AENSI Journals

Advances in Environmental Biology

ISSN-1995-0756 EISSN-1998-1066

Journal home page: http://www.aensiweb.com/AEB/

Choice of Law: Arbitrating Insurance Dispute Clause

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ARTICLE INFO

Article history:
Received 25 May 2014
Received in revised form
26 July 2014
Accepted 22 August 2014
Available online 28 November 2014

Keywords:
policy, arbitration, law

ABSTRACT

The outcome of arbitration can be determined by choice-of-law provisions and other clauses that dictate who may serve as an arbitrator and how the proceedings must be conducted. This is particularly true in the context of insurance coverage litigation, which often turns upon which state's substantive law applies and on such state's established doctrines of insurance policy interpretation. As a result, policyholders in different states who are sold the same policies do not necessarily have the same coverage.

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To Cite This Article: Omid Qasemi and Froq Bahmani., Choice of Law: Arbitrating Insurance Dispute Clause. ***Adv. Environ. Biol., 8(12),*** *1638-1641, 2014*

INTRODUCTION

Commercial line insurance policies often include arbitration clauses, under which the insurer and insured agree to arbitrate, rather than litigate, their coverage disputes. Even though an arbitration panel ultimately might have the final word in resolving such disputes, frequently, various related issues may require judicial attention prior to arbitration, or even during the arbitration process. For example, the preliminary question of whether a dispute must be arbitrated under the arbitration clause at issue is fodder for courtside litigation, as is the question of whether one party has complied with the relevant arbitration clause's specified procedures for choosing arbitrators.

One issue that has the potential to affect significantly the outcome of arbitration is whether the Federal Arbitration Act ("FAA"), or a state arbitration act, governs arbitration of disputes under an insurance policy's arbitration agreement. The issue becomes more complex when the policy at issue contains a "choice of law" provision calling for application of a particular state's laws in resolving coverage disputes. Further, in the Second Circuit, resolution of the issue also can be affected by whether choice of law provision is found in the arbitration clause itself, or elsewhere in the policy. This article summarizes the Second Circuit's current position on reconciling FAA and state arbitration laws, in light of such "choice of law" clauses.

Ii. Governing principles of federal versus state arbitration law applicability:

A. Which Court?

As noted above, under 9 U.S.C. §2, i the FAA applies to all written arbitration agreements involving "commerce." Courts have interpreted the term "commerce" in that section to mean "interstate commerce and even the most tenuous out-of-state contact can convert commerce into "interstate commerce" for purposes of applying the FAA.

"The basic purpose of the [FAA] is to overcome courts' refusals to enforce agreements to arbitrate." Congress "intended courts to enforce arbitration agreements into which parties had entered ... and to place such agreements upon the same footing as other contracts." (Citation omitted; internal quotation marks omitted.) . Thus, the FAA sets forth federal substantive law that preempts state law, and as such, the FAA must be applied in state court proceedings when its provisions are implicated.

However, the FAA does not create subject matter jurisdiction. Courts regularly misstate this rule, writing that one of the criteria for applicability of the FAA is diversity jurisdiction.

B. Which Law?

State courts frequently attempt to side-step the difficult question of FAA versus state arbitration law applicability by noting that the FAA does not contain any explicit preemptive provisions, and therefore, only preempt state arbitration law that is "inconsistent" with the FAA.

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They then declare that their state's arbitration laws are "not inconsistent" with the FAA, and therefore, under either Federal or state arbitration law, the outcome presumably should be the same. However, as discussed below, the interface between the FAA and state arbitration law often is considerably more complex than these "quick fix" solutions, where the parties have specified, through a "choice of law" provision, that a particular state's laws should govern their arbitration agreement.

Iii. The fine print: choice of law provisions' affects on therelationship between the faa and state arbitration laws:

The more complex issue that frequently underlies the question of FAA versus state arbitration law applicability is whether a "choice of law" provision in an arbitration agreement or a contract containing an arbitration agreement, can override the FAA, and ensure that state arbitration law is applied in its stead. Both federal and state courts have rendered widely divergent opinions on this issue. However, based on United States Supreme Court precedent, and Second Circuit precedent interpreting the U.S. Supreme Court decisions, the rule in the Second Circuit appears to be that state arbitration rules will apply in lieu of FAA rules only if the choice of law provision

1. is contained within the arbitration clause or agreement itself (and not in a separate clause of the contract), and
2. contains language explicit enough to indicate that the parties intended state arbitration rules to apply as opposed to just state "substantive" law (i.e., providing that state law will apply to "enforcement" of the contract).

The main sources of confusion among the courts on this issue are two apparently conflicting U.S. Supreme Court decisions. In Volt, the specific question before the Court was whether a construction contract containing an arbitration clause that provided that the contract should be governed by the law of the place where the project was located (California) incorporated a California procedural rule that permits the court to stay arbitration pending resolution of related litigation between a party to the arbitration agreement and third parties not bound by the arbitration agreement. Significantly, the parties first litigated the issue in state court. The California Appellate Court affirmed the trial court's ruling that under California contract law, the choice of law clause should be construed an indicating that the parties intended the State stay of arbitration rule to apply.

The California Appellate Court had acknowledged in its decision that the FAA governed the contract, and that the FAA contains no provision similar to the California state rule permitting the arbitration stay. Nonetheless, the California Appellate Court held that the parties clearly intended California arbitration rules to apply, and rejected the argument that the FAA preempted the State’s stay of arbitration rule.

The Supreme Court affirmed the California Appellate Court's decision, holding that the FAA does not confer a right to compel arbitration of any dispute at any time and that it only confers the right to obtain an order directing the arbitration to proceed in the manner provided for in the parties' agreement.

The Court further explained that the FAA does not necessarily prevent enforcement of agreements to arbitrate under different rules than those set forth in the FAA, and that such a result would be "inimical to the FAA's primary purpose of insuring that private agreements to arbitrate are enforced according to their coercion and parties are generally free to structure their arbitration agreements as they see fit." Thus, the Court concluded that where the parties have agreed to abide by state rules of arbitration, enforcing those rules according to the terms of the agreement is "fully consistent with the goals of the FAA, even if the result is that arbitration is stayed where the [FAA] would otherwise permit it to go forward." Thus, on its face, Volt appears to allow parties to an arbitration agreement to choose state arbitration rules over the FAA rules, as long as the state arbitration rules do not hinder arbitration, and the federal purpose of encouraging arbitration is otherwise served in applying state arbitration rules. However, six years later, in Mastrobuono, the Court significantly qualified and limited its decision in Volt.

In Mastrobuono the question before the Court was whether an arbitration panel, arbitrating a dispute under New York law, could award punitive damages given that New York law allows courts but not arbitrators to make such awards. The petitioners argued that the FAA preempts the New York prohibition against arbitral awards of punitive damages as that rule was a "vestige of the ancient judicial hostility to arbitration."

Relying on Volt, the respondents argued that the parties lawfully could agree to limit the issues to be arbitrated. The Mastrobuono court acknowledged that under the Court’s own precedent, parties to an arbitration agreement are free to choose the issues to be arbitrated, including claims for punitive damages, and that the FAA ensures that their agreement will be enforced according to its terms, even if the rule of state law would otherwise exclude such claims from arbitration. Importantly, however, the Court distinguished Volt, explaining that unlike in that case, its task in the case before it was to review the parties' arbitration agreement de novo, in order to determine whether the parties intended to arbitrate the issue of punitive damages. The Court proceeded with an analysis of the contract language itself, and concluded that its separate choice of law and arbitration clauses created an ambiguity as to whether the parties intended to incorporate New York law relating to arbitration. The Court reiterated the rule that when a court interprets such provisions in an agreement covered by the FAA "due regard must be given to the federal policy favoring arbitration and ambiguities as to the scope of

the arbitration clause itself resolved in favor of arbitration." It concluded: we think the best way to harmonize the choice of law provision with the arbitration provision is to read "the laws of the State of New York" to encompass substantive principles that New York courts would apply, but not to include special rules limiting the authority of the arbitrators. Thus, the choice of law provision covers the rights and duties of the parties, while the arbitration clause covers arbitration; neither sentence intrudes upon the other.

In trying to reconcile Volt and Mastrobuono both federal and state courts have focused onthe fact that Volt involved a review of a state court's interpretation of the relevant contract,whereas Mastrobuono involved de novo interpretation of the subject contract. Indeed, theMastrobuono court itself raised this distinction.Nonetheless, generally speaking, Second Circuit courts have taken Mastrobuono as avirtual reversal of the Volt decision and have consistently held that a choice of law provision inan arbitration agreement, whether contained in the arbitration clause itself, or within a separateclause, does not indicate that the parties intended to have state arbitration rules apply in lieu ofthe FAA, unless the arbitration clause explicitly so states.

In Levine, supra, the Connecticut Supreme Court acknowledged that Luckie probably isgood law notwithstanding the dispute among the New York and federal courts about that case. It noted that the choice of law portion of the agreement before it contained thevery phrase "and its enforcement" that the Luckie court found dispositive. However, the Courtreasoned that the individual clauses of the contract could not be construed out of context. As in Mastrobuono, the Court undertook a detailed analysis of thearbitration clause language to determine whether the parties intended to arbitrate all disputes (asprovided under FAA rules), or exclude from arbitration timeliness rules (as provided under NewYork law). Ultimately, the Court concluded that the arbitration portion of the parties' agreementcreated an ambiguity not present in the Luckie contracts as to whether the parties intended thechoice of law provision to incorporate New York law limiting timeliness issues to courtdecision. Thus, the Court held that due regard to the federal policy favoring arbitration requiredthat the agreement be construed to mean that controversies as to timeliness of claims are to beresolved by arbitrators.

More recently, in Protostorm, LLC v. Antonelli, supra, the Federal District Court for theEastern District of New York tackled this issue, ultimately relying on the U.S. Supreme Court'sdecision in Preston v. Ferrer, rather than Second Circuitdecisional law that attempts to reconcile Volt and Mastrobuono.

In Protostorm, the court considered whether a stay of arbitration was proper under aRetainer Agreement between the parties that included a general choice-of-law clause (selectingCalifornia law), and an arbitration clause incorporating AAA arbitration rules. The stay wasbased on a California rule authorizing courts to deny a motion to compel arbitration where a partyto the arbitration agreement is also a party to a pending court action or special proceeding with athird party, arising out of the same transaction or series of related transactions and there is apossibility of conflicting rulings on a common issue of law or fact. After grappling extensivelywith the conflicting Second Circuit and other Circuits' case law pertaining to whether the choiceof law provision incorporated all aspects of California law, the Protostorm court ultimatelylooked to the U.S. Supreme Court's 2008 decision in Preston for guidance.

Preston involved an arbitration clause providing for the resolution of "any dispute ...relating to ... the breach, validity, or legality" of the subject contract in accordance with AAAarbitration rules. The contract also contained a general choice-of-law clause selecting Californialaw. The Court considered whether the choice-of-law clause should be interpreted to incorporatesection 1700.44(a) of the California Talent Agencies Act (TAA), which vests the CaliforniaLabor Commissioner with exclusive original jurisdiction to determine whether a particularagreement is subject to a statutory provision that requires parties to exhaust administrativeremedies before resorting to arbitration. Ferrer argued that, under Volt, the contract's choice-oflawprovision should be read to incorporate California procedural law, including the relevantCalifornia statutory provisions.

The Preston court rejected the argument that Volt controlled for two reasons.

- First, theCourt found that in Volt, nothing in the parties' contract addressed the specific situation at issue - litigation involving third-parties - such that the contract could be read to have incorporatedCalifornia statutory law as "gap filler." In contrast, the contract in Preston incorporated AAAarbitration rules that called for an arbitrator to settle the disputed issue.
- Second, the Preston court stated that its decision was based on the more recentMastrobuono decision rather than on its decision in Volt because in Volt, the plaintiff neverargued that incorporation of private arbitration rules trumped the choice-of-law clause containedin the contract. Finding that Mastrobuono "reached that open question," the Preston Courtconcluded that the choice-of law clause should be read to incorporate "prescriptions governingthe substantive rights and obligations of the parties, but not the State's 'special rules limiting theauthority of arbitrators.'"

Thus, at a minimum, Preston holds that a contract containing a general choice-of-lawclause and an arbitration clause incorporating AAA arbitration rules does not incorporate specialstate rules limiting the authority of arbitrators. In other words, a fair reading of Preston andMastrobuono indicates that where a contract incorporates private arbitration rules, a generalchoice-of-law clause is insufficient to incorporate procedural state arbitration law that limitsarbitrators' authority. However, those cases appear to leave open the possibility

that stateprocedural rules that do not offend the FAA's pro-arbitration policy may be incorporated by ageneral choice-of-law clause, even where an arbitration clause expressly incorporates a body ofprivate arbitration rules.

In sum, Second Circuit precedent "raises the bar" for parties wishing to enforce thechoice of law provisions in their arbitration agreements. As the cited decisions indicate, SecondCircuit courts typically cite to the FAA's underlying policy favoring arbitration over litigation tojustify their avoidance of an arbitration agreement's "choice of law" provisions, especially ifapplication of that provision would remove an issue from an arbitration panel's reach orotherwise limit arbitrators' authority.

Conclusion:

However, this does not mean it is impossible to enforce a choice of law provision in theSecond Circuit. Rather, such clauses carry the most "clout" under Second Circuit precedent whenthey are written into the arbitration agreement itself, rather than set out as a separate clause in thesubject contract of which the arbitration agreement is only one part. For example, consider apolicy that includes a choice of law provision, within the arbitration clause itself, which statesthat New York law shall govern the "interpretation and application of the policy." Even in theSecond Circuit, there is a tenable argument that the intent to have New York law govern the"application" of the policy is the equivalent, in the insurance context, of stating that it is to governthe "enforcement" of the contract, and therefore, New York arbitration rules apply in lieu offederal rules, so long as they do not conflict with the FAA.

In all cases, it is worthwhile to undertake an analysis as to whether application of federalor state arbitration law to a particular issue has the potential to affect the outcome of resolutionof that issue. As the cited cases indicate, in some cases, the question is critical, such as inMastrobuono, where the application of state law would bar punitive damages, but federal lawwould not. Thus, the analysis must be undertaken on an issue by issue basis. Even better, indrafting contracts containing an arbitration clause, if state law is of particular importance to aparty's arbitration position, the "choice of law" clause should be written directly into thearbitration clause of the contract, and should contain specific language regarding the parties'intent that the named state's laws govern enforcement of the contract at issue.

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce tosettle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal toperform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversyarising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save uponsuch grounds as exist at law or in equity for the revocation of any contract.

REFERENCE

[1] Allied-Bruce Terminix Cos. V., 1995. Dobson, 513 U.S. 265, 270, 115 S. Ct. 834.
[2] Southland Corp. V., 1984. Keating, 465 U.S. 1, 10-14.
[3] Volt Information Sciences Inc. V., 1989. Board of Trustees of Laland Stanford Junior University, 489 U.S. 468 and Mastrobuono v. Shearson Lehman Hutton, Inc., et al., 514 U.S. 52, 1995.
[4] See e.g., Protostorm, LLC v. Antonelli, 2010 WL 2195679 (E.D.N.Y. May 28, 2010)(discussing at length the courts' struggle to reconcile the Volt and Mastrobuono decisions); Nat'l Union Fire Ins. Co. v. Belco Petroleum Corp., 88 F.3d 129 (2d Cir. 1996)(declining to read choice of law clause as incorporating New York State law on arbitration); Doctor's Assoc., Inc. v. Distajo, 107 F.3d 126 (2d Cir. 1997)(general choice of law clause does not require application of state law to arbitrability issues unless it is clear parties intended state arbitration law to apply on a particular issue).ii In contrast, in Smith Barney, Harris Upham & Company v. Luckie, 85 N.Y. 2d 193 (1995), the Court held that by specifying in their agreement that the agreement "and its enforcement" would be governed by New York law, the parties intended to incorporate into that agreement New York arbitration rules. However, as the Connecticut Supreme Court noted in Levine et al. v. Advest, Inc., 244 Conn. 732 (1998), even that specific language "has engendered a dispute between a New York court and a number of federal courts as to the effect of the [FAA] on the construction of contracts containing a choice of law. . . ." Id. at 752 n. 14 [citations omitted].