reconsider the merits of an arbitral award ‘even though the parties may allege that the award rests on errors of fact or on misinterpretation of the contract.’”<sup>76</sup> Although the Federal Arbitration Act provides four statutory bases to vacate an arbitration award,<sup>77</sup> substantive challenges traditionally have contended that the award “manifests a disregard of the law.”

To vacate an arbitral award based on a manifest disregard of the law challenge, the court “must be persuaded that the arbitrators understood but chose to disregard a clearly defined law or legal principle applicable to the case before them.”<sup>78</sup> The Second Circuit has warned that the “error must be so palpably evident as to be readily perceived as such by the average person qualified to serve as an arbitrator. Thus, manifest disregard can only be established where an arbitrator ignores a governing legal principle that “is ‘well defined, explicit, and clearly applicable to the case.’”<sup>79</sup> In *Goldman v. Architectural Iron Co.*,<sup>80</sup> the Second Circuit held that there was no well defined, explicit, or clearly applicable law on the central legal issue in the matter and, therefore, even if the arbitrator “erred in resolving the conflicting precedent in favor of AIC [prevailing party], the arbitral decision cannot be said to have exhibited manifest disregard of the law.”<sup>81</sup>

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<sup>75</sup> *Manion v. Nagin*, 392 F.3d 294, 298 (8<sup>th</sup> Cir. 2004).

<sup>76</sup> *Id.* (citing *Stark v. Standberg, Phoenix, & von Gontard, P.C.*, 381 F.3d 793, 798 (8<sup>th</sup> Cir. 2004)).

<sup>77</sup> Alaska has disposed of the “American Rule” in all actions. *Alcoha R. Civ. P. 82(a) 2008*.

<sup>78</sup> *Duferco Int’l Steel Trading v. T. Klaveness Shipping A/S*, 333 F.3d 383, 385 (2d Cir. 2003); *Durkin v. Cigna Prop. & Cas. Corp.*, 986 F. Supp. 1356, 1358 (D. Kan. 1997) (stating that manifest disregard of the law may “be characterized as ‘willful inattentiveness to the governing law.’”).

<sup>79</sup> *Duferco Int’l*, 333 F.3d at 385.

<sup>80</sup> 306 F.3d 1214 (2d Cir. 2002).

<sup>81</sup> *Id.* at 1217.

Furthermore, the arbitrator's erroneous interpretation or application of the law or errors in its findings of fact does not support a finding of manifest disregard of the law. In *Commercial Refrigeration, Inc. v. Layton Constr. Co.*,<sup>82</sup> a party challenged the arbitral award arguing that the arbitrator was "willfully inattentive to principles of contract law requiring that the intentions of the parties determine issues of contract formation and interpretation."<sup>83</sup> The Court held that the award would not be vacated based on the arbitrator's decision regarding the intentions of the parties because errors in the arbitrator's findings of fact do not merit reversal.<sup>84</sup> The arbitrator's expertise in the particular area in dispute is the motivating factor behind the party's selection of them to resolve their dispute and further supports the judiciary's tendency to "accord maximum deference to an arbitrator's decision."<sup>85</sup>

Although challenges based on the "manifest disregard of the law" standard are not rare, courts have very rarely vacated an award on this basis. In *Duferco*, the court explained the reason for the judiciary's reluctance to find manifest disregard of the law as follows:

It should be remembered that arbitrators are hired by parties to reach a result that conforms to industry norms and to the arbitrator's notions of fairness. To interfere with this process would frustrate the intent of the parties, and thwart the usefulness of arbitration, making it "the commencement, not the end, of litigation."<sup>86</sup>

Moreover, in 2008, the U.S. Supreme Court commented, in *dictum*, that the "manifest disregard" standard may not constitute a distinct ground for overturning an arbitration

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<sup>82</sup> 319 F. Supp. 2d 1267, 1269 (D. Utah 2004).

<sup>83</sup> *Id.* at 1270.

<sup>84</sup> *Id.*

<sup>85</sup> *Id.* at 1269.

<sup>86</sup> *Duferco Int'l*, 333 F.3d at 389.

award under the FAA.<sup>87</sup> Accordingly, counsel and parties are well-advised not to be overly reliant on the courts to protect them from extra contractual damages imposed in arbitration particularly where such damages are not contractually precluded.

In sum, establishing that an arbitrator exhibited a manifest disregard of the law is very difficult. Notably, the Second Circuit has observed that it had vacated an arbitration award for manifest disregard only four times since 1960.<sup>88</sup>

## **VI. CONCLUSION**

Arbitration awards that shift attorney's fees to the prevailing party, or award interest or punitive damages are frequently contested. Such awards may be overturned when they are contrary to the parties' contract, or (less commonly) when they contradict controlling substantive law. Parties that wish to limit exposure to fee shifting or extracontractual damages should expressly preclude them in their arbitration clauses, using precise and comprehensive terms. Even then, a party seeking to preclude fee shifting should refrain from asserting, on its own behalf, any right to recover fees, to avoid being deemed to have waived its right to claim that fee shifting is contractually precluded.

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<sup>87</sup> *Hall Street Assocs, L.L.C. v. Mattel, Inc.*, 128 S.Ct. 1396, 1403 (2008). Following *Hall Street*, the Fifth Circuit has held that "manifest disregard" no longer is a ground for vacating an arbitration award. *Citigroup Global Markets, Inc. v. Bacon*, 562 F.3d 349 (5<sup>th</sup> Cir. 2009).

<sup>88</sup> See e.g., *Duferco Int'l* 333 F.3d at 389.