The National Forum
For Environmental And Toxic Tort Issues
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The October 2003 FETTI Annual Conference in Schaumburg, Illinois was a great success. We thank all the attendees and contributors to this outstanding event.

If you missed the conference, you missed not only the substantive speeches, but networking opportunities as well. We hope to see everyone next October and welcome your input toward the 2004 conference.

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FETTI Welcomes Three New Editors

FETTI extends its gratitude to three new editors who have volunteered their time to help make this publication as useful as possible. Thank you Alexis Hawker, Melicent Thompson and Matthew Wiese.

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Article Submissions

Article submissions for the March 2004 National Forum Newsletter are now being accepted. Please forward your contributions to Carey Cooper at ccooper@klinedinstlaw.com or to any of the editors mentioned above. The deadline for article submissions is February 27, 2004, for publication in our March edition.

Taking The Sting Out Of Joint And Several Allocation: Ohio Court Grants Excess Insurers Full Credit For The Limits Of All Settled Coverage Before Triggering Excess Indemnity Obligations

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A federal court in Ohio has significantly distinguished the impact of joint and several allocation in situations where a policyholder has settled with carriers in multiple years of triggered coverage. Applying Ohio law in an environmental coverage suit, the court in Gencorp, Inc. v. AIU Ins. Co., No. 1:02-CV-1770, slip op. (N.D. Ohio Oct. 15, 2003) (*Gencorp*) held that excess insurers were not obligated to indemnify a policyholder because the combined limits of coverage provided by insurers with whom the policyholder had settled exceeded the policyholder's losses. Gencorp provided the excess insurers with a full credit for the limits of all settled coverage, regardless of the year in which the settled coverage was provided and regardless of the amount actually received in settlement by the policyholder. Id. at 20-21. All excess insurers were dismissed from the case because the policyholder had settled with primary carriers issuing $64 million in coverage, while the policyholder's damages did not exceed $29 million. Id. at 21.

Gencorp arose from the typical context of environmental coverage. The policyholder had underlying liability associated with its historic waste disposal practices at six landfill sites in the Northeastern United States from 1955-1982. *Id.* at 2-3. The policyholder brought suit against primary and excess insurers issuing policies from 1960-1982. *Id.* at 3-4. Through almost 8 years of litigation, the policyholder reached settlements with its primary carriers. Id. at 4-5. After the Ohio Supreme Court adopted joint and several allocation for "all sums" occurrence-based policies in Goodyear Tire & Rubber Co. v. Aetna Cas. & Sur. Co., 769 N.E.2d 835 (Ohio 2002), the policyholder attempted to spike its damages vertically to reach previously inaccessible excess coverage. Id. at 6. These excess insurers, in turn, filed third party complaints for contribution against insurers in other years of triggered coverage, including those insurers who had settled. Id. at 6-7.

The Gencorp Court first reached the contribution issue in an opinion issued in July of 2003. *See* Gencorp, Inc. v. AIU Ins. Co., No. 1:02-CV-1770, slip op. (N.D. Ohio July 23, 2003). In this earlier opinion, the court held that excess insurers had no right of contribution against settling insurers because the policyholder's settlement extinguished all claims against these parties, effectively exhausting this insurance. Id. at 9-10.

Taking this reasoning one step further in its October opinion, the Gencorp Court noted that the Ohio Supreme Court in Goodyear expressly preserved the right of insurers to seek contribution. Gencorp at 19-20. Thus, while Ohio law rejects horizontal allocation across triggered coverage when applied vis a vis the policyholder, Ohio recognizes that the responsible insurers may horizontally re-allocate any indemnity among themselves to the extent that the insurer pays more than its share of a common loss.

Applying its July holding regarding contribution, the Gencorp Court held that the policyholder must bear responsibility for its decision to impair the contribution rights of excess carriers. Id. at 20-21. Having made the decision to prejudice the rights of non-settling parties, the policyholder in effect decided to allocate its liabilities across multiple years of coverage, irrespective of whether Ohio law provided the right to seek vertical exhaustion in any single year. Id. at 20. Thus, rather than disrupt the confidentiality and finality of settlement, the Gencorp Court credited the policy limits of settled coverage to excess insurers in recognition of their contribution rights and the policyholder's decision to accept recovery in multiple triggered years.

The Gencorp decision halts a significant trend in cases involving settlement credits. In the last three years, courts in Washington, Connecticut, Rhode Island, and Kentucky each have denied settlement credits of the nature provided by Gencorp. See Puget Sound Energy, Inc. v. Alba Gen. Ins. Co., 68 P.3d 1061, 1064 (Wash. 2003); Weyerhauser Co. v.

Commercial Union Ins. Co., 15 P.3d 115, 126-127 (Wash. 2000); United Technologies Corp. v. American Home Assurance Co., 237 F.Supp.2d 168, 173-74 (D. Conn. 2001); Ins. Co. of North America v. Kayser-Roth Corp., 770 A.2d 403, 414 (R.I. 2001); Aetna Cas. & Sur. v. Nuclear Engineering Co., 2002 Ky. App. Lexis 451 *32 (Ky. Ct. App. March 8, 2002) *cert. granted* 2003 Ky. Lexis 197 (August 13, 2003).

Generally, the above-cited cases analyze the settlement credit issue in terms of burden of proof without discussing the effect of settlement upon contribution rights. These courts had eroded some of the vitality of the 3d Circuit's earlier adoption of settlement credits as a form of setoff against the policyholder in Koppers Co., Inc. v. Aetna Cas. and Sur. Co., 98 F.3d 1440 (3d Cir. 1996) (Pennsylvania law). The Gencorp Court now joins Koppers in providing a higher ceiling for triggering the indemnity responsibilities of excess carriers in the typical context of environmental, asbestos, or other long tail claims. In addition, Gencorp provides those insurers who decide to settle with the assurance that the finality of these settlements will not be disrupted by third party contribution actions. Thus, the decision places the risk of a low settlement back upon the policyholder. For any questions concerning the impact of settlement upon contribution or setoff, please feel free to contact the author. ■

Arbitrating Insurance Disputes In The Second Circuit: "Choice Of Law" Provisions' Affect On Federal Arbitration Act Preemption Of State Arbitration Laws

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I. Introduction

Commercial line insurance policies increasingly 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. One issue that has the potential to significantly affect the outcome of arbitration is whether the Federal Arbitration Act ("FAA"), or a state arbitration act governs arbitration of disputes under the policy's arbitration agreement. The issue becomes more complex when the policy at issue contains a "choice of law" provision in the arbitration clause itself, or elsewhere in the policy, calling for application of a particular state's laws to resolution of disputes under 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, the FAA applies to all written arbitration agreements involving "commerce". Courts have interpreted the term "commerce" in that section to mean "interstate commerce", see e.g., Levine et al. v. Advest, Inc., 244 Conn. 732, 747 (1998), and even the most tenuous out-of-state contact can convert commerce into "interstate commerce" for purposes of applying the FAA. Thus, the FAA applies in state court proceedings. See Southland Corp. v. Keating, 465 U.S. 1 (1984); PCS 2000 LP v. Romulus Telecomm., Inc., 148 F.3d 32, 35 n.1(1st Cir. 1998)(state "courts must adhere to and enforce the FAA as that statute applies unreservedly in state as well as federal courts"); M&L Power Services, Inc. v. American Networks International et al., 44 F. Supp. 2d 134 (D.R.I. 1999).

However, the FAA does not create subject matter jurisdiction. See Moses H. Cone Memorial Shops. v. Mercury Constr. Corp., 460 U.S. 1, 25 n.32 (1983). Thus, in order to bring a claim under the FAA in federal court, there must be an independent basis for federal court jurisdiction, such as diversity, or a separate "federal question". Id. Courts regularly misstate this rule, writing that one of the criteria for *applicability* of the FAA is diversity jurisdiction. See, e.g.,

Acequip Ltd. v. American Engineering Corp., 315 F. 3d 151 (2nd Cir. 2003)(explaining "this dispute is governed by the [FAA], because all the statute's criteria for jurisdiction apply [including diversity]"). Instead, the proper statement of the rule is that the FAA applies whenever a written arbitration agreement involving interstate commerce is at issue, and where diversity jurisdiction, or another basis for federal court subject matter jurisdiction exists, federal courts have jurisdiction to enforce the FAA. See M&L, *supra* at 193-40.

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 preempts state arbitration law that is "inconsistent" with the FAA. 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' Affect on the Relationship Between the FAA and State Arbitration Law

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 decisions 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 just in a separate clause of the contract), and (2) contains language explicit enough (i.e., providing that state law will apply to "enforcement" of the contract) to indicate that the parties intended state arbitration rules (as opposed to just state "substantive" law) to apply.

The main sources of the confusion among the courts on this issue are two apparently conflicting U.S. Supreme Court decisions, Volt Information Sciences Inc. v. Board of Trustees of Leland Stanford Junior University, 489 U.S. 468 (1989), and Mastrobuono v. Shearson Lehman Hutton, Inc., et al., 514 U.S. 52 (1995). 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 indicated that the parties intended the state stay of arbitration rule to apply.

In its decision, the California Appellate Court had acknowledged that the FAA governed the contract, and that the FAA contains no provision similar to the 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 stay of arbitration rule.

The Volt court affirmed the California Appellate Court's decision. It held 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 proceed *in the manner provided for in the parties' agreement*. Id. at 474-475 citing 9 U.S.C. § 4. 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 terms." Id. at 479. The Court wrote that "arbitration under the act is a matter of consent not coercion and parties are generally free to structure their arbitration agreements as they see fit." Id. 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." Id.

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 preempted the New York prohibition against arbitral awards for punitive damages as that rule was a "vestige of the ancient judicial hostility to arbitration." Id. at 56. Relying on Volt, the respondents argued that the parties could lawfully 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 instant case was to review the parties' arbitration agreement de novo, in order to determine whether the parties intended to arbitrate punitive damages.

The Court proceeded to analyze the contract language itself and concluded that its separate choice of law and arbitration clauses created an ambiguity regarding whether the parties intended to incorporate New York law relating to arbitration. Id. at 62. 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." Id. at 62 citing Volt at 476. 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.

Id. at 63-64.

In trying to reconcile Volt and Mastrobuono both federal and state courts have focused on the 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, as noted above, the Mastrobuono court itself raised this distinction.

Nonetheless, generally speaking, Second Circuit courts have taken Mastrobuono as a virtual reversal of the Volt decision and have consistently held that a choice of law provision in an arbitration agreement, whether contained in the arbitration clause itself, or within a separate clause, does not indicate that the parties intended to have state arbitration rules apply in lieu of the FAA, unless the arbitration clause explicitly so states. See e.g., Nat'l Union Fire Ins. Co. v. Belco Petroluem Corp., 88 F.3d 129 (2d Cir. 1996)(declining to read choice of law clause as incorporating New York State law on arbitration); Circle Industries USA, Inc. v. Parke Construction Group, Inc., No. 97 CV 3334, 1998 U.S. Dist. LEXIS 22281 (E.D.N.Y. October 14, 1998)("the mere inclusion in a contract of a standard choice of law clause will not be construed as an intent to override the FAA

in favor of state arbitration rules"); 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).

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].

In Levine, the Connecticut Supreme Court acknowledged that Luckie probably is good law despite the dispute among the New York and federal courts about that case. Id. at 752 - 753. It noted that the choice of law portion of the agreement before it contained the very phrase "and its enforcement" that the Luckie court found dispositive.

However, the Levine Court reasoned that the individual clauses of the contract could not be construed by taking them out of context and giving them an interpretation apart from the contract of which they are a part. Id. at 753 [citation omitted]. As in Mastrobuono, the Court undertook a detailed analysis of the arbitration clause language to determine whether the parties intended to arbitrate all disputes (as provided under FAA rules), or exclude from arbitration timeliness rules (as provided under New York law). Ultimately, the Court concluded that the arbitration portion of the parties' agreement created an ambiguity not present in the Luckie contracts as to whether the parties intended the choice of law provision to incorporate New York law limiting timeliness issues to court decision. Thus, the Court held that due regard to the federal policy favoring arbitration required that the agreement be construed to mean that controversies as to timeliness of claims are to be resolved by arbitrators.

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

However, this does not mean it is impossible to enforce a choice of law provision arbitrating disputes in the Second Circuit. Rather, such clauses carry the most "clout" under Second Circuit precedent when they are written into the arbitration agreement itself, rather than set out as a separate clause in the subject contract of which the arbitration agreement is only one part. For example, consider a CGL policy that includes a choice of law provision, *within the arbitration clause itself*, which states that New York law shall govern the "interpretation and application of the policy". Even in the Second 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 govern the "enforcement" of the contract, and therefore, New York arbitration rules apply in lieu of federal rules, so long as they do not conflict with the FAA.

In all cases, it is worthwhile to undertake an analysis of whether application of federal or state arbitration law to a particular issue has the potential to affect the outcome of resolution of that issue. In many cases, it will not, and thus, the above-described analysis is moot. However, as the cited cases indicate, in some cases, the question is critical, such as in Mastrobuono, where the application of state law would bar punitive damages, but federal law would not. Thus, the analysis must be undertaken on an issue by issue basis. Even better, in drafting policies containing an arbitration clause, if state law is of particular importance to a party's arbitration position, the "choice of law" clause should be written directly into the arbitration clause of the policy, and should contain specific language regarding the parties' intent that the named state's laws govern *enforcement* of the policy at issue. ■

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