Enforceability of Choice of Law Clauses in Arbitration When Such Clauses Are Contrary to the Public Policy of the Puerto Rico Relationship Statutes

Rossell Barrios

I. Introduction

The issue of the enforceability of choice of law clauses in arbitration arises whenever state public policy would be defeated if the case is decided under a law chosen by the parties that is inconsistent with such public policy. Normally, the issue revolves around the public policy of the forum where enforcement is sought and/or where the controversy arose. Sometimes, state or territorial public policies emanate from commercial relationship statutes applicable to distributors, franchisees, sales brokers, and other independent contractors that act as commercial intermediaries. These policies are raised in arbitration proceedings that putatively involve those commercial relationship statutes.

II. Enforceability of Choice of Law Clauses Prior to Arbitration When Such Enforcement Might Collide with Public Policy of Relationship Statutes

Federal courts have passed on the issue of the enforceability of choice of law clauses prior to arbitration if state or territorial law would consider such clauses unenforceable because they violate such state’s or territory’s public policy. The seminal case on the subject of how public policies interact

2. These statutes often require “cause” for the nonrenewal, termination, or impairment of a covered distribution, franchise, or similar commercial relationship.

Rosell Barrios (rbarrios@gaclaw.com) is a partner with Goldman Antonetti & Cordova, LLC in San Juan.
with arbitration and choice of law agreements involved federal public policy. In *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth*, the U.S. Supreme Court remarked that “in the event the choice-of-forum and choice-of-law clauses operated in tandem as a prospective waiver of a party’s right to pursue statutory remedies for antitrust violations, we would have little hesitation in condemning the agreement as against public policy.” This language only refers to federal public policy under the federal antitrust statutes. The issue of state or territorial public policy was not addressed in *Mitsubishi*. Other courts have tackled the problem based on state public policies.

To determine which law should be applied in an arbitration proceeding or whether the choice of law clause agreed by the parties should be enforced, the court, sitting in diversity, should look to the law of the forum where the court sits. The Puerto Rico federal district court followed this same principle in *Medika International, Inc. v. Scanlan International, Inc.*

In contrast to some of the cases cited above, the U.S. District Court for the District of Puerto Rico has ruled that the arbitrator, not the court, has the authority to decide whether to enforce the choice of law clause. The First Circuit, which includes the District of Puerto Rico, adopted this conclusion in *P.R. Hospital Supply, Inc. v. Boston Scientific Corp.* Actually, the First Circuit followed *Mitsubishi* by referring the issue of the enforceability of the choice of law clause to the arbitrator. The ruling in *Mitsubishi* was reaffirmed by the U.S. Supreme Court in *Vimar Seguros y Reaseguros, S.A. v. M/V Sky Reefer*.

Later, in *Diagnostic Imaging Supplies & Services, Inc. v. General Electric Co.*, the U.S. District Court for the District of Puerto Rico held, in a case brought under Act 75 of June 24, 1964, that it was also up to the arbitrator to decide the enforceability of a choice of law clause agreed by the parties. It cited a Puerto Rico Supreme Court case captioned *World Films Inc. v. Paramount Pictures Corp.* as well as *Mitsubishi* and *Medika International* and concluded:

---

4. Id.
5. See *Ticknor v. Choice Hotels Int'l, Inc.*, 265 F.3d 931 (9th Cir. 2001) (choice of law clause was not enforced because Montana public policy trumped the application of Maryland law which was chosen by the parties in the agreement); *Am. Express v. Yantis*, 358 F. Supp. 2d 818 (N.D. Iowa 2005) (Iowa public policy would be violated if the state law chosen by the parties was applied).
8. Id.
9. 426 F.3d 503 (1st Cir. 2005).
12. Puerto Rico Dealers Act (Act 75), P.R. LAWS ANN. tit. 10, § 278 et seq. This statute affords distributors and franchisees the same protection that Act 21 affords sales representatives.
The general rule is that arbitration agreements are to be enforced according to their terms.

... [I]t would be inappropriate for the Court to reach the issue of whether Law 75 should be applied to resolve any dispute arising out of the distribution agreement in the event of future arbitration because—pursuant to the FAA and the strong federal policy favoring arbitration—such a question is for the arbitrator not this Court. 15

As we have seen, some courts, such as the Ninth Circuit in *Ticknor v. Choice Hotels International, Inc.*, have decided, prior to arbitration, the issue of the enforceability of the choice of law clauses *vis à vis* state or territorial public policy. 16 Other courts, like the First Circuit, have abstained from deciding that issue and have referred it to the arbitrator.

The parties to the arbitration will dispute before the arbitrator whether any public policy has been violated. The franchisor has an additional argument based on the reasonable uniformity which it has a right to seek by applying the same law to all franchisees. 17 Moreover, the laws expressly chosen in franchise agreements are, normally, the laws of the states where the franchisors are either incorporated or headquartered and, thus, where the franchisor sometimes performs most, if not all, its duties. Thus, the chosen law normally has substantial ties to at least one of the parties.18

### III. Contesting Arbitration Awards Based on the Law Applied by the Arbitrator Despite the Public Policy of Relationship Statutes

After the arbitration, however, an award could be contested in court and vacated because it violates public policy. This was so at least before *Hall Street Associates, L.L.C. v. Mattel.* 19 *Hall Street Associates* decided that the bases for vacatur under the Federal Arbitration Act (FAA) 20 were only those specifically listed in that statute. 21 Violation of public policy is not one of the bases to vacate an award listed in the FAA. Rather, it was created by the courts. In particular, the First Circuit has yet to decide whether the “violation of public policy” survived *Hall Street Associates.* 22

---

18. See Restatement (Second) of Conflict of Laws § 187(2) (1971).
21. *Id.*
22. *Id.* After *Hall v. Mattel*, other courts have held that violation of public policy is no longer a viable basis to vacate an arbitration award. See *Am. Postal Workers Union, AFL-CIO v. U.S. Postal Serv.*, No. 3:09-CV-1084-B, 2010 WL 1962676 (N.D. Tex. May 14, 2010). Other courts have been noncommittal. See *Legacy Trading Co. v. Hoffman*, 363 F. App’x 633 (10th Cir.)
Vacating an arbitration award based on the violation of public policy derives from the basic notion that no court will enforce an award to commit an immoral or illegal act. The public policy relied on “must be explicit, well-defined, and dominant.” The policy advanced must reference “laws and legal precedents” rather than “general considerations of proposed public interests.” The relevant focus is not on any mischief leading up to the award, but the impact of implementing the award itself. Thus, such public policy must militate against the relief ordered by the arbitrator.

In Puerto Rico, vacatur based on public policy has been specifically addressed by the U.S. District Court for the District of Puerto Rico. In *Hawayek v. A.T. Cross Co.*, the court held that the policy behind Act 21 of December 5, 1990 (Puerto Rico’s Sales Representative Act) did not make the choice of law clause unenforceable because the plaintiff did not prove “manifest disregard of the law” on the part of the arbitrator when the latter decided to apply Rhode Island law. In *Hawayek*, “violation of public policy” and “manifest disregard of the law” were conflated without explanation. Thus, the court denied the request to vacate an interim arbitration award that decided that Rhode Island law would be applied to the arbitration instead of Puerto Rico’s Act 21, citing, inter alia, *Mitsubishi*. The court concluded:

The Court understands, and in fact finds very persuasive, Plaintiff’s argument that the Arbitrator’s interpretation of *Mitsubishi* and *World Films* effectively destroys the power of Law 21. In fact, we find that the Arbitrator’s decision creates a loophole to the requirements established as the clear and compelling public policy embodied in Law 21. Under such jurisprudence, a manufacturer need only include in its contracts an arbitration clause specifying the substantive law it prefers, to avoid the grip of Law 21.

... Nonetheless, we cannot safely say that the Arbitrator’s decision is in manifest disregard of the law. Again, the strict standard by which we measure the Arbitrator’s decision requires that we let stand his reasonable decision, even though we might

28. 221 F. Supp. 2d at 258.
disagree with its wisdom. “As long as the arbitrator is even arguably construing or applying the contract and acting within the scope of his authority, that a court is convinced he committed serious error does not suffice to overturn his decision.” *Challenger Caribbean*, 903 F.2d at 861. In this case, this Court’s difference of opinion with the Arbitrator is not enough to overturn his verdict.30

The drafting of the relevant section of Act 21 might explain why the court in *Hawayek* found that the arbitrator did not evince “manifest disregard of the law.” Act 21 provides:

The sales representation contracts referred to in this chapter shall be construed pursuant to, and shall be governed by the laws of the Commonwealth of Puerto Rico, and any stipulation to the contrary shall be null. However, this nullity shall not include any arbitration clause agreed upon.31

The last sentence could be read to exempt the arbitrator from the statutory bar against enforcing the choice of law clause. The choice of law and arbitration clauses are separable, but were conflated in this provision. Thus, the exemption of arbitration from nullification could also save the choice of law clause applicable to the arbitration. Otherwise, it would be difficult to explain the use of the word “however” in the second sentence when the previous sentence refers to which law may be applied, not to which forum will adjudicate the controversy. Thus, the conclusion that arbitration acts as a safe harbor for the choice of law clause is a plausible interpretation of the cited provision.

**IV. New York Convention and Vacatur Based on Public Policy of Relationship Statutes**

Vacatur in arbitration covered by the New York Convention32 for international33 arbitration requires the application of a more stringent standard to the “public policy” exception against enforcement of arbitration awards. Article V(2)(b) of the Convention34 provides, inter alia, that enforcement of an arbitration award is barred if it violates the public policy of the country in

---

30. *Id.* at 257–58.
31. P.R. LAWS ANN. tit. 10 § 279f.
33. Article I of the New York Convention provides:

> This Convention shall apply to the recognition and enforcement of arbitral awards made in the territory of a State other than the State where the recognition and enforcement of such awards are sought, and arising out of differences between persons, whether physical or legal. It shall also apply to arbitral awards not considered as domestic awards in the State where their recognition and enforcement are sought.

*Id.* at art. I.
34. According to art. V(2)(b):

Recognition and enforcement of an arbitral award may also be refused if the competent authority in the country where recognition and enforcement is sought finds that:

...
which recognition and enforcement are sought. The First Circuit has yet to address the specific issue of vacatur on the specific basis of the violation of public policy under the New York Convention.

The Convention applies only when arbitral awards are not considered domestic in the jurisdiction where their recognition and enforcement is sought.35 The Second Circuit has held that the phrase “public policy” refers to “basic notions of morality or justice.”36 Moreover, the violation of “public policy” to which the Convention refers to is the “national public policy, not the policy of the states within the country.”37 In any event, the concept of “public policy” must be construed narrowly.38 The First Circuit could easily follow these general principles to limit the instances in which arbitration awards governed by the New York Convention may be overturned.

V. Conclusion

In conclusion, under First Circuit and Puerto Rico case law, the arbitrator has the authority to decide the fate of the choice of law clause. Moreover, overturning an arbitration award based on the violation of Puerto Rico public policy of its relationship statutes appears to be a difficult if not insurmountable task.

---

b. The recognition or enforcement of the award would be contrary to the public policy of that country.

Id.

38. Id.