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NOT TO BE PUBLISHED

Commonwealth of Kentucky

Court of Appeals

NO. 2005-CA-001083-MR

ROBERT L. AND GINGER STRAUSBAUGH — APPELLANTS

v.

APPEAL FROM JEFFERSON CIRCUIT COURT
HONORABLE DENISE G. CLAYTON, JUDGE
ACTION NO. 05-CI-001687

H & R BLOCK FINANCIAL ADVISORS, INC., F/K/A OLDE DISCOUNT CORPORATION; GREG W. RUBER; KYLE E. HIGGASON; AND LEO A. GIES, III — APPELLEES

OPINION
AFFIRMING

** ** ** ** **

BEFORE: COMBS, CHIEF JUDGE; ACREE, JUDGE; KNOPF,[1] SENIOR JUDGE.

ACREE, JUDGE: This is an appeal from the Jefferson Circuit Court's confirmation of an arbitration award in favor of the Appellees, H & R Block Financial Advisors, Inc. f/k/a Olde Discount Corporation, Greg W. Ruber, Leo A. Gies III and Kyle E. Higgason (referred to herein cumulatively as "H & R Block"), and against H & R Block's former clients, Appellants Robert and Ginger Strausbaugh. For the reasons stated, we affirm.

[1] Senior Judge William L. Knopf sitting as Special Judge by assignment of the Chief Justice pursuant to Section 110(5)(b) of the Kentucky Constitution and KRS 21.580.

In February 1996, the Strausbaughs opened a securities account with H & R Block and deposited $1,800,000. The relationship among the parties was memorialized in various securities brokerage and other agreements, each of which included a provision that required any dispute to be resolved by arbitration. The Strausbaughs concentrated their investment in technology stocks. By 2000, they had a portfolio valued at $60,000,000. However, when they terminated their relationship with H & R Block in 2001, after the tech-stock bubble burst, the profit they realized on their $1,800,000 was only $12,500,000.

A dispute did arise between the parties over their agreements and the performance required of those agreements. In December 2002, in accordance with the agreements to arbitrate, the Strausbaughs executed an "NASD[2] Dispute Resolution Arbitration, Uniform Submission Agreement" initiating an arbitration proceeding against H & R Block. The Strausbaughs alleged statutory and common law causes of action relating to their securities account. They claimed compensatory damages in the amount of $17,000,000 and punitive damages in the amount of $50,000,000. They also sought recovery of interest, costs and attorney's fees.

H & R Block denied the allegations and requested that the arbitrators dismiss all claims with prejudice. They also requested that all reference to the proceeding be expunged from each of the individual Appellees' records maintained by NASD. Finally, they requested that the arbitrator award them their costs and attorney's fees.

[2] National Association of Securities Dealers.

The arbitrators conducted a ten-day hearing and issued an award on November 23, 2004. The award dismissed all of the Strausbaughs' claims with prejudice, recommended to NASD that it expunge all reference to the arbitration proceedings from its records of the individual Appellees, awarded Appellees their costs in the amount of $21,000, and assessed forum fees against the Strausbaughs in the amount of $25,200.

On February 21, 2005, the Strausbaughs filed an action asking the Jefferson Circuit Court to vacate the award. They did not challenge the dismissal of their claims or the expungement of the Appellees' NASD records. They only challenged the award of costs and forum fees.

The Strausbaughs make the same arguments before this Court that they made to the Jefferson Circuit Court. Their only statutory ground for vacatur is that the award exceeded the arbitrators' powers in violation of KRS 417.160(1)(c). However, they claim three non-statutory grounds for relief as well: (1) the award is in manifest disregard of the law; (2) the award is against public policy; and (3) the award against them of costs and forum fees will create a chilling effect on securities investors.

The circuit court considered Kentucky's Uniform Arbitration Act (KUAA), KRS 417.045, the Federal Arbitration Act (FAA), 9 U.S.C. § 1 (2002), *et seq*., and federal cases interpreting the FAA. The lower court implicitly held that Kentucky courts could vacate an arbitration award based on non-statutory grounds generally by explicitly holding, on the strength of federal case law, that Kentucky courts have "the authority to vacate any portion of an arbitration award it finds is contrary to clearly defined public

policy." Having thus defined the scope of its authority, the circuit court held that the Appellants "failed to make the necessary showing that the arbitrators violated a clearly defined public policy, manifestly disregarded the law or exceeded or abused their arbitral powers[.]" The circuit court entered its judgment confirming the arbitration award on April 28, 2005. The Strausbaughs take their appeal from that judgment.

Before proceeding further, we must determine what law applies.

An arbitrator's decision "is considered an extension of the parties' voluntary agreement to arbitrate." *Taylor v. Fitz Coal Co., Inc.,* 618 S.W.2d 432, 432 (Ky. 1981). Consequently, it is always a good thing for a reviewing court to start by examining that agreement. Unfortunately, despite acknowledging that they entered into various securities brokerage and other agreements, all of which included provisions requiring the arbitration of disputes, none of the parties made the agreements a part of the record. What we know of these agreements we glean from the briefs. We presume nothing in those agreements would affect our review of the issues on appeal, or one of the parties would have brought the affecting provision to our attention. Nevertheless, we are able to determine that Kentucky law applies.

As is clear from *Mastrobuono v. Shearson Lehman Hutton, Inc.,* 514 U.S. 52 (1995), a case reviewing an arbitration with similar facts, if an arbitration "contract, without a choice-of-law provision, had been signed in New York and was to be performed in New York, presumably 'the laws of the State of New York' would apply, *even though the contract did not expressly so state*." *Id.* at 59 (emphasis supplied).

Similarly, where a contract "contained a choice-of-law clause providing that '[t]he Contract shall be governed by the law of the place where the Project is located,'" the Supreme Court held that the arbitration procedure was governed by California law. *Volt Information Sciences, Inc. v. Board of Trustees of the Leland Stanford Junior University,* 489 U.S. 468, 470, 476, 109 S.Ct. 1248 (1989).

This is consistent with Kentucky choice of law principles. "[I]n contract actions . . . the law of the state with the greatest interest in the outcome of the litigation should be applied." *Bonnlander v. Leader Nat. Ins. Co.,* 949 S.W.2d 618, 620 (Ky.App. 1996), *citing Breeding v. Massachusetts Indem. and Life Ins. Co.,* 633 S.W.2d 717, 719 (Ky. 1982). This is a contract action. While the underlying arbitrated claims against Appellees sounded in both contract and tort, the matter before us is the enforcement of the terms of an arbitration agreement. The parties represent that the contracts giving rise to this litigation were signed in Kentucky. Performance, including performance of the arbitration, was to occur, and in fact did occur, in Kentucky. Kentucky has the greatest interest in the outcome of this litigation. Therefore, we will apply Kentucky law. We apply it first to the Strausbaughs' statutory ground for vacatur.

If our review of the record reveals that "[t]he arbitrators exceeded their powers[,]" KRS 417.160(1)(c), we must vacate the award. The question then is, "Was the award of costs and forum fees against the Strausbaughs in excess of the arbitrators' powers?" This question is easily answered in the negative.

The Strausbaughs acknowledge that they submitted their claim to arbitration by signing the "NASD Dispute Resolution Arbitration, Uniform Submission Agreement." Thereafter, the arbitration was conducted in accordance with the NASD Code of Arbitration Procedure. When the arbitrators awarded costs and forum fees against the Strausbaughs, they specifically cited their authority as "Rule 10330(g) of the Code" which states:

> Fees and assessments imposed by the arbitrators under Rules 10205 and 10332 shall be paid immediately upon the receipt of the award by the parties. Payment of such fees shall not be deemed ratification of the award by the parties.

NASD Code, Rule 10330(g), Awards. Rule 10205, referenced in this Rule 10330(g) states, in pertinent part:

> The arbitrators, in their award, shall determine the amount chargeable to the parties as forum fees and shall determine who shall pay such forum fees. . . . In addition to forum fees, the arbitrator(s) may determine in the award the amount of . . . other costs and expenses of the parties and arbitrator(s) which are within the scope of the agreement of the parties. The arbitrator(s) shall determine by whom such costs shall be borne.

NASD Code, Rule 10205(c), Schedule of Fees for Industry and Clearing Controversies.

The Strausbaughs' claim under KRS 417.160(1)(c) that the arbitrators exceeded their powers is without merit. By agreeing to arbitrate by NASD rules, they granted the arbitrators the power to award costs and forum fees against them. Furthermore, KRS 417.140 expressly authorizes allocation of "the arbitrators' expenses,

fees and other expenses incurred in the conduct of the arbitration." The arbitrators did not exceed their power in awarding forum fees and costs.

The Strausbaughs' alternative argument is that Kentucky should recognize non-statutory grounds for vacating an arbitration award created by the federal courts in their interpretation of the FAA. Both parties indicate that federal law controls and the circuit court even indicated that the federally-created non-statutory grounds could be the basis for vacating awards. We disagree with the parties and the lower court.

The focus on federal law begs the question whether the FAA has entirely preempted the field of arbitration law where interstate commerce is involved. If that question is answered in the affirmative, we have no choice but to apply the FAA standard of review, 9 U.S.C. § 10, and, arguably, the non-statutory grounds for vacating an arbitration award developed in the federal courts because complete preemption requires the application of a single federal common law that avoids "the possibility of conflicting substantive interpretation under competing legal systems[.]" *Allis-Chalmers Corp. v. Lueck,* 471 U.S. 202, 209 (1985), *quoting Local 174, Teamsters v. Lucas Flour Co.,* 369 U.S. 95 (1962). Because we conclude that Congress has not intended complete preemption, we are not compelled to apply federal law.

Nothing in the law, federal or state, legislatively or judicially created, requires a state court to undertake its review of an arbitration as though the FAA "preempts all state law." *Saneii v. Robards,* 289 F.Supp.2d 855, 858 (W.D.Ky. 2003)("The FAA, *where applicable*, preempts all state law." Emphasis supplied). "The

FAA contains no express preemptive provision, nor does it reflect a congressional intent to occupy the entire field of arbitration." *Volt Information Sciences, Inc. v. Bd. of Trustees of the Leland Stanford Junior University,* 489 U.S. 468, 477 (1989); *see also, Buckeye Check Cashing, Inc. v. Cardegna,* 546 U.S. 440, 449, 126 S.Ct. 1204, 1209 (2006)("§ 2 [of the FAA is] the only provision that we have applied in state court."); *but see Volt* at 477 n.6 ("[W]e have held that the FAA's 'substantive' provisions --§§ 1 and 2 -- are applicable in state as well as federal court[.]").

Our review of federal case law reveals that the scope of preemption is very narrow and limited to circumstances in which a state law frustrates Congress's purpose in enacting the FAA. *Dean Witter Reynolds, Inc. v. Byrd,* 470 U.S. 213, 219-20 (1985)(Congress' purpose in enacting the FAA was "to overrule the judiciary's longstanding refusal to enforce agreements to arbitrate[.]"). Stated another way, the FAA is only "pre-emptive of state laws *hostile to arbitration*[.]" *Circuit City Stores, Inc. v. Adams,* 532 U.S. 105, 112, 121 S.Ct. 1302, 1307 (2001).

Kentucky's statute establishing the standard for vacating arbitration awards is not hostile to arbitration because, while it may affect the enforcement of an arbitration *award*, it in no way impacts the enforceability of the arbitration agreement. Therefore, there is no justifiable argument for federal preemption. *See, Doctor's Associates, Inc. v. Casarotto,* 517 U.S. 681, 688, 116 S.Ct. 1652, 1656-57 (1996)("[A]pplying state [procedural] rule would not 'undermine the goals and policies of the FAA[.]'"); *see also Volt Information Sciences, Inc. v. Board of Trustees*, 489 U.S. 468, 477-78

(1989)(Procedural rule allowing a stay of arbitration does not "undermine the goals and policies of the FAA.").

Kentucky's Act does not frustrate, but is entirely consistent with Congress's purpose in enacting the FAA. "Both acts have been held to favor arbitration agreements, at least to the extent of abolishing what once was a widespread policy against them." *Conseco Finance Servicing Corp. v. Wilder,* 47 S.W.3d 335, 339 (Ky.App. 2001). This consistency is not diminished merely by the procedural variation of differing standards of review. The United States Supreme Court has said that

> [t]here is no federal policy favoring arbitration under a certain set of procedural rules; the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate.

Volt Information Sciences, Inc. v. Board of Trustees, 489 U.S. 468, 476 (1989).

More than twenty years ago, our Supreme Court of Kentucky concluded that the FAA's preemptive effect only extended to substantive, and not to procedural, arbitration law.

> In *Southland Corp.* [*v. Keating,* 465 U.S. 1 (1984)], the United States Supreme Court holds that the federal "Arbitration Act," Title 9, U.S. Code, Secs. 1-14, preempts the "*substantive* law" regarding arbitration "in contracts involving interstate commerce."

Atlantic Painting & Contracting Inc. v. Nashville Bridge Co., 670 S.W.2d 841, 846 (Ky. 1984)(emphasis in original). The Court distinguished federal review from state review, noting that when parties look to the federal courts to vacate an arbitration award, the *federal* courts are required to apply *federal procedural* rules. *Id.* However, state courts

are not required to apply the procedural aspects of the FAA to a review of arbitration awards, even those in which the underlying dispute involves interstate commerce.

> The federal Arbitration Act covers both substantive law *and* a procedure for federal courts to follow where a party to arbitration seeks to enforce or vacate an arbitration award in federal court. ***The procedural aspects* [*of the FAA*] *are confined to federal cases.***

Id. (emphasis in original; double emphasis added); *see also, Bridgestone/Firestone v. McQueen,* 3 S.W.3d 366, 367 n.2 (Ky.App. 1999)("The provisions of the federal Act do not preempt Kentucky's procedure for obtaining an immediate review of an order denying the application for arbitration.").

Based on our analysis of federal and state law, we hold that Kentucky courts are not compelled by federal preemption to substitute and apply 9 U.S.C. § 10 (2002), and the federal case law interpreting it, in place of the KUAA, even when reviewing arbitration awards involving interstate commerce. *Accord, e.g., Quick & Reilly, Inc. v. Zielinski,* 713 N.E.2d 739, 742 n.1 (Ill.App. 1999)(Reviewing another NASD arbitration; "[O]ur supreme court has refused to follow federal cases interpreting the Federal [Arbitration] Act in cases where the Illinois [Arbitration] Act [citation omitted] applies."); *but see Cornerstone Propane, L.P., v. Precision Investments, L.L.C.,* 126 S.W.3d 419 (Mo.App. 2004)(presuming without analysis that where interstate commerce is involved, the state court must apply the FAA).

The Strausbaughs argue that, even without applying federal law, this Court should adopt non-statutory grounds as adjunct to KRS 471.160(1), claiming this to be a

question of first impression in Kentucky. In fact, it is not. The question has been addressed squarely by *3D Enterprises Contracting Corp. v. Lexington-Fayette Urban County Gov't,* 134 S.W.3d 558 (Ky. 2004).

The arbitrators in *3D Enterprises* refused to enforce a "no-damages-for-delay" clause in the construction contract. The circuit court set aside that award because it was "contrary to law and principles of equity to award damages for delays that Appellant effectively waived[.]" *Id.* at 560. In today's terms, we would say the circuit court ruled that the arbitrator's award was in manifest disregarded the law of waiver.

On appeal to this Court, the circuit court was affirmed. We interpreted *Carrs Fork Corp. v. Kodak Mining Co.*, 809 S.W.2d 699 (Ky. 1991) as "expand[ing] the scope of review of arbitration awards based on equity." The Court of Appeals believed the Supreme Court had "suggested the grounds on which to vacate an award set out in the [Kentucky] Act were not exclusive." *Id.* at 562. But we were wrong.

The Supreme Court reversed the Court of Appeals, saying we misinterpreted *Carrs Fork*. The higher Court specifically held that "a court may only set aside an arbitration award pursuant to those grounds set forth in the [Kentucky Uniform Arbitration] Act." *Id.* at 562-63. Therefore, *3D Enterprises* requires rejection of any ground for vacatur that cannot be found in KRS 417.160(1).

The Jefferson Circuit Court reached the correct result, but for the wrong reason. The lower court's holding that non-statutory grounds for vacatur were available

in Kentucky is in error. However, for the reasons stated, the judgment of the Jefferson Circuit Court is affirmed.

ALL CONCUR.

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