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Punitive Damages in International Commercial Arbitration: A Conflict of Laws Lesson

Markus Petsche

This article examines the conflict of laws issues (with an emphasis on choice of law) arising in the context of punitive damages claims in international commercial arbitration. It explains that the appropriate choice of law methodology is based on a distinction between the 'power' of arbitrators to grant punitive relief (governed by the applicable arbitration law) and the 'availability' of punitive damages stricto sensu (governed by the applicable substantive law). It shows that this approach is confirmed by most available arbitral awards and court decisions. In this respect, it highlights that the US Supreme Court's decision in Mastrobuono v. Shearson Lehman Hutton, Inc. is frequently misinterpreted as implying that arbitral tribunals sitting in the United States (and thus subject to US arbitration law) may award exemplary damages despite those damages being unavailable under the applicable substantive law. This article also explores the impact of the incompatibility of punitive damages with the public policy of the arbitral seat and other relevant jurisdictions.

1 INTRODUCTION

In recent years, the question of the availability of punitive (or exemplary) damages in the context of international commercial arbitration has received increasing attention. Two reasons account for this heightened interest: first, the express recognition, at least in the United States, of the power of arbitrators to grant punitive relief and, second, the seemingly declining hostility of civil law nations


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vis-à-vis American punitive damages awards.\textsuperscript{3} Although empirical data suggests that, to date, only very few arbitral tribunals have awarded punitive damages in international disputes,\textsuperscript{4} it is likely that such decisions should be rendered with increasing frequency in the future.

A central aspect of the availability of punitive damages in international commercial arbitration is the issue of the applicable law. Though fundamental, the answer to this question remains somewhat unclear. As will be shown, it is rather uncontroversial that, as a matter of general private international law, the availability of exemplary relief is determined by the applicable substantive law. In the specific context of international commercial arbitration, however, the question arises as to whether, and to what extent, the availability of punitive relief may (also) be governed by the applicable arbitration law.

Punitive damages are unheard of in the vast majority of civil law countries, and most of those jurisdictions consider such damages to violate basic notions of public policy. Hence, as far as arbitral choice-of-law analysis is concerned, the question arises as to whether this incompatibility of exemplary relief with the public policy of certain jurisdictions impacts, or should impact, arbitral determinations. Specifically, the question arises as to whether arbitrators do, or should, disregard laws authorizing them to award punitive damages, if such an award would infringe upon the public policy of the arbitral seat or of the probable enforcement jurisdiction.

This article aims to provide answers to these questions and to establish an appropriate analytical framework and methodology. Section 2 explains that, in international arbitration, the question of the availability of exemplary relief is divided into two aspects: the ‘power’ of arbitrators to grant punitive relief, on the one hand, and the ‘availability’ strictly speaking (or \textit{stricto sensu}) of such relief, on the other. Section 3 shows that the former aspect is governed by the arbitration law of the arbitral seat, while section 4 establishes that the latter is determined in accordance with the applicable substantive law. Section 5 explores the issue of ‘conflicts’ between substantive and arbitration law, emphasizing the implications of

\textsuperscript{3} See, as far as German law is concerned, Volker Behr, \textit{Punitive Damages in American and German Law: Tendencies Towards Approximation of Apparently Irreconcilable Concepts}, 78 Chi.-Kent L. Rev. 105 (2003). In France, a recent proposal to reform parts of the Civil Code suggests authorizing the award of punitive damages. See \textit{Proposal to Reform the Law of Obligations and the Law of Prescriptions}, Sept. 22, 2005, Art. 1371: ‘One whose fault is manifestly premeditated, particularly a fault whose purpose is monetary gain, may be ordered to pay punitive damages in addition to compensatory damages.’

\textsuperscript{4} Significantly, there is no reported ICC case in which the arbitrator(s) awarded punitive damages. Such damages are occasionally awarded in maritime disputes, but it is unclear to what extent those disputes can adequately be described as ‘international’. See also Karen J. Tolson, \textit{Conflicts Presented by Arbitral Awards of Punitive Damages}, 4 Arb. Intl. 255, 256 (1988) (observing that ‘no record of any international arbitral award of punitive damages exists’, though this statement is now somewhat outdated).
the US Supreme Court’s decision in Mastrobuono, which is frequently misunderstood. Section 6 explores the impact of the incompatibility of punitive damages with the public policy requirements of the arbitral seat and probable enforcement jurisdictions.

2 DISTINCTION BETWEEN THE POWER OF ARBITRATORS TO GRANT PUNITIVE RELIEF AND THE AVAILABILITY OF PUNITIVE RELIEF STRICTO SENSU

2.1 RATIONALE OF THE DISTINCTION

In order to better understand the conflict of laws issues raised by the availability of exemplary damages in international commercial arbitration, it is fundamental to realize that this question consists not of one, but of two distinct issues. The first and preliminary issue pertains to the ‘power’ of arbitrators to grant such relief, while the second aspect relates to the availability *stricto sensu* of punitive relief. Each of these two issues is governed by its ‘own’ law.

The issue of the availability *stricto sensu* of exemplary relief (chronologically, the second issue) pertains to the question of whether, under the applicable (substantive or procedural) law, punitive damages are recognized as a remedy and whether the requirements for the award of such damages are met. When a claim for punitive relief is brought before a court, this is the only question that arises, that is, a court will/may award punitive damages whenever those damages are provided for under the applicable law.

The issue of the ‘power’ of arbitrators to award punitive damages, however, is specific to arbitration. In fact, arbitrators do not necessarily enjoy the same powers as courts, and it would be erroneous to assume that they possess an inherent power to grant punitive relief. In certain respects, the powers or discretion of arbitrators may be more extensive; in other areas, their powers may be more limited. For example, arbitrators do not generally have the power to impose fines or penalties on the parties.

As far as the ability of arbitrators to award punitive damages is concerned, domestic legislators or courts may limit or even exclude such ability if they believe that such limitation or exclusion would be appropriate. A useful example is provided by the decision of the New York Court of Appeals in *Garrity v. Lyle*

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5 *Mastrobuono v. Shearson Lehman Hutton, Inc.*, supra n. 2, at 52.
6 Nigel Blackaby, Constantine Partasides, et al., *Redfern and Hunter on International Arbitration* 528 (Wolters Kluwer 2009) (observing that ‘the powers of an arbital tribunal are not necessarily the same as those of a court’).
7 Ibid.
Stuart, Inc.\textsuperscript{8} where the court held that arbitrators did not have the power to award punitive damages, and that such awards were violative of public policy because the ‘power to punish’ constitutes a ‘monopoly of the state’.\textsuperscript{9}

\subsection*{2.2 Recognition of the distinction}

Although this distinction is by no means widely accepted, a few authors have expressly recognized the necessity to distinguish between the arbitrators’ power to award punitive relief and the availability \textit{stricto sensu} of such relief. In an earlier contribution on punitive damages in arbitration, Professor Farnsworth addressed, \textit{inter alia}, the circumstances in which arbitrators may grant such damages. Without analyzing the relevant choice of law issues, he appropriately noted that:

\begin{quote}
This question has two aspects. First, will the arbitrators consider the case at hand an appropriate one for punitive damages under the applicable \textit{[substantive or procedural]} law …? Second, will the arbitrators assume that they—as arbitrators—have the power to award punitive damages …?\textsuperscript{10}
\end{quote}

A similar distinction, along with a statement of its conflict of laws implications, is made by the authors of \textit{Redfern and Hunter on International Arbitration}. They observe that arbitral tribunals, when hearing punitive damages claims, should:

\begin{quote}
examine the question of whether or not such damages may be awarded under the law applicable to the substance of the dispute [and that] [t]hey should also address themselves to the threshold question as to whether or not they have power to make such an award, even if a claim for punitive damages is admissible under the law applicable to the substance.\textsuperscript{11}
\end{quote}

Several US courts have implicitly adopted a similar approach,\textsuperscript{12} holding that the applicable substantive law is irrelevant for the purposes of determining whether arbitrators have the ‘power’ to award punitive relief. As one commentator observed in this respect, those courts:

\begin{quote}
have held that the procedural law decides whether the arbitrators have the power to award punitive damages or not, while the substantive law is applied to justify whether certain circumstances are proper for granting such remedy.\textsuperscript{13} (internal notes omitted)
\end{quote}

\begin{itemize}
\item \textsuperscript{8} Garrity v. Lyle Stuart, Inc., 353 N.E.2d 793 (N.Y. 1976).
\item \textsuperscript{9} Ibid., at 797–98.
\item \textsuperscript{11} Blackaby, Partasides et al., \textit{supra} n. 6, at 531.
\item \textsuperscript{13} Noussia, \textit{supra} n. 1, at 281.
\end{itemize}
3 APPLICABILITY OF THE ARBITRATION LAW OF THE ARBITRAL SEAT TO THE QUESTION OF THE POWER OF ARBITRATORS TO AWARD PUNITIVE DAMAGES

The question of the ‘power’ of arbitrators to grant punitive relief is a question the answer to which is found in the applicable arbitration law. In fact, it is that branch of the law that governs all aspects related to the conduct of arbitral proceedings, from the conclusion of the arbitration agreement to the enforcement of the arbitral award, including issues related to the powers of arbitrators. Technically, arbitration law is of procedural nature, which explains why a number of commentators refer to it as ‘procedural law’.

Having established that the issue of the power of arbitrators to award exemplary damages is governed by the applicable arbitration law, the question arises as to which country’s arbitration law applies. As a matter of principle, the parties are free to select any domestic arbitration law which they consider appropriate, subject to the mandatory provisions of the place of arbitration (or arbitral seat). However, in the absence of any such choice by the parties, the arbitration law of the seat will apply.

A summary review of the arbitration laws in force in some major industrialized nations reveals that those laws do not generally address the question of whether arbitrators may award punitive relief. As a general rule, they do not even deal with the more general question of the available remedies. They do not, for example, contain any provisions regarding the arbitrators’ ability to order specific performance. While most arbitration laws do, however, include one or several provisions regarding the rendering of the final award, those provisions generally merely set forth the requirements that the award shall be in writing, reasoned and signed.

Courts and arbitral tribunals have reached varying conclusions regarding the legal implications of this silence of arbitration laws. Under one view, which is the position taken by the Garrity court, arbitrators may not award punitive damages,
even if the parties intended to confer such powers upon them. Under the predominant view, however, the silence of the applicable arbitration law does not imply that arbitrators lack the ability to grant punitive relief, although the parties may agree to exclude this ability.

One decision following this predominant view is the US Supreme Court’s decision in *Mastrobuono*.\(^{20}\) In the United States, the power of arbitrators to award punitive damages is not expressly addressed in the Federal Arbitration Act (FAA) (the applicable arbitration law). In *Mastrobuono*, the Court interpreted this silence as implying that the issue of the power of arbitrators to grant punitive relief must be assessed in light of the intent of the parties (which is, in itself, an acknowledgment that arbitrators may award exemplary damages),\(^{21}\) and that, in the absence of a clear intent to the contrary, arbitrators are empowered to grant punitive relief.\(^{22}\)

Under such an approach, the determination of the (actual or hypothetical) intent of the parties plays a pivotal role. As a practical matter, arbitration agreements are generally silent with regard to the arbitrators’ ability to award punitive damages. As *Mastrobuono* illustrates, the applicable institutional arbitration rules may, however, address this point. In that case, the applicable arbitration rules (the rules of the National Association of Securities Dealers (NASD)), as interpreted by the NASD, authorized the award of punitive damages.\(^{23}\) However, the vast majority of institutional rules do not contain any specific provisions excluding or authorizing punitive damages awards.\(^{24}\)

*Mastrobuono* also provides general support for the idea that the power of arbitrators to award punitive damages is, in fact, a procedural issue and, thus, governed by the applicable arbitration law (in this case, the FAA). Indeed, the Court entirely based its decision on its interpretation of the FAA, without any reference to the applicable substantive law (the law of New York). It did, however, examine the impact of *Garrity*, but as the Court rightly observed, *Garrity* is part of New York arbitration law, and not of its substantive law.\(^{25}\)

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\(^{20}\) *Mastrobuono v. Shearson Lehman Hutton, Inc.*, supra n. 2, at 52.

\(^{21}\) *Ibid.*, at 52, 58 (holding that ‘the case before us comes down to what the contract has to say about the arbitrability of petitioners’ claim for punitive damages’).

\(^{22}\) *Ibid.*, at 52, 63 (holding that ‘in the face of such doubt [regarding petitioners’ intent to waive their right to punitive damages], we are unwilling to impute this intent to petitioners’).


\(^{24}\) Section 4 of the UNCITRAL Rules (entitled ‘The award’), for example, contains no provision pertaining to remedies. Article 31 of the ICC Arbitration Rules, which relates to the ‘making of the award’, similarly fails to address this issue. Article 26 of the LCIA Rules also remains silent on this issue.

\(^{25}\) *Mastrobuono v. Shearson Lehman Hutton, Inc.*, supra n. 2, at 52, 64 (implicitly holding that the *Garrity* rule forms a part of ‘special rules limiting the authority of arbitrators’ which have to be distinguished from ‘substantive principles that New York courts would apply’).
4 APPLICABILITY OF THE APPLICABLE SUBSTANTIVE LAW TO THE QUESTION OF THE AVAILABILITY STRICTO SENSU OF EXEMPLARY RELIEF

4.1 SUBSTANTIVE NATURE OF THE QUESTION OF THE AVAILABILITY OF PUNITIVE RELIEF

The issue of the substantive or procedural nature of the question of the availability of punitive damages is, at least in the United States, the subject of some controversy. Although the predominant approach views this question as one of substance, US courts have occasionally expressed a contrary opinion. Professor Borchers notes in this respect that, even though the availability of punitive damages is most appropriately governed by the applicable substantive law, such a solution is ‘far from an unavoidable conclusion’. He also observes that ‘even in recent times courts have considered at great length the possibility that questions of punitive liability might be questions of procedure’. As will be shown, this ‘controversy’ is entirely unjustified.

All private international law systems draw a basic distinction between procedural and substantive matters. Substantive matters include those that affect the ‘substance’ of the parties’ rights, that is, the question of what those rights consist of (notably the scope and extent of those rights). Procedural matters, however, relate to how those rights can be enforced (in a court of law). For some reason, the boundaries between issues of substance and issues of procedure may occasionally be blurred, and the treatment that specific questions receive may sometimes vary over time.

The availability of punitive damages is most adequately characterized as a substantive issue. In fact, the possibility for a party to obtain such damages affects the ‘substance’ of its rights, that is, it affects ‘what its rights consist of’. Undoubtedly, there is a ‘substantial’ difference between a right to compensatory damages and a right to both compensatory and exemplary damages. Conversely, it is difficult to see how the availability of punitive damages could be qualified as a procedural issue, that is, as an issue that pertains to ‘how’ a specific (existing) right can be enforced.

27 Ibid.
28 J.J. Fawcett & J.M. Carruthers, Cheshire, North and Fawcett, Private International Law 75 (Oxford 2008) (observing that ‘[o]ne of the eternal truths of every system of private international law is that a distinction must be made between substance and procedure, between right and remedy’ (internal note omitted)).
29 Ibid., at 80 (explaining that, in the UK, statutes of limitation are regarded as substantive rules, even though they had traditionally been considered as procedural rules).
As is well known, punitive damages claims are primarily raised in tort matters. In this context, the availability of punitive relief is governed by the (substantive) law applicable to the obligation arising from the tortious behaviour. In fact, such law not only governs the determination of the circumstances that create tortious liability, but also the consequences that flow from such liability. In Europe, for example, EU Regulation 864/2007 provides that the law applicable to a non-contractual obligation notably applies to ‘the existence, the nature and assessment of damage or the remedy claimed’ (emphasis added).\(^{30}\)

In the United States, the Second Restatement follows a similar approach.\(^{31}\) Section 145 lays down the rules pertaining to the determination of the law governing ‘the rights and liabilities of the parties to an issue in tort’. Section 171 clarifies that this law notably ‘determines the measure of damages’ and comment (d) to section 171 specifies that ‘the rule of § 145 determines the right to exemplary damages’. While it is true that the same comment also suggests that the law governing the right to punitive relief is not necessarily the same as the one applying to the measure of compensatory damages, this does not call into question the ‘substantive’ nature of the issue of the availability of punitive damages.

As far as contract claims are concerned, the question of the availability of punitive relief is similarly governed by the applicable substantive law (\textit{lex contractus}). Under EU Regulation 593/2008 (‘Rome I Regulation’), for instance, ‘the law applicable to a contract . . . shall govern . . . the consequences of a total or partial breach of obligations, including the assessment of damages’.\(^{32}\) Hence, under the Regulation, the availability of punitive relief clearly falls within the scope of the \textit{lex contractus}.

A number of writers expressly affirm the applicability of the relevant substantive law to the question of the availability of exemplary relief. With specific reference to the European context, Rouhette writes that ‘the law applicable to punitive damages . . . should be the \textit{lex loci delicti} in case of tortious matters and the \textit{lex contractus} in case of contractual matters’.\(^{33}\) Commenting on US conflict of laws perspectives, Professor Borchers notes that ‘the question of the conduct necessary to create punitive liability should be an issue of substance’, and that this is ‘how courts have conventionally treated it’.\(^{34}\)

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\(^{31}\) \textit{Restatement (Second) Conflict of Laws} (1971).


\(^{34}\) Borchers, \textit{supra} n. 26, at 544–545.
4.2. Applicability of the lex contractus

Disputes submitted to arbitration are almost invariably of a contractual nature. In fact, as a general rule, such disputes are referred to arbitration by virtue of an arbitration agreement which the parties entered into in connection with their contractual transaction. As a result – and this is hardly controversial – arbitral tribunals will apply the law governing the contract or lex contractus to the merits of the dispute. Hence, the lex contractus will apply to all claims raised by the parties, including claims for punitive damages.

Two ICC arbitral awards help to illustrate the applicability of the lex contractus to the availability of punitive damages in international commercial arbitration. In ICC Case No. 5946, the parties had selected the law of the state of New York as the law governing their contract. When addressing the claimant’s request for punitive damages, the arbitral tribunal recognized the applicability of the lex contractus to this claim. However, it ultimately declined to consider awarding such damages, since it held that such a decision would have been contrary to the public policy of the Swiss arbitral seat.

ICC Case No. 8445 involved a dispute between parties to a knowhow/technology licensing agreement which the parties had expressly subjected to Indian law. The claimants requested, inter alia, punitive damages on the grounds that the respondents had intentionally breached the agreement. The arbitral tribunal held that it was not in a position to grant exemplary relief since, ‘as a matter of Indian law (the lex contractus) ... a court, and thereby by extension an arbitral tribunal, will normally give damages for breach of contract only by way of compensation for loss suffered, and not by way of punishment’.

However, the applicability of the lex contractus to punitive damages claims raised in the context of international commercial arbitration may not always be uncontroversial. In the United States (which is one of the two countries that

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35 See Castagno, supra n. 1, at 729 (observing that international commercial arbitration ‘mainly regards contract liability’).
37 Ibid., at 113 (stating that ‘respondent has not proven that under New York law [the lex contractus] a claim for such punitive or exemplary damages would lie’).
38 Ibid. (holding that ‘[d]amages that go beyond compensatory damages to constitute a punishment of the wrongdoer (punitive or exemplary damages) are considered contrary to Swiss public policy, which must be respected by an arbitral tribunal sitting in Switzerland’). On the issue of the impact of such a lack of conformity with the public policy of the arbitral seat, see infra.
40 Ibid., at 178.
41 Ibid. (internal quotations omitted).
authorizes punitive damages awards in contract cases.\textsuperscript{42} exemplary damages may be available in breach of contract cases either if the breach is ‘fraudulent, malicious, grossly negligent or oppressive’\textsuperscript{43} or if it also constitutes an ‘independent’ tort.\textsuperscript{44} In the latter scenario, one may ask whether it would not be more appropriate to apply the law governing tortious liability, rather than the \textit{lex contractus} – but such a question is unfortunately beyond the limited scope of this article.

5 CONFLICTS BETWEEN ARBITRATION AND SUBSTANTIVE LAW:
A CLARIFICATION REGARDING MASTROBUONO

If the applicable arbitration law empowers arbitrators to award exemplary relief, but such relief is not available under the applicable substantive law (or the reverse), then one may speak of a ‘conflict’ between the two laws. In reality, however, there is no ‘conflict’ since the two laws relate to two distinct aspects of the question of the availability of punitive relief. Accordingly, in order for arbitrators to be able to grant exemplary damages in a particular case, both the applicable arbitration law and substantive law must authorize exemplary relief. Some commentators, however, relying on the US Supreme Court’s decision in \textit{Mastrobuono}, have expressed a different viewpoint – wrongly so.

In \textit{Mastrobuono},\textsuperscript{45} the claimants, Mr and Mrs. Mastrobuono, had opened a securities trading account with the respondent, Shearson Lehman Hutton, Inc. (Shearson). The contract, Shearson’s standard form agreement, contained a choice-of-law clause selecting ‘New York law’. It also included an arbitration clause under which all disputes had to be submitted to arbitration in accordance with the rules of the NASD. Those rules, as interpreted by the NASD in a manual provided to NASD arbitrators, expressly authorized the award of exemplary damages.

The claimants initiated proceedings against the respondent, alleging that the latter had mishandled their account. The arbitral tribunal found in favour of the claimants and awarded them both compensatory and punitive damages. The respondent moved to have the punitive damages award vacated, maintaining that the arbitral tribunal had not been authorized to award exemplary damages. The District Court granted respondent’s motion and the Court of Appeals affirmed. The Supreme Court reversed.

\textsuperscript{43} Castagno, supra n. 1, at 733.
\textsuperscript{44} \textit{Restatement (Second) on Contract}, sec. 355 provides: ‘Punitive damages are not recoverable for a breach of contract unless the conduct constituting the breach is also a tort for which punitive damages are recoverable.’
\textsuperscript{45} \textit{Mastrobuono v. Shearson Lehman Hutton, Inc.}, supra n. 2, at 52.
The Supreme Court’s decision rested essentially on two grounds. The first one related to the idea that the FAA prevails over contrary state arbitration law. Specifically, the Court observed that, ‘in the absence of contractual intent to the contrary, the FAA would pre-empt the Garrity rule’. In the view of the Court, the FAA authorizes punitive damages awards because it is based on a ‘pro-arbitration’ policy and because its primary purpose is to ensure that ‘private agreements to arbitrate are enforced according to their terms’.

The second idea, which is a consequence of the first, pertains to the crucial importance of party intent. In this respect, the Court attached particular significance to the parties’ choice-of-law clause which provided for the application of New York law. The Court rightly held that the object of this clause was the selection of the applicable substantive law, to the exclusion of ‘special rules limiting the authority of arbitrators’, such rules being part of the applicable arbitration law. The parties’ choice-of-law did not, therefore, include the Garrity prohibition, which is part of New York arbitration, not substantive law. By the same token, the Court implicitly confirmed that the question of the power of arbitrators to award punitive relief must be determined in accordance with the applicable arbitration law (here, the FAA).

At least two commentators have taken the view that Mastrobuono suggests that the FAA (and possibly, more generally, the applicable arbitration law) prevails over contrary substantive law. According to those authors, whenever the FAA governs arbitration proceedings and the parties have not expressly excluded the availability of punitive damages, arbitrators will be authorized to award such damages, even if they are not available under the applicable substantive law. In other words, the arbitration law alone would be relevant to determine whether arbitrators may grant exemplary relief.

In a recent article on punitive damages in (international) arbitration, Kyriaki Nousia observed that, ‘as Mastrobuono v. Shearson Lehman Hutton Inc. shows, the Federal Arbitration Act pre-empts state substantive law’. He goes on to draw the logical conclusion from his analysis by arguing that ‘selecting French law to apply to the substantive claims does not sacrifice the pursuit of punitive damages under U.S. law’. Nousia’s analysis is flawed since, as has been explained, the FAA prevails over contrary state arbitration law. It cannot possibly prevail over substantive law since conflicts between the two are logically excluded.

46 Ibid., at 52, 59.
47 Ibid., at 52, 57.
48 Ibid., at 52, 64.
49 Nousia, supra n. 1, at 281 (emphasis added, internal note omitted).
50 Ibid., at 283.
Professor Gotanda also takes the view that the applicable arbitration law (specifically, the FAA) may prevail over a prohibition contained in the applicable substantive law. According to Professor Gotanda, *Mastrobuono* implies that ‘an arbitrator sitting in the United States would have the authority to award such relief, even if the governing law prohibits awards of punitive damages’. An arbitral tribunal sitting in New York, for example, would be authorized to award exemplary damages, even though the merits of the dispute are governed by Swiss law, which prohibits punitive damages awards.

Professor Gotanda is certainly right when he states that such a ‘presumption in favor of awarding punitive damages in international commercial arbitration could be extremely problematic’, but the fact is that the Court did not establish any such presumption. As has been explained, the Court merely solved a conflict between state (*Garrity*) and federal (FAA) arbitration law, but no conflict between arbitration and substantive law. In fact, at no point did the Court examine the availability of punitive relief under New York substantive law. Indeed, in *Mastrobuono*, the Court only examined the question of the ‘power’ of arbitrators to award punitive relief, not the question of the availability of such relief under New York substantive law, such availability being undisputed.

6 IMPACT OF THE INCOMPATIBILITY OF PUNITIVE DAMAGES WITH THE PUBLIC POLICY OF THE ARBITRAL SEAT OR OF PROBABLE ENFORCEMENT JURISDICTIONS

For a number of reasons, punitive damages are, in many countries, considered to be contrary to public policy. This hostility towards punitive relief stems from the fact that, in the jurisdictions concerned, such relief is incompatible with the basic distinction that those legal systems draw between criminal and private law. Under those systems, the functions of deterrence and punishment are confined to the area of criminal law. In a private law (and notably tort) context, punitive damages are considered as unacceptable because defendants lack procedural safeguards habitually associated with criminal law.

Thus, the question arises as to the impact of the incompatibility of punitive damages with the public policy of the arbitral seat or of probable enforcement fora. Unlike courts, arbitrators do not, as is well known, have a ‘forum’. Hence, the choice of law methodology followed by arbitrators does not include any public policy exception whereby the applicable foreign law is excluded, in whole or in

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51 Gotanda, supra n. 1, at 60.
52 Ibid., at 61.
54 Ibid., at 756.
part, because it violates the forum’s public policy. However, as will be shown, the incompatibility of an award with the public policy of the seat may lead to the setting aside of the award. Also, if punitive damages are contrary to the public policy of (the) probable enforcement jurisdiction(s), this may undermine the enforceability of the award in this/those jurisdiction(s). Hence, arbitral tribunals generally take potential violations of the public policy of the seat and of probable enforcement jurisdictions into consideration.

6.1 Annulment of, and refusal to enforce, arbitral punitive damages awards due to their incompatibility with public policy

The incompatibility of punitive damages with domestic public policy requirements may have a twofold impact on the enforceability of arbitral punitive damages awards. First of all, it may lead to such awards being annulled (set aside) by the courts of the place of arbitration. Under virtually all arbitration laws, as is well known, arbitral awards may be the subject of setting aside proceedings in those courts. One of the grounds upon which an award may be set aside is the award’s incompatibility with the forum’s public policy. Therefore, if the courts of the arbitral seat consider that punitive damages violate public policy, they may annul punitive arbitral awards.

Second, incompatibility with public policy is also a ground upon which courts may refuse to enforce foreign arbitral awards. Under the New York Convention, for example, ‘[r]ecognition and enforcement of an award may . . . be refused if the competent authority in the country where recognition and enforcement is sought finds that . . . recognition or enforcement of the award would be contrary to the public policy of that country’. The UNCITRAL Model Law contains a similar provision regarding the enforcement of foreign arbitral awards.

To this author’s knowledge, there are no reported cases in which courts have either enforced, or refused to enforce, foreign punitive damages awards under the New York Convention or domestic legislation based on the UNCITRAL Model Law. Back in 1987, Karen Tolson attributed this lack of relevant case law to the fact that ‘no record of any international arbitral award of punitive damages exist[ed]’. As has been pointed out, to a large extent, this observation remains accurate today.

55 See, e.g., Arts. 1(2) and 34 of the UNCITRAL Model Law.
56 See, e.g., ibid., at Art. 34(2)(b)(i).
57 Article V(2)(b) of the New York Convention.
58 Article 36(1)(b)(ii) of the UNCITRAL Model Law.
59 Tolson, supra n. 4, at 256.
Despite the absence of relevant empirical data, most commentators agree that arbitral punitive damages awards are generally not enforceable in jurisdictions that do not recognize this remedy. Castagno, for example, observes that, in those countries, ‘the public policy defence . . . could . . . represent a strong bias against the enforcement of punitive damages awards’. As a result, he argues, it is unlikely that such awards would be enforced in Italy or Germany, for example. He also takes the view that the enforcement of punitive arbitral awards is highly improbable in the United Kingdom, considering that, under English law, such relief is not available in contract cases. A number of other writers have acknowledged that the enforcement of punitive arbitral awards may be problematic.

Other scholars, however, take a different view. They rely primarily on the idea that, under the New York Convention’s public policy exception (or similar domestic provisions), an award will only be refused recognition or enforcement if it violates ‘international’, rather than ‘domestic’ public policy. They consider, in other words, that the public policy exception applying to arbitration awards is more restrictive than the one pertaining to foreign court judgments. Thus, the fact that a court of country A refuses to enforce a foreign punitive damages judgment would not necessarily imply that another court of country A would deny enforcement of a punitive arbitral award.

Arbitration laws and court decisions confirm the relevance of ‘international’, rather than ‘domestic’ public policy standards for the purposes of assessing the enforceability of foreign arbitral awards. Although express legislative references to the concept of international public policy are rare, one such reference can be found in Article 1520(5) of the French Code of Civil Procedure. In other countries, the courts have reached similar results by relying on the idea that the New York Convention’s public policy exception must be interpreted restrictively. In the United States, for example, courts generally consider that ‘the Convention’s

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60 Castagno, supra n. 1, at 747.
61 Ibid., at 748.
62 Ibid., at 407 (pointing out the anecdotal fact that his ‘[c]olleagues from civil law systems seem to think that an award of punitive damages would not be against their international public policy’) (emphasis added). See also Albert Jan van den Berg, The New York Arbitration Convention of 1958: Towards a Uniform Judicial Interpretation 360 (Kluwer Intl. 1983).
63 French Code of Civil Procedure, Art. 1520(5) provides: ‘An award may only be set aside where . . . recognition or enforcement of the award is contrary to international public policy.’
public policy defense should be construed narrowly\textsuperscript{67} and that its application requires ‘supranational emphasis’, rather than reliance on ‘national political interests’.\textsuperscript{68}

6.2 REFUSAL TO AWARD PUNITIVE DAMAGES IN LIGHT OF THEIR INCOMPATIBILITY WITH THE PUBLIC POLICY OF THE PLACE OF ARBITRATION OR OF PROBABLE ENFORCEMENT JURISDICTIONS

As has been explained, punitive arbitral awards may be annulled by the courts of the arbitral seat if they contravene the applicable public policy requirements. This prospect inevitably influences the arbitral tribunal’s decision. In fact, arbitral tribunals may be reluctant to grant punitive relief if it is probable, or at least possible, that such an award would be set aside by the courts of the place of arbitration. Two factors play a role in this respect.

First, arbitrators have an understandable interest in issuing an enforceable award. Since the arbitral process is ultimately ineffective if it does not lead to the rendition of such an enforceable award, arbitrators generally consider enforceability as a duty owed to the parties. While it may not constitute a ‘legal’ duty in the strict sense, some arbitration rules expressly refer to the award’s enforceability as an objective of the arbitral process. Under the ICC Rules, for example, arbitral tribunals ‘shall make every effort to make sure the Award is enforceable at law’.\textsuperscript{69}

Second, the reluctance of arbitrators to issue an award that is likely to be annulled by the courts of the seat is reinforced by the fact that the legal consequences of an annulment are particularly ‘drastic’. In fact, as a general rule, an award that has been set aside at the place of arbitration can no longer be enforced in a third country. Under the New York Convention, for instance, an award may be refused recognition or enforcement if it ‘has been set aside or suspended by a competent authority of the country in which . . . that award was made’.\textsuperscript{70} While it is true that the courts of a few countries have occasionally enforced annulled awards,\textsuperscript{71} those decisions remain exceptional.

Although, as has been mentioned, the relevant case law is limited, one ICC award provides a useful illustration. In ICC Case No. 5946,\textsuperscript{72} the respondent claimed punitive damages on the basis of the claimant’s alleged unilateral and

\textsuperscript{67} Parsons & Whittemore Overseas Co. v. Société Générale de l’Industrie du Papier, 508 F.2d 969, 975 (2d Cir. 1974).

\textsuperscript{68} Ibid.

\textsuperscript{69} Article 35 of ICC Rules of Arbitration.

\textsuperscript{70} Article V(1)(e) of New York Convention.

\textsuperscript{71} For a recent discussion of such decisions, see Emmanuel Gaillard, \textit{Legal Theory of International Arbitration} 135–143 (Martinus Nijhoff Publishers 2010).

\textsuperscript{72} Seller v. Buyer, supra n. 36.
unprovoked termination of the parties’ agreement. The sole arbitrator denied the respondent’s claim on the grounds that punitive damages were ‘considered contrary to Swiss public policy, which must be respected by an arbitral tribunal sitting in Switzerland even if the arbitral tribunal must decide a dispute according to a law that may allow punitive or exemplary damages as such.’

The concern of arbitral tribunals with the enforceability of their award may also prompt those tribunals to deny a request for punitive relief if it is unlikely that a punitive award can be enforced in the relevant foreign jurisdictions. An arbitral tribunal sitting in New York, for example, may be reluctant to award punitive damages in a case brought by an American claimant against a German respondent, considering that it would most probably be impossible to enforce such an award in the respondent’s home jurisdiction. To this author’s knowledge, there are no reported cases where arbitral tribunals have expressly adopted this line of reasoning, but their natural interest in the award’s enforceability suggests that it is likely that arbitral tribunals should take those considerations into account.

7 CONCLUSION

This article has shown that the question of the availability of punitive damages in international commercial arbitration must be analyzed as comprising two distinct issues: (i) the power of arbitrators to award such relief; and (ii) the availability of punitive damages stricto sensu. This article has also demonstrated that the former question is governed by the applicable arbitration law, while the latter is subjected to the applicable substantive law, the lex contractus. Importantly, as has been explained, arbitral tribunals should only award exemplary damages if both arbitration and substantive law authorize such an award.

Although some contrary opinions have been expressed, this is what arbitral tribunals actually do in practice and how courts review their decisions. It is true that arbitral awards and court judgments do not always expressly address both aspects of the availability of punitive relief. However, as has been pointed out, this is due to the fact that only one of those two aspects may be at issue in a given case. In Mastrobuono, for example, the US Supreme Court only examined the question of whether the arbitrators had the ‘power’ to grant punitive relief since the availability of such relief under the applicable substantive law (New York law) was neither disputed, nor otherwise controversial.

This article has also shown that the lack of conformity of punitive damages with the public policy of the arbitral seat or of probable enforcement jurisdictions may play a significant role in the arbitrator’s choice of law analysis. However,

73 Ibid., at 113.
recent developments suggest that, at least in the context of arbitration, a narrow interpretation of public policy may be followed, and that punitive arbitral awards may ultimately be recognized or enforced in jurisdictions that prohibit punitive relief.
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